THE 1978 ECONOMIC REPORT OF THE PRESIDENT

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HEARINGS

BEFORE THE

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CONGRESS OF THE UNITED STATES

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THE 1978 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 7, 1978

Congress of the United States,
Joint Economic Committee,
Washington, D.C.

The committee met, pursuant to recess, at 10:27 a.m., in room 2154, Rayburn House Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Moorhead, Long, and Brown of Michigan.

Also present: Louis C. Krauthoff II, assistant director; G. Thomas Cator, Thomas F. Dernburg, Kent H. Hughes, L. Douglas Lee, Deborah Norelli Matz, George R. Tyler, and Katie MacArthur, professional staff members; Mark Borchelt, administrative assistant; and 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.

We are pleased to have Mr. James McIntyre, Acting Director of the Office of Management and Budget with us today.

We understand why he was delayed. He had urgent business on the Senate side which he had to attend to and we are entirely sympathetic to that delay.

Before we begin testimony, I want to compliment you on presenting an excellent budget document. The presentation is exceptionally clear and forthright and it represents a significant improvement over past budgets.

I have been saying for years that I have gotten very tired of the budget documents that in effect were designed more to confuse people than to clarify facts and issues.

I believe you have come a long way in this document in correcting what my complaints have been.

I am well aware that the improvement is consistent with the facts because what I thought was going on in the other budget documents was what I considered to be unprofessional and political and what has happened in this one is a large move in the direction of professional and nonpolitical.

I think that is the kind of thing the American people deserve in their budget documents. It is, after all, an outline of an enormously complicated, enormously important program presented by the President of the United States, and it deserves to be presented in such a way that people's understanding of the program is increased and not confused.

Of course, there are always additional things to be done. I imagine in questions we will get to some of them.

I am very pleased with the progress that has been made in this document. We welcome you to our hearing. You may proceed as you wish.

STATEMENT OF HON. JAMES T. McINTYRE, JR., ACTING DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY W. BOWMAN CUTTER, EXECUTIVE ASSOCIATE DIRECTOR FOR BUDGET; AND DALE R. McOMBER, ASSISTANT DIRECTOR FOR BUDGET REVIEW

Mr. McIntyre. Thank you, Mr. Chairman.

I would like to introduce my colleagues at the table. On my right is Bowman Cutter, the Executive Associate Director for Budget, and on my left is Dale McOmber, Assistant Director for Budget Review.

I have a prepared statement and I would like to submit that for the record.

Representative Bolling. Without objection, it will be included in full in the record at the end of your oral statement.

Mr. McIntyre. I will highlight this statement and reserve the rest of the time for answering the questions.

I am pleased to be with you today to discuss the President's 1979 budget and to answer any questions that you might have concerning its basic contents and the philosophy and policies embodied in it.

At the President's direction, these requests were, for the first time, prepared using a detailed, zero-base process that:

One: Provided new ways to look at program budgets.

Two: Involved program managers more directly than ever before in the evaluation of program operations.

Three: Provided agency rankings of their programs that were used to compare and evaluate the many requests competing for resources.

We believe that zero-base budgeting resulted in a better, more consistent set of budget proposals than we would have had under previous practices.

We intend to continue this process in future budgets, and we are convinced that we can achieve even better results in the years ahead.

Throughout these reviews we kept in mind several themes that the President has now identified in this budget message.

In brief, the themes are:

One: Our fiscal policy must provide for continuing recovery of the Nation's economy.

Two: We must meet critical national needs, particularly human and social ones.

Three: The use of Government resources must be carefully planned with an awareness that they originate from the American taxpayer.

Four: There is a limit to what Government can do. New priorities must be set and some old priorities must be altered to meet our needs effectively.

Five: The large sums entrusted to us by the taxpayers must be managed with excellence.

These considerations resulted in a budget with a spending total of a little over $500 billion in 1979 and a deficit of a little under $61 billion.

The budget totals are shown in my prepared statement.

This budget keeps open the option for a balanced budget in 1981. In an effort to control the budget more effectively so that we can remain on this path, the President has asked each agency to prepare future budget requests within the context of a planning period that extends for 3 years beyond the budget year.

The multiyear budget planning system that we are developing will help to assure better control of Federal spending by identifying the long-term spending consequences of program proposals.

I am sure that members of this committee can think of numerous programs that started off with a very small appropriation and ballooned into large appropriations.

We hope to get a handle on those types of programs.

The 1979 budget requests together with detailed long-range estimates prepared in connection with this budget will form the initial elements of the new system.

I would like to address briefly the topics that Chairman Bolling raised in his letter to me of January 18. The first question concerns economic stimulus.

The administration's fiscal policy proposals that were announced shortly after taking office in January have played an important role in continued economic recovery.

Tax reductions in 1977, together with increased spending for public works, countercyclical revenue sharing, and public service jobs and other employment-related programs were instrumental in maintaining a strong economy in 1977.

The effects of these programs increased during the year and helped to offset weakness in some sectors of private spending during the second half of the year, when growth of real output slowed.

The increase in employment in the last year was considerable, rising from 88.4 million in December 1976 to 92.6 million a year later.

The unemployment rate dropped significantly over this period, from 7.8 percent in December 1976 to 6.4 percent a year later.

This drop on unemployment would have been larger but for an unusually large number of new entrants—mostly women and teenagers—to the labor force.

The economic policies that have been put into effect in the last year, together with the policy recommendations proposed in the 1979 budget, will help sustain economic expansion in the years ahead.

For 1978 and 1979, proposed tax reductions, together with prudent increases in Federal spending, will help maintain the momentum of the current expansion.

The achievement of a high employment economy with a vigorously expanding private sector can do far more than any single Government program to solve the human and social problems that have been so evident in past years.

This is a major reason why the stimulus provided in the 1979 budget is mostly from tax reductions.

The new stimulus proposed on the outlay side is focused primarily on the hard-core unemployed. For example, because unemployment remains unacceptably high, the budget will continue, rather than phase down, the public service employment program.

Further, it will initiate a significant effort to increase private sector jobs for the disadvantaged, and substantially increase youth employment programs, especially for minority youth.

Outlays for youth training and unemployment programs are, as I noted above, proposed to increase from $0.8 billion in 1977 to $1.6 billion in 1978 to $2.3 billion in 1979.

Let me add a point that is very important: If we are ever to have a chance to achieve full employment without an unacceptably higher rate of inflation, capital investment must be increased significantly.

We have proposed a substantial tax reduction for corporations and a liberalization of the investment tax credit precisely for that reason.

You also asked, Mr. Chairman, for a comparison of current services with the administration proposals.

The current services estimates required by the Congressional Budget Act of 1974 were submitted concurrently with the President's budget proposals this year with the agreement of this committee.

These current services estimates appear as the first analysis in the separate volume entitled "Special Analyses."

We hope that the Congress will agree that this change in timing enhances the usefulness of the current service estimates.

For the first time, it is possible to compare the President's proposals directly with the current service estimates without having to make adjustments for differences in economic assumptions or timing.

We have a table from the current services special analysis showing the difference between the administration request and current services levels for budget authority and outlays.

That table is contained in my prepared statement.

The final point you specifically raised in your letter to me, Mr. Chairman, concerned the underspending problem.

The accuracy of spending forecasts is obviously a source of concern for fiscal policy decisions. The problem in part arises because of unavoidable difficulties in making reliable estimates for programs that are affected by economic or demographic considerations.

But the significant problem is caused by a clear upward bias that exists in estimating outlays.

There is a tendency to be too optimistic about the progress of program actions, particularly the rapidity with which new programs can be accomplished.

We in OMB have taken a number of steps aimed at improving the accuracy of the outlay estimates. We have focused on the estimating techniques of around 60 large accounts that seem to have particular problems.

We hope to improve the estimates for those particular accounts as well as more generally.

OMB is also monitoring agency estimates more closely and will reduce the agency estimates whenever we believe that evidence of persistent upward bias exists.

Mr. Chairman, to conclude, I would say President Carter's 1979 budget is realistic, responsible, and responsive to the Nation's most critical needs. At the same time, it is lean and tight.

All of us in the administration, from the President down, recognize that to carry it out successfully we will need the help and the cooperation of the Congress.

We look forward to working with the Congress in its actions on the budget.

Thank you.

[The prepared statement of Mr. McIntyre follows:]

PREPARED STATEMENT OF HON. JAMES T. MCINTYRE, JR.

Mr. Chairman and Members of the Committee: Good morning. I am pleased to be here with you today to discuss the President's 1979 budget—President Carter's first full budget—and to answer any questions you may have concerning its basic content and the philosophy and policies embodied in it.

Our work on the 1979 budget began last spring, with detailed reviews by OMB of the fiscal policies needed to sustain the recovery and of spending programs. Following those reviews, the President met with his economic advisers and with each of the Cabinet officers to discuss major budget issues and to set budget targets. In September, the agencies submitted their budget requests to OMB. At the President's direction, these requests were—for the first time—prepared using a detailed, zero-base process that:

Provided new ways to look at program budgets,

Involved program managers more directly than ever before in the evaluation of program operations, and

Provided agency rankings of their programs that were used to compare and evaluate the many requests competing for resources.

We believe that zero-base budgeting resulted in a better, more consistent set of budget proposals than we would have had under previous practices. We intend to continue this process in future budgets, and we are convinced that we can achieve even better results in the years ahead.

OMB's reviews of agency requests and our discussions with agencies about them were followed by many hours of detailed discussions with the President. Throughout these reviews we kept in mind several themes that the President has now identified in his budget message. In brief, the themes are:

1. Our fiscal policy must provide for continuing recovery of the Nation's economy.

2. We must meet critical national needs, particularly human and social ones.

3. The use of government resources must be carefully planned with an awareness that they originate from the American taxpayer.

4. There is a limit to what Government can do. New priorities must be set and some old priorities must be altered to meet our needs effectively.

5. The large sums entrusted to us by the taxpayers must be managed with excellence.

These considerations resulted in a budget with a spending total of a little over $500 bilion in 1979 and a deficit of a little under $61 billion. The budget totals are shown in the following table, which I would like to insert for the record.

THE BUDGET TOTALS

[In billions of dollars]

	1977 actual	1978 estimate	1979 estimate
Budget receipts	356.9	400.4	439.6
Budget outlays	401.9	426.2	500.2
Deficit (−)	−45.0	−61.8	−60.6

The 1979 budget is realistic, responsible, and responsive to the Nation's most critical needs. Spending has been held to an overall increase of eight percent, the smallest increase since 1973. True, the deficit for 1979 is only one billion less than the deficit in 1978. Had no tax cut been proposed, we could have shown a decrease of $15 to $20 billion. It is more important now, however, that we have a tax cut to help the economy continue to grow and to encourage the increased capital investment that will improve productivity. The President's proposed reductions also mean that Federal taxes will represent a smaller share of our gross national product. This, in turn, will provide an additional incentive for both the Congress and the President to restrain the growth in spending.

This budget keeps open the option for a balanced budget in 1981. In an effort to control the budget more effectively so that we can remain on this path, the President has asked each agency to prepare future budget requests within the context of a planning period that extends for three years beyond the budget year. The multi-year budget planning system that we are developing will help to assure better control of Federal spending by identifying the long term spending consequences of program proposals. The 1979 budget requests together with detailed long-range estimates prepared in connection with this budget will form the initial elements of the new system.

While the spending recommended in this budget is restrained, it is, nevertheless, directed toward overcoming our Nation's crucial problems. The Administration looked carefully at existing approaches to these problems and improved these approaches where possible. The spending priorities of the past are now being shifted toward long-neglected areas. I will summarize a few of these new priorities:

An effective national energy plan is essential to reduce our increasingly critical dependence upon diminishing supplies of oil and gas, to encourage conservation of scarce energy resources, to stimulate conversion to more abundant fuels, and to reduce our large trade deficit.

To move toward these goals, the budget reiterates the President's energy proposals made last April. As his budget message states, the President believes firmly that the Nation's leaders have an obligation to plan for the future in this area. The budget proposes:

A 23 percent increase in spending for all energy programs.

An increase of 33 percent in outlays for research and development of energy conservation programs.

Substantial increases for research in fossil fuels and inexhaustible fuels, including solar energy.

Full funding of more than $4 billion to buy and store the first 500 million barrels of crude oil in the Strategic Petroleum reserve, as well as funds to begin construction of facilities for the next 250 million barrels.

The essential human needs of our citizens must be given high priority. In the spring of 1977, the President proposed a long-overdue reform of the Nation's welfare system that included a combination of employment opportunities and incentives for those who should work, and a basic income for those who cannot. The 1979 budget anticipates that Congress will pass the program for better jobs and income, and begins the process of careful planning for the implementation of an efficient and equitable system.

The budget also recognizes that ensuring the opportunity to complete and excel remains very important to our people. Toward this end it proposes:

Major expansion of medical care and nutritional supplements for low-income expectant mothers and infants to give all children the healthiest possible start in life;

Major increases in educational assistance at all levels, including increases of more than 16 percent in spending for elementary and secondary education, primarily to improve basic skills (especially reading) of the children from poor families, and more than 50 percent in funds to assist State and local education agencies to meet excess costs required to educate handicapped children;

Continuation of the public sector jobs program at 725,000 jobs for another year to help reduce the current rate of unemployment, particularly among minorities;

Major increases in programs stressing employment for unemployed—from $0.8 billion in 1977 to $1.6 billion in 1978 and to $2.3 billion in 1979; and

A $400 million initiative to place more disadvantaged persons in private sector jobs by increasing the involvement of the business community in local employment and training programs.

Because a workable urban strategy is an important link in a well-articulated domestic program and is essential to the continuing recovery of the national economy, the budget includes increases for many programs benefiting urban areas and supports several efforts to improve these programs. The President anticipates sending to the Congress early in the spring a set of further proposals dealing with the Nation's urban problems.

The Nation's armed forces must always stand sufficiently strong to deter aggression and to assure our security. The 1979 budget provides for the steady modernization of our strategic forces, and for substantial improvements in the combat readiness of our tactical forces. To parallel commitments made by our European allies, it proposes significant increases in our overall defense effort, with special emphasis on those forces and capabilities most directly related to our NATO commitments. At the same time defense expenditures are being restrained by introducing important efficiencies and by placing careful priorities upon our defense needs. The 1959 defense budget is prudent and tight. It:

Provides three percent real growth in outlays between 1978 and 1979, with particular emphasis on assistance to our NATO allies; and

Is $8 billion less in total obligational authority and $5½ billion less in outlays than that provided by the previous Administration for 1979.

The Federal Government has an obligation to nurture and protect our environment—the common resource, birthright and sustenance of the American people. Accordingly, this budget provides for substantially increased emphasis on protection of all our environmental resources, for new attention to our common heritage, and for substantial additions to our system of public lands.

The Federal Government must lead the way in investing in the Nation's technological future. Shortly after taking office, the President determined that investment in basic research on the part of the Federal Government had fallen far too low over the past decade, and he directed that a careful review be undertaken of appropriate basic research opportunities. As a result of that review, this budget proposes a total of $3.6 billion in obligations—a real rate of growth of almost five percent—for basic research in 1979. This emphasis is important to the continued vitality of our economy.

The Federal Government must change its program priorities as the needs of the nation change. This adjustment is reflected in the 1979 budget in the programs noted above and in the following programs as well:

For *agriculture,* fiscal year 1978 outlays for farm price supports and related programs are estimated to be $7.3 billion. This is a record high and is 92 percent above the $3.8 billion paid out in 1977. For 1979, the budget assumes a return to more normal weather. As a result, outlays for farm price supports are estimated to decline to $4.3 billion, still a very high level by historical standards.

For *transportation,* the Administration is proposing a major new highway and transit bill that will provide more than $45 billion in the next four years. The most important feature of this legislation is the increased flexibility it would provide State and local governments in planning the use of highway and transit funding.

For subsidized *housing* programs outlays: Will increase more than 17 percent; and will provide rental and home-ownership assistance to an additional 450,000 lower income families, about 10 percent more than the 1978 level.

Before turning to whatever questions the members of the Committee may have, I would like to address the topics that Chairman Bolling raised in his letter to me on January 18.

ECONOMIC STIMULUS

The administration's fiscal policy proposals that were announced shortly after taking office in January have played an important role in continued economic recovery. Tax reductions in 1977, together with increased spending for public works, countercyclical revenue sharing, and public service jobs and other employment-related programs were instrumental in maintaining a strong economy in 1977. The effects of these programs increased during the year and helped to offset weakness in some sectors of private spending during the second half of the year, when the growth of real output slowed.

The increase in employment in the last year was considerable, rising from 88.4 million in December 1976 to 92.6 million a year later. The unemployment rate dropped significantly over this period, from 7.8% in December 1976 to 6.4% a year later. This drop on unemployment would have been larger but for an unusually large number of new entrants—mostly women and teenagers—to the labor force.

The economic polices that have been put into effect in the last year, together with the policy recommendations proposed in the 1979 budget, will help sustain economic expansion in the years ahead. For 1978 and 1979, proposed tax reductions, together with prudent increases in Federal spending, will help maintain the momentum of the current expansion.

The achievement of a high employment economy with a vigorously expanding private sector can do far more than any single Government program to solve the human and social problems that have been so evident in past years. This is a major reason why the stimulus provided in the 1979 budget is mostly from tax reductions. The new stimulus proposed on the outlay side is focused primarily on the hard core unemployed. For example, because unemployment remains unacceptably high, the budget will continue, rather than phase down, the public service employment program. Further, it will initiate a significant effort to increase private sector jobs for the disadvantaged, and substantially increase youth employment programs, especially for minority youth. Outlays for youth training and unemployment programs are, as I noted above, proposed to increase from $0.8 billion in 1977 to $1.6 billion in 1978 to $2.3 billion in 1979. However, these efforts cannot be successful in the absence of a healthy economy, which can offer hope of new careers and opportunities to the unemployed.

Let me add a point that is very important: if we are ever to have a chance to achieve full employment without an acceptably higher rate of inflation, capital investment must be increased significantly. We have proposed a substantial tax reduction for corporations and a liberalization of the investment tax credit precisely for that reason. More spending in the public sector would not stimulate investment as directly and could ultimately frustrate our efforts to achieve full employment *and* stable prices.

A COMPARISON OF CURRENT SERVICES WITH ADMINISTRATION PROPOSALS

The current services estimates required by the Congressional Budget Act of 1974 were submitted concurrently with the President's budget proposals this year with the agreement of this Committee. These current services estimates appear as the first analysis in the separate volume, Special Analyses. We hope that the Congress will agree that this change in timing enhances the usefulness of the current service estimates.

For the first time, it is possible to compare the President's proposals directly with the current service estimates without having to make adjustments for differences in economic assumptions or timing. The current service estimate of outlays for 1979 is $492.4 billion, almost $8 billion less than the amount the President has proposed. The differences between the two amounts come from a number of sources. Increases over current services amounts have been proposed for energy, education, defense, and number of other areas. The Administration is also requesting reductions from current service levels in Medicare and Medicaid by limiting hospital price increases, in social security through proposed program reforms, and in several other programs.

I would ask that the table from the Current Services Special Analysis showing the differences between the Administration request and the current services levels for budget authority and outlays be inserted here in the record.

DIFFERENCE BETWEEN ADMINISTRATION 1979 BUDGET REQUEST AND CURRENT SERVICES LEVELS

[In billions of dollars]

	Budget authority	Outlays
Current services estimates for 1979	538.2	492.4
Proposed reductions:		
Medicare and medicaid hospital price increase limitations	-.1	-.7
Social security changes	(1)	-.6
Other	.5	-.4
Subtotal, reductions	.4	-1.8
Proposed increases:		
Energy programs	2.7	2.1
Fuel efficiency tax refund (income security)	1.3	1.3
Education, training, employment and social services	4.5	1.0
Defense	2.1	1.0
International affairs	2.3	.3
Transportation	3.0	.3
Taxable municipal bond option	7.1	.1
Allowance for contingencies	3.0	1.7
Other	3.5	1.8
Subtotal, increase	29.5	9.6
President's request for 1979	568.2	500.2

[1] $50,000,000 or less.

UNDERSPENDING

The accuracy of spending forecasts is obviously a source of concern for fiscal policy decisions. The problem arises in part because of unavoidable difficulties in making reliable estimates for programs that are affected by economic or demographic considerations. But the significant problem is caused by a clear upward bias that exists in estimating outlays. There is a tendency to be too optimistic about the progress of program actions, particularly the rapidity with which new programs can be accomplished. We in OMB have taken a number of steps aimed at improving the accuracy of the outlay estimates. We have focused on the estimating techniques of around 60 large accounts that seem to have particular problems. We hope to improve the estimates for those particular accounts as well as more generally. OMB is also monitoring agency estimates more closely and will reduce the agency estimates whenever we believe that evidence of persistent upward bias exists.

In November, we reduced earlier 1978 estimates by $11 billion. During the subsequent budget review, additional reductions were made, although the necessity for increasing estimates for other programs such as the price support program more than offset these further cuts.

I can assure this Committee that we continue diligent efforts to avoid the shortfall problem.

To summarize—and to repeat—President Carter's 1979 budget is realistic, responsible, and responsive to the Nation's most critical needs. At the same time, it is lean and tight. All of us in the Administration—from the President down—recognize that to carry it out successfully we need the help and the cooperation of the Congress. We look forward to working with the Congress in its actions on the budget.

Mr. Chairman, this concludes my formal statement. I would be pleased to answer the Committee's questions.

Representative BOLLING. Thank you, Mr. McIntyre.

I wanted to add that we, too, are pleased with your treatment of current services and also your additional information on future years and the information on Federal credit programs.

All of that is useful.

Congressman Moorhead.

Representative MOORHEAD. Thank you very much, Mr. McIntyre, for the excellent statement.

I would like to learn a little bit more about the zero-base budgeting process.

To make it simple for me, could you give me an example of some program that was either terminated or drastically cut back because of this new approach?

Mr. MCINTYRE. Yes, sir.

Let me talk just a minute about the way we used the process and then I will try to give you some specific illustrations.

The Federal Government has a variety of management opportunities that lend themselves to different treatments. For example, we have a number of programs in the Government that are fixed by formula. It would require statutory change if we were to deal with the program in a different manner.

We have other requirements such as the interest on debt that are uncontrollable in the sense that they depend on the size of the debt, interest rates, and other economic variables.

Those types of programs were to be treated differently from other programs where one has more discretion.

So, we devised a system to implement zero-based budgeting that was flexible and that tried to recognize the differences that existed among programs throughout the Federal Government.

There were some elements, though, of the process that we applied across the board, even on uncontrollable programs.

We asked the agencies to give us their requests in zero base format which is called a decision package. These decision packages provided information about other ways to perform the service even including recommendations for statutory changes if needed.

We recognized that there were differences in data bases and systems in the agencies and we tried to accommodate those differences in the process.

To get to your specific question: Some of the real benefits that we attained from zero-base budgeting resulted because for the first time agency managers were involved in the budget process. These are the people who are on the line, who know what their problems are, who understand how they can do a better job if given a few alternatives.

Because they were involved in the budget process in agencies like EPA, the results were not found so much in OMB's analysis but were rather in the analysis done by EPA itself as it went through its process of putting the budget together.

They reallocated resources among different programs and the managers looked at different ways of accomplishing their tasks. Zero-base budgeting became a very important management tool in EPA.

We also received information about different levels of effort for carrying out programs. In many instances we recommended minimum levels rather than the current level or an enhanced level.

In addition to that, as I mentioned in my prepared statement, we asked the agencies to rank or prioritize their budget requests. As a result, we had for the first time agency managers sitting down and trying to establish their own priorities.

In those areas we felt that the program was very, very successful. We did, as I indicated, agree with the reallocation of resources in EPA to various programs. I have some specific examples. I will have to get them for you.

Also, we found in our own analysis that we could take some different levels of effort to accomplish the agency's mission. We did that and I can get you ome specific examples.

One case that comes to my mind readily is the national petroleum reserves. This is a good example of where, through the analysis, we felt that we could extend the program for a couple of years, and still meet our national goals and objectives.

In looking at the space shuttle, we went from five to four shuttles. There are examples in several other programs that I would be glad to submit to this committee to show how we used the process.

The process also produced some increases. For example, we found that there was a great deal of merit in the education requests in the budget based on their analysis.

So, you will see a substantial increase in education.

I have dwelled too long on the subject, but it is an important one. I think it is important to recognize its value as a management tool and how successful it was in its first year of utilization.

Representative MOORHEAD. I do think it is important not only for the members of this committee and the Congress generally but for the people to be aware of how this tool works.

The easiest way is by relatively simple examples, so I would appreciate it if you could supply those to me.

Mr. MCINTYRE. We are preparing, Congressman Moorhead, an evaluation of this first year's implementation of zero-base budgeting. As soon as that is available I will make it available to the Congress.

Representative MOORHEAD. I agree with the chairman's complimentary words, about the budget, but with one possible exception.

In your prepared statement you talk about the keeping of the option for a balanced budget in 1981. Isn't this based on some assumptions that maybe cannot all be true at one time, that there would be no additional spending beyond that which is programed in this budget, and no. 2, that there will be no further tax reductions, and no. 3, that GNP will continue to grow at 4.5 or 5.5 percent per annum?

Do you think that is really a realistic projection?

Mr. MCINTYRE. The phraseology of the statement, I think, is very important in trying to answer your question. Based upon the assumptions that are contained in the budget the phrase says, as I recall it, it keeps the option open.

It does not say specifically that it will be achieved but it keeps the option open.

Now, obviously, over a 2-year period there are a number of considerations that we are going to have to make to deal with the issue of balancing the budget.

I think the important thing to remember is that this is still a goal of the President, it is a very important goal of the President, and it is a goal that we have at OMB, one I think we should strive to attain.

We should not take action that would have an adverse effect on the economy or that would not recognize some significant and critical national need just to balance the budget.

I still think that we should keep that as an objective. It should be our objective to get this deficit down so that it is manageable, so that we can deal with it, and then when we need to have a deficit for fiscal policy reasons, we can do it without getting up to the $40 to $60 billion range.

That is really the important goal we should be trying to achieve, to get this deficit down so it is manageable. That is our goal.

Now, subsequently if we determine—and many economists feel we will—that we need further tax reductions in the next couple of years to keep the economy moving forward in a very strong, vigorous manner, then, obviously, that is the route we will take.

So, I would say that the balanced budget is still a goal, but we recognize that other important considerations will have to be taken into account. It might be that we would have to defer that goal for a year or so but we have not given it up as an objective.

Representative MOORHEAD. Thank you Mr. McIntyre.

Turning now to the President's proposed urban program, the last I heard he was making an announcement or would send a message on the subject and there will be a report in March.

Mr. McINTYRE. That is correct.

Representative MOORHEAD. I haven't heard anything about the cost or the magnitude of this program, but I wonder if the money for it is contained in this budget or does this mean that we will have to have additional funds for the proposed urban program?

Mr. McINTYRE. The urban program will be presented to the Congress around the middle of March. Anticipating the question that you have raised back some time in December, I met with the chairmen of the House and Senate Budget Committees and explored this problem with them.

I explained that to the extent we knew those types of urban programs we would be recommending, we would go ahead and fund those and we have done that.

For example, there is a significant increase in HUD for the community development bloc grant program; there is an increase in the subsidized housing programs; and we have some increases in EDA, specifically designed to deal with urban problems.

To the extent that we knew which programs would fall into an urban package, we would price them out and put the money in the budget.

I think the jobs programs also fall into that category. We continued the 725,000 public service jobs, we have a new initiative for private sector jobs, specifically designed to get at hard-core unemployed in the amount of $400 million.

The programs we knew we would be proposing, we went ahead and funded.

Obviously, we did not know all of the parts of the urban package. Otherwise, we could have sent it up here earlier.

We are still working on that. As soon as the President decides the urban package, we will price it out and will follow with those recommendations.

We have put into the budget a very large contingency amount—in fact, I think it is the largest one that has been proposed in recent years—to deal with some of these additional proposals. We have included a contingency of $3 billion in budget authority in this budget which can be used for this purpose, alone with some other purposes that were not resolved at the time that we will be sending up later.

Representative MOORHEAD. So, your position is that you think there is enough in the budget, including in the contingency fund, to cover the President's urban proposal when it is sent up here.

Mr. MCINTYRE. I would hope so.

I would not want to mislead you and totally rule out the possible need for some amendments to be sent up later on. It depends on where we come out on the urban package and what it costs. We can certainly fund some of it from the contingency and that was part of our intent in putting a very large contingency allowance in the budget.

Representative MOORHEAD. Thank you, Mr. McIntyre.

Thank you, Mr. Chairman.

Representative BOLLING. Congressman Long.

Representative LONG. Thank you, Mr. Chairman.

Mr. McIntyre, the statistics, as you well know, generally show what is perhaps the beginning of a return from urban to rural areas; I think this is particularly true of many areas of the South.

I think all of us are well aware of the fact that there are very substantial differences in costs, because of geographical considerations in providing services to people in rural areas, as distinguished from people in urban areas. Rural programs have simply been more expensive to operate.

As a consequence, most of the departments of government, over the years, have been really unwilling to tackle the problems that exist.

But now, especially with the return to rural areas that we are witnessing, one of the things that concerns me the most is that we do everything in our power to avoid making the same mistakes with respect to our rural policies that we made with respect to our urban policies.

It seems to me the only real chance we have to provide these services to people who live in rural areas is by a closer coordination between the various agencies.

I have talked to Secretary Bergland about this matter, particularly with respect to the activities of the Farmers Home Administration. I have talked to Secretary Marshall about this matter also, and I have talked to Secretary Adams, because transportation becomes a central issue; if you don't have the transportation, you can't have effective programs.

It seems to me that a determined effort could be made to coordinate these efforts; a substantial amount of money could be saved if there were better coordination between, for example, the activities of OEO in rural areas and the activities of EDA in rural areas.

The Department of Transportation has a number of programs affecting rural areas, and the Department of Labor has a number of training programs in these areas. Yet, we find such things as buses running side by side taking people to a hot lunch program under two different, but related programs. I have not yet found any of those three gentlemen, all of whom I know well, and for all of whom I have a great deal of respect, who have been willing to take responsibility, and to say, "Look, we have to take the bull by the horns and consolidate, and we are going to effectuate savings".

It seems to me your office is one that could, perhaps, take a firmer hand with respect to seeing that, at least in the planning stages, this gets looked at.

Nobody has even looked at it. Perhaps it is because of the so-called "territorial imperative" and each is reluctant to step on the other's toes, because each has to live with somebody else.

Have you done any work in this field at all; or, have you given it any thought, or do you have a group that is working on this, and is there anything we can do to assist you in this regard?

Mr. McINTYRE. Congressman Long, I certainly have given that a lot of thought and I share your concerns.

We talk about urban policies, but we also have to recognize there are a lot of people that live all over this country and we can't ignore the people in the rural areas. We think that we have approached this budget in a way to deal with those conecrns and those problems.

I am familiar with some of the rural transportation programs that you have mentioned.

I have a particular knowledge about dealing with the rural areas, having come from a rural area myself.

I think that this is an issue about which we need to give a lot of attention. In OMB we deal with that as we put the budget together.

We recognize that this budget affects the lives of every American no matter where that individual might live.

Representative LONG. How about my specific question of maybe your office taking the lead in trying to get Bob Bergland, Ray Marshall, and Brock Adams, or someone from their staffs, together and saying: "Look, we are doing all of these things and we are passing each other on the roads, on the country lanes as we go up and down them, so how about us all sitting down and figuring out how to act more efficiently".

Mr. McINTYRE. I think that is an excellent idea, and we will proceed to do it.

Representative LONG. If I can participate from this end—I think I can speak for the Congressional Rural Caucus, there are about 100 of us who represent basically rural areas—we would be most interested in pursuing that kind of program.

Speaking of rural problems, we know that the farmers' problems that exist in the country today are very serious. In particular this is true, again, of young farmers who have moved onto new farms and are, for the first time, having to consider land costs in the production of their products.

In the past, this has not really been a factor, at least to the extent that it is today.

I am very interested in your statement that outlays for the farm programs will almost double this year to $7.3 billion, which is up 92 percent from 1977.

I make two comments on that—well, one comment and one question.

I really don't think this has been given the attention that it should have been given. I don't think it has been pointed out to the farmers of the country, and it should be, to show them that a great deal is being done, and so they don't have the feeling of hopelessness that so many of them have exhibited to me in my office these last 2½ or 3 weeks.

Also, I think it is very good democratic politics to let the American people know what we are doing in order to try to meet this crisis.

A lot is being done, but much of it is getting lost because of the magnitude of the problem.

With respect to that additional money, where is that money going and which farmers are going to receive it? Also, what do you see happening if there is any significant change in farm income during 1978–79?

Mr. McIntyre. Congressman Long, on page 131 of our budget document, we show the outlays in the agricultural function. Those outlays are going, of course, in the commodity loan programs, in the commodity purchases programs, and direct payments programs essentially. Also, the short-term export credit sales is up. I am not certain which group of farmers will be helped most. We have tried, in this budget, to carry out the policies expressed by the Congress in the 1977 farm legislation.

We had unusual weather in 1977. In the South there was a severe drought. We have had to deal with the drought problem. We have funded significant increases in agriculture budgets to pay benefits to farmers for the reserves, set-asides, and for the target prices that are being set.

Representative Long. The figures are most impressive.

I was giving you the broad general figure. Looking at your breakdown on page 131, I see that commodity loans up from $3.4 billion to $6.1 billion, which is a very, very substantial increase.

If you look at the commodity purchases, they are going from $974 million up to $1.8 billion, nearly doubling.

The direct payments program is going from $594 million to $2.421 billion—which is more than three times, and approaching four times the 1977 level.

Grain reserve payments for the first time are going in to the extent of $182 million, short-term export trading sales are more than doubling, the interest expenditures, which I assume will enable these people to carry loans that they are not able to make the payments on, in some instances, are more than tripling; and other price support operations are themselves increased by substantial percentages.

I think a great deal is being done. But as I said, I think it is being lost in the magnitude of the problem.

Mr. McIntyre. Thank you.

I would like to emphasize further that our estimates for 1979 represent implementation of 1977 farm legislation.

Representative LONG. Thank you, Mr. Chairman.

Representative BOLLING. Congressman Brown.

Representative BROWN of Michigan. Thank you, Mr. Chairman.

Mr. McIntyre, I have no doubt you have seen some of the critiques of the budget that have been floating around.

Some of them suggest that the budget contemplates the savings—I have forgotten the exact figures—that will come about due to the tax reform proposals the President has submitted.

Some say those tax reforms won't be enacted by the Congress and therefore that is a false saving that should be added on to the deficit.

Other items that the Congress won't act on, it is claimed, are such things as reduction in impact aid, water projects, and it is also alleged that you have grossly underestimated your costs of the farm program in expectation of a good year, et cetera.

I think, all total, the complete allegation says that the deficit is maybe $20 million underestimated.

What is your response to that?

Mr. MCINTYRE. There are a number of points that could be made regarding that statement.

First of all: I would say this is the President's budget and his recommendations do include the tax reform items as an integral part of his total tax package.

As you are well aware, the reforms total about $9 billion, the total tax reductions total about $34 billion, and there is a net reduction of about $25 billion.

We think they are tied together and are very important to the overall fabric of the fiscal policy and the economic policies that are explicit in the President's proposals.

Second: I would say we have proposed far fewer savings in this budget than in any recent budget.

The savings that we have proposed are fairly small. I don't have the exact total at hand right now, but I think it is in the neighborhood of only $3 billion.

We have tried to propose savings resulting from legislative changes only in areas that we really felt we could achieve some economies and efficiencies.

In response to the general statement about the budget deficit being understated, I would only point out that the Congressional Budget Office, in it own assessment of the President's budget, stated that the $500.2 billion estimate for 1979 "appears to be realistic in light of historical spending patterns." In addition, the ratio of outlays to budget authority is about in the middle of the range for the last 10 years.

I don't understand the complaints about the problems of the budget.

Representative BROWN of Michigan. I think what the critiques have claimed is that the Congress just isn't going to do some of the things that the President contemplates.

Do you think that the things the Congress won't do on the plus side of the ledger will be equal and offsetting to the things the

Congress will do on the minus side of the ledger and therefore the budget really does, in effect, take into account and anticipates congressional action in these different areas?

You would agree, wouldn't you, that there are items in the budget that are kind of optimistic when you view the Congress' track record in some of these things?

Mr. McIntyre. For example?

Representative Brown of Michigan. Well, the water projects, impact aid.

Mr. McIntyre. Impact aid, we have recommended a substantial amount of funding for the impact aid program. It is just a slight amount more than it was for 1978, or is it the same, Mr. McOmber?

Mr. McOmber. It is just a slight amount more.

Mr. McIntyre. It is just a slight amount more than in 1978.

Representative Brown of Michigan. Actual dollars, or does it take an inflationary figure?

Mr. McIntyre. Yes, actual dollars.

I would say that the Congress is always going to change the executive budget in some manner. You and I both know that and I think that is as it should be.

The President submits the budget. The Congress reviews it and makes its own judgments and decisions.

I think that is a good system, myself.

I would expect there to be some changes, but we are going to try to hold the President's budget as it is unless there is some demonstrated need to make a change somewhere.

Representative Brown of Michigan. That is a promise?

Mr. McIntyre. Yes, sir.

Representative Brown of Michigan. Congressman Moorhead and the others were talking about the contingency fund. It would appear that the fiscal year 1979 allowance for contingencies in the budget is about the same size as has been provided in previous years, contemplating salaries, wages, fringe benefits, et cetera, and some of the other things.

I therefore have some difficulty seeing how you could feel that any kind of a significant urban initiative program could be handled by the contingency allowance in the budget or am I to presume that the urban program is going to be of no great significance and therefore you don't have to provide any funding for it?

Mr. McIntyre. I can't predict the future. The urban package will not be completed until some time early in March and will be submitted to the Congress around the middle of March.

We have anticipated some things that we felt that would be in any type of urban program we would submit to the Congress and, to the extent that we could anticipate those and price them out, they are in the budget.

I mentioned three or four examples. In EDA, we have added several hundred million dollars to deal with urban problems, we have increased the subsidized housing budget by 17 percent, we have increased the youth jobs programs; and we have initiated a private sector jobs program and provided $400 million in the budget for that.

We do have a large contingency in the budget, and I will be glad to get you a history of that contingency allowance over the last 10 years.

In outlay terms for the last 2 years, it was $1.5 billion.

We are recommending $1.7 billion in outlays and $3 billion in budget authority.

We do anticipate this will provide funding for the urban package, but as I said earlier, in answer to a similar question, until we know what that package is going to be, how much it is going to cost, I can't predict how much money we are going to ask for.

We hope to be able to fund the new urban programs out of our contingency, but there is the possibility that if we have some good proposals that the Congress ought to have a chance to consider, we might have to send up an amendment.

Representative BROWN of Michigan. Has your office critically examined that which appears to be a dualism in the handling of economic assistance, that being provided by the EDA, and the UDAC program with HUD, both of which appear to be pretty much directed at the same goal of economic development?

Are you going to let those two Departments continue to go up kind of parallel tracks?

Have you made any recommendations with respect to consolidation?

Mr. MCINTYRE. During the process of going through the budget for HUD and Commerce, I did raise that question personally about the difference between the two programs.

It was pointed out to me at that time that the UDAC program dealt more with community development in general.

Representative BROWN of Michigan. But the key to it is economic development.

That is how the program was sold to us on the committee as being a program different from the ordinary community development since it tended to hit hard on the economic development side involving private sector funds, other involvements, in short, it was basically an economic development program.

Mr. MCINTYRE. Congressman Brown, I don't want to appear to disagree with your analysis of the similarity in the two programs.

Representative BROWN of Michigan. It is not my analysis. I will go back and show you the testimony.

Mr. MCINTYRE. Let me rephrase it.

I don't disagree with the point that has been raised about the similarities of the two programs.

We share your concern and we intend to look very carefully at these two programs. We do have a reorganization study that is looking specifically at community and local economic development, and I am certain that it will be taken up in that view.

Representative BROWN of Michigan. In the budget I have noticed that HUD is getting about an 8.1 percent increase in funding for personnel amounting to around 1,400 permanent slots.

This comes at the same time that HUD has announced reorganization of its field offices. The justification for such reorganization is that it will provide for more cost-effective use of personnel and is keyed to the fact that there was not included in the President's budget of last year the slots that were asked for; therefore, this would be part of the cutting back.

At the same time, HUD made the argument that it should take over the flood insurance program because it would be more cost effective. Other similar claims and actions could be recited, yet, with all of those things that basically look to more cost effectiveness, more efficiencies, the Department, nevertheless, asked for and got the largest increase in all of the Federal Government, that is, the largest percentage increase in personnel costs, amounting to 1,400 slots.

How did HUD justify this to you so that it came up as part of the President's budget?

Mr. McIntyre. I would have to look at a program-by-program analysis to review the justification for this.

Representative Brown of Michigan. I certainly wish you would.

It just is totally incongruous to me, especially since I think HUD is making bad decisions with respect to the reorganization of its field offices, and I think it made a bad decision with respect to the flood insurance program. All of this was done for cost effectiveness. It came in with a request and you endorsed it to increase their personnel costs 8.1 percent, the largest of any program in the Government, including the 1,400 new, permanent slots.

Mr. McIntyre. I will have to look into the percentages. Just in general terms, the increase will go to programs such as the housing program, the community development and fair housing, and equal opportunity housing programs.

I will have to get you something specific.

Representative Brown of Michigan. Would you look into it further for me and try to do a pretty critical analysis of where those new slots are; certainly, they should not be in the field and they should not be in the flood insurance program, because they were going to be able to save $15 million by their switch.

The problem is in many of these cases—I will give you another one.

In their housing assistance programs, HUD is cutting back and limiting very much what the State housing authorities can do and assuming more of the role of direct funding by HUD; this would seem to involve more personnel.

I think the arguments being made are totally inconsistent with what is being done.

I would appreciate that.

My time has expired.

Mr. McIntyre. Let me respond to that.

We looked at all these personnel requests very hard and in fact the agencies did not get anywhere near the number they requested.

I will get the details on those 1,400 positions for you.

Representative Brown of Michigan. Thank you very much.

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

The total staff for the Federal Insurance Administration, which administers the flood insurance program, is now 343 as compared to 399 initially requested for 1978; a reduction of 56 positions. The 1979 request does not include any additional positions over the current 1978 level for the Federal Insurance Administration. The recent change in contractural servicing for the Federal Insurance Administration does not have any impact or requirements for HUD staffing. These services have been and will continue to be performed under contract, not by in-house staff. The savings anticipated are savings in contract costs.

The HUD field reorganization is being implemented during 1978 and the resultant staff savings are reflected in the staffing level for that year. HUD's initial staffing request for FY 1978 was 16,790, as compared to the current level of 15,990. This reduction of 800 positions is principally due to the reorganization. Thus the personnel savings from the reorganization have already been taken into account in the requested staffing for 1979. The vast majority of the staffing requests for HUD, including all field staff, are based upon a workload measurement system which relates the staff requirement to the program levels to be executed. A detailed examination is made of each item in the HUD workload and the staff-hours necessary to carry out each unit of work are applied. The staff level requested for 1979 reflects workload calculations fully consistent with decisions made for the 1979 budget.

The staffing increases requested for 1979 are due to increased program workload and are as follows:

September 30, 1978 Employment: 15,990

Housing Programs: Increased activity is projected under the Section 8 program. A change in the mix of unit reservations toward more staff intensive new construction and rehabilitation, as well as an increase in the total amount of reservations partially explain the increased workload. In addition, the availability of tandem plan money will allow for more construction starts—which requires increased staff time to accomplish—as well as increased FHA multifamily insurance processing workload. There will also be an increase in the number of units in the pipeline resulting from program growth in 1977 and 1978, an increased number of Section 8 public housing units under management along with increased processing workload for single family mortgage insurance resulting from the revised down payment, mortgage limits and payment plans recently introduced. Revitalization of the Section 235 combine with these to require additional staff to ensure timely and proper execution and processing: +883

Community Planning and Development: Additional staff are required to implement new management initiatives which primarily focus on the effectiveness of grantees in meeting the needs of low and moderate-income groups under the Community Development Block Grant program and to support full scale implementation of the Urban Development Action Grant and Urban Homesteading programs. Additionally, grants issued in prior years require monitoring and as the program continues to grow the monitoring workload grows: +413

Fair Housing and Equal Opportunity: Additional staff are required for increased complaints and compliance reviews under HUD Title VIII, Title VI/Section 109 and Executive Order 11246/Section 3 and for increased review and monitoring activities associated with the upgrading Community Development and Block Grant program: +42

Working Capital Fund: Additional staff are required for the automated data processing activity to provide improved and more efficient services and to support expanded usage: +40

Field Direction and Operational Support: The increased level of program activities in the field require additional staff support, principally in the areas of economic and market analysis and labor relations: +11

Field Administration: Additional staff are required to provide administrative support to the higher level of program staff and program activities in the field: +21

September 30, 1979 Employment: 17,400

Of the 1,410 increase, almost all are in the HUD field offices. This is where the requirement exists because this is where the workload must be dealt with. The following table shows changes between Washington and field staffing:

	Estimate		
	Sept. 30, 1978	Sept. 30, 1979	Difference
Washington	4,125	4,165	+40
Field	11,865	13,235	+1,370
Total	15,990	17,400	+1,410

Representative BOLLING. Yesterday, we had a group of forecasters who were uniformly gloomy about the outlook for 1979 in particular.

They believed that international considerations will force money policy to be quite restrictive. They believe that the tax reduction program is inadequate, and you proposed to raise outlays by only 2 percent in real terms.

I wish you would discuss that.

That is the principal sort of unanimous criticism that we are getting. It came from a variety of sources, some conservative and some less conservative.

The question of realism in the budget in that respect is a matter of real concern.

Mr. MCINTYRE. Let me make a few preliminary observations about this, and try to answer some of the specific questions you might have.

The administration recognized that based on its economic forecasts we would have good economic activity in the first two quarters of this year, but it was predicted that we would experience some slowdown in the economy without some fiscal stimulus action by the third quarter of the fiscal year.

Accordingly, we recommended to the Congress the tax program, the fiscal stimulus that would be involved in the tax reductions.

We feel that this is very important to attain one of the objectives I mentioned in discussing the themes of the budget; that is, to maintain the strong continuous economic recovery from the recession.

It is a very important aspect of our overall fiscal and economic program to keep the economy strong and to keep it moving forward.

We also recognize the need for a national energy policy.

It is absolutely essential that we have a good comprehensive energy policy, if we are to deal with the international considerations you referred to.

I don't think that I have to go into the energy program that the President has presented and that it is now in conference.

It is absolutely essential.

We also are recommending some fiscal stimulus on the outlay side of the budget. I mentioned the jobs program, the continuation of the 725,000 public service jobs, the new private initiative to deal with structural unemployment. I think we really must concentrate our efforts in the structural unemployment area. We are trying to do that, to target our jobs program better to deal with the structural unemployment problem.

We also are recommending the continuation of countercyclical revenue sharing to deal with this problem. As well as outlays of $2 billion for the local public works projects approved last year by the Congress for 1979.

So, there are some programs on the outlay side of the budget that directly provide economic stimulus.

The principal means, as I said, is on the tax side of the budget.

We are concerned about the inflation problem and in that regard we have presented to the Congress a series of anti-inflationary policies.

These are some of the efforts that we have undertaken in this budget to deal with the questions that you have raised, Mr. Chairman.

I might ask Mr. Cutter, who is an economist, if he has any further observations he would like to make about this.

Representative BOLLING. Mr. Cutter.

Mr. CUTTER. Basically, as I think you are aware, sir, we all face the need to walk a fairly tight line at the moment.

We felt as we were developing the budget and thinking about fiscal policy with the Treasury Department and the Council of Economic Advisers that there was a clear need for additional stimulus, but at the same time at an underlying rate of inflation of about 6 percent we had to be prudent about the speed with which we reached the economy's capacity. The thrust of your question really was: "Will international problems require a monetary policy which does not accommodate our fiscal policy and therefore directly require a fiscal policy which overpowers monetary policy?"

Our judgment was made knowing the balance of payments problems, and being able to develop some alternative scenarios that looked at the problem. In our analysis of fiscal policy we looked at alternatives both substantially higher and substantially lower than the amounts the President finally decided. The President's judgment was that the tax reduction of approximately $25 billion—I guess it is actually $24.8 billion and the expenditure increase at a real rate of slightly less than 2 percent is a prudent and realistic stimulus given where the economy is today and given the balances that have to be struck.

I guess there really isn't very much more to say than that. We were aware of the same problems you raised and struck this balance.

Representative BOLLING. I suppose one of my concerns, one of my principal concerns—and not for a moment do I forget that the least flexible of all institutions with regard to taxes and tax reform and so on is probably the Congress—but I guess my concern is that given the very real stakes in human misery and national strength is that we have continued, orderly growth of the economy, and in light of the concern expressed by this range of forecasts that we are to be assured that the administration is unlikely to be inflexible in staying with its numbers.

I think if I had a criticism to make of the administration in its first year it would be on the question of a mixture of too much flexibility and not enough flexibility.

I could be very specific but I won't. I think the real concern that we have in trying to come up with a comment on the President's economic report that is reasonable and realistic is that we recognize how relatively narrow a line we must proceed on and hope that the administration and the Congress will turn out to have the foresight and the flexibility to meet those difficulties.

I don't think that requires any answer because you are just testifying on a budget that has not been submitted for all that length of time.

We are already finding very real concerns with regard to the adequacy of the stimulus and the timing of the stimulus. I think that is inevitable just as it is inevitable to find some people that are saying there should not be any tax cut at all.

I am not going to pursue that. I don't really know what you could say about it.

I would like to pursue a more or less technical problem.

I haven't had an opportunity to look at the figures carefully enough myself to know this, but my staff informs me that as good as the current services treatment is that there is some problem with the treatment of inflation within that.

Apparently, there are slightly different treatments from one program to another, and what I really want is an assurance that if that is the case, and I am sure it is, that we will move as rapidly as possible to a situation where the comparability of the treatment as to inflation and so on is such as to make it most easy to understand the meaning of the figures.

Do I make myself clear, or have I totally obfuscated the issue?

Mr. McIntyre. I think your point is well taken.

I understand that there has been this type of technical problem over the years. We have, I believe, presented some alternative approaches in our "Special Analysis." This is a question that perhaps, Mr. Chairman, during the coming year I can pursue with you. I share the concern you have expressed.

Representative Bolling. Fine.

I think that is important because the beginning we have made in effect on the current services concept in terms of its use as a tool for both the administration and Congress I think is a very useful one, and I think we should continue to move to improve it.

I am delighted to be reassured that that is your intention, as I expected, too.

Mr. McIntyre. I think our objective for the current services estimates is the same as yours.

We want to make them as useful as possible and to also make our approaches as consistent as possible.

Representative Bolling. You are well aware, I am sure, that we are under constant pressure here from some sources to junk the budget process, that we have had very real trouble in dealing with the timing problem, the constrictions which have been a very harsh discipline for a Congress that has gotten used to not passing any of the major appropriations bills until the middle of the fiscal year, so we have our problems.

Anything that we can get that will help us anticipate some of them is crucially important to our ability to continue to be more self-disciplined.

I am not trying for a moment to lay the blame on the administration, because we have been very, very slow to move in the right direction.

Mr. McIntyre. Mr. Chairman, let me put in a plug for your budget process.

We have found it to be very helpful. We believe that our working relationships with the people involved in the process from the congressional side has improved substantially over the past years. We expect it to continue to improve and also to work very closely with the Congress.

Representative BOLLING. Thank you.

I have one more on an entirely different subject.

With regard to the business tax cut, it has been argued that the tax policy this year represents a substantial tax increase for business.

The argument is this: In 1979 unemployment taxes will raise $4.8 billion, social security taxes paid by employers will rise by $7.7 billion, and this gives a total increase of $12.5 billion, which can be partially offset by a $5.7 billion corporate tax cut.

This yields an increase of $6.8 billion. That is the argument. It doesn't seem to me to tell the whole story. Payroll taxes are a reduction of corporate income taxes.

This means when social and insurance taxes rise $1, the corporate taxes fall 48 cents; thus, of a $12.5 billion increase in payroll taxes, about $6 billion comes back to the corporation through income tax deductions.

Of the remaining payroll tax increase, part shows up in higher prices and part shows up in lower wages.

It is doubtful that there is much of a reduction in corporate profits.

Thus, on balance, I would say that the Carter proposal includes a relatively small tax cut for business.

How would you assess the situation?

Mr. MCINTYRE. You have made a number of points there that are very valid.

No one could argue with them.

We attempted to take the approach of recommending the historical ratio of business to peronal tax cuts. We certainly feel that we have done some very beneficial things for business. In addition to the cut in the rates, we have proposed liberalizing the investment tax credit.

We have tried to take into account in our analyses and assumptions some of the increases that are built into the revenue structure.

So we looked at various alternatives to deal with the business problem and came up with this recommendation: I believe your figure of $5.7 billion is the correct amount of the reduction.

I would also remind you that as additional increases come into effect, those that have already been enacted into law, we have certainly not ruled out the possibility of additional tax reductions in the next couple of years.

I might ask Mr. Cutter if he has anything he wants to add to that, Mr. Chairman.

Representative BOLLING. Mr. Cutter.

Mr. CUTTER. I do have a point to add to that; maybe two points.

The larger one is that corporations aren't people. With respect to the impact of tax changes on people, we are concerned about their level of well-being before and after the impact of the taxes and therefore, their after-tax income is important as a measure of well-being. With corporations, we are really more concerned about their behavior. We are concerned about whether or not a change in taxes will induce more investment, will induce more expansion in capacity, and more employment.

Moreover, the tax reductions that the President has proposed result in substantially less taxes than if he had not made his proposals. Therefore, they will produce, we think, an incentive for increased performance and increased investment.

I do think that it is perfectly valid to argue that we are not concerned about the social well-being of a corporation in the same sense that we are as an individual.

Representative BOLLING. That is a good point, a very interesting point.

I hope that the expectation turns out to be correct.

Obviously, we all agree on that.

I find that I need to go back.

We were talking a little bit about the effects of the international situation on the dollar, and I want to go back.

The Fed almost always expresses great concern about the value of the dollar falling on international exchange markets and, of course, it recently took some action to raise the interest rates to help support the dollar.

Classically, over time, I think forever, since it was founded, this committee has taken the position that such measures as raising the Federal fund rate or the rediscount rate are inappropriate uses of domestic monetary policy for international purposes.

Could you explain the impact on our domestic economy of such a policy and would you agree or disagree or, I will give you a third alternative, be neutral on the committee's old position on it?

I think it is an important point.

In effect, it amounts to our saying that we think domestic considerations must override the international considerations in the matter of interest.

Mr. MCINTYRE. Mr. Chairman, I haven't followed the historical development of the committee's position on this issue.

I would be inclined to generally agree with that and I would like to, if I might, look at your position and I would be glad to answer you in writing for the record.

Representative BOLLING. I wish you would do that and just remember our problem with our report.

I know you are under great pressure but I would like to very much be able to include this in our report.

Although we have the right to go to the end of March, I don't intend for us to go that long.

At least, I think we will have that opportunity. I don't know whether the resolution passed the Senate or not. We still have to go before the Budget Committee on March 15, and we have other things.

I am not trying to pressure you too hard.

Thank you very much.

It has been a very interesting session.

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

I do not generally agree with the position stated by Chairman Bolling. The monetary policy authorities must share with those of us who have responsibility for fiscal policy the burden of pursuing all our economic policy objectives, including balance of payments, exchange rate or other international market objectives. They, too, must face the difficult choices which are necessary when policy objectives partically conflict, as they do now when high unemployment argues for low interest rates while speculative movements in international exchange markets argue for high interest rates. It would not be the most efficient use of our arsenal of economic policy instruments to reserve monetary policy only for domestic policy objectives.

Having said this, I would like to add that I do not believe that it will be necessary to raise short term interest rates to stem speculative flows very often. Despite the enormous pressures which have been placed upon exchange rate markets by the change in energy prices in recent years, a very large part of the necessary adjustments have come through market-determined changes in exchange rates. There have been many fewer foreign exchange crises than we would have had under the old system. Because we adopting a floating exchange rate system, it is necessary to intervene to stabilize exchange flows only occasionally.

Moreover, most of the recent increase in interest rates has been at the short end of the market. Very few forecasters predict similar increases in the long end of the market, yet only then would a serious conflict between domestic and international objectives emerge. I am convinced that we still have the ability to achieve all of our objectives; certainly now we do not need to sacrifice our domestic goals to achieve our international goals.

Representative BOLLING. We very much appreciate your appearance and we are delighted to be working with you.

The committee stands recessed until tomorrow.

[Whereupon, at 11:33 a.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 8, 1978.]

THE 1978 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 8, 1978

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

The committee met, pursuant to recess, at 10:10 a.m., in room 2337, Rayburn House Office Building, Hon. William S. Moorhead (member of the committee) presiding.

Present: Representatives Reuss and Moorhead; and Senator McGovern.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director; Richard F. Kaufman, general counsel; Thomas F. Dernburg, Kent H. Hughes, L. Douglas Lee, Deborah Norelli Matz, and Katie MacArthur, professional staff members; Mark Borchelt, administrative assistant; and Charles H. Bradford, Stephen J. Entin, George D. Krumbhaar, Jr., and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE MOORHEAD

Representative MOORHEAD. The Joint Economic Committee will please come to order.

I think we might as well get started. We have enough problems in getting people through the snow.

Will the witnesses please come forward.

It seems to me that it is now increasingly widely accepted that, in the words of the President's Economic Report:

> Recent experience has demonstrated that the inflation we have inherited from the past cannot be cured by policies that slow growth and keep unemployment high. Since 1975, inflation has persisted stubbornly at a 6 to 6½ percent rate—even though unemployment went as high as 9 percent and still stands above 6 percent, and even though a substantial proportion of our industrial capacity has been idle.
>
> The human tragedy and waste of resources associated with policies of slow growth are intolerable, and the impact of such policies on the current inflation is very small.

This is also the view expressed in the midyear report of this committee last year.

There we characterized the attempt to slow inflation by restrictive monetary and fiscal policies as a "costly and abysmal failure," and we gave considerable attention to policies that could slow inflation without resorting to tight budgets and tight money.

It is gratifying that the President and his advisers have come around to our way of thinking. However, I am disappointed because the administration's program of "voluntary deceleration" appears to me to be inadequate.

I am hopeful that we, in the Congress, can find more effective means of controlling inflation than the method proposed by the President. It is absolutely essential that we do this because recovery cannot proceed rapidly and successfully as long as inflation exerts its drag, including the danger that it will frighten us into conservative fiscal and monetary policies.

Our purpose today is to study various nonmacroeconomic approaches to inflation control. There are many choices, and I am particularly hopeful that the members of our panel will address themselves to the advantages of the various tax-based incomes policies—or TIP—as they are called.

When we planned this hearing we were delighted that Mr. Otto Eckstein agreed to serve as one of our witnesses. Mr. Eckstein is professor of economics at Harvard University and president of Data Resources Inc. He is a former member of the Council of Economic Advisers, an expert on wage and price behavior, and he has been most helpful to this committee in the past.

Regrettably, Mr. Eckstein has been grounded by 30 inches of snow in the New England area and even the ingenuity of Data Resources has been unable to extricate him from that situation.

We are, however, extremely fortunate that Data Resources has a Washington office. The head of that office, Mr. Joseph Kasputys, has very generously agreed to come here to fill in for Mr. Eckstein. Mr. Kasputys is a former Assistant Secretary of the Department of Commerce.

Mr. Kasputys, we are exceedingly grateful to you for subjecting yourself to this imposition on such short notice. I know you have been here since early this morning consulting with our staff, and I am most appreciative.

Another witness is Mr. Rudy Oswald, a distinguished labor economist who has succeeded the late Nat Goldfinger as director of research for the AFL-CIO. Mr. Goldfinger was for many years a most helpful witness for this committee, and I am sure Mr. Oswald will be equally helpful.

Our leadoff witness is Henry Wallich. Mr. Wallich is a member of the Board of Governors of the Federal Reserve System wha has had a long and distinguished career in the field of monetary economics.

However, he appears here today not for his monetary expertise or as a representative of the Federal Reserve, but rather as a private witness who has the distinction of having been one of the earliest proponents of the concept of using tax incentives and penalties to slow inflation.

Thank you for coming today gentlemen.

Let us begin with Governor Wallich. We will then hear from Mr. Oswald, and, then Mr. Kasputys.

STATEMENT OF HON. HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Governor WALLICH. Thank you very much, Congressman Moorhead.

It is a pleasure to appear before the Joint Economic Committee to present my personal views in the area of incomes policies. I want to make it quite clear that these views should not be interpreted in any way as implying those of any of my colleagues on the Federal Reserve Board.

Disruptive inflation has plagued our economy for something like 12 years. During that period its virulence has varied, as high as 12 percent in the fourth quarter of 1974 and as low as 1.5 percent in the second quarter of 1967. But the experience has made clear that we are not "learning to live" with inflation. Increasingly, inflation is seen for what it is—a serious addiction that gradually undermines the vitality and even viability of the addict.

While currently inflation is being forecast for the indefinite future at a rate close to that of the present, there is no reason at all to believe that inflation will stabilize if left alone.

Inflation has shown itself in recent years to be highly inflexible downwards. It has shown no similar inflexibility upwards. Any one of a number of factors could send inflation spiraling again. Pressure of demand on limited manufacturing capacity, a major wage breakthrough resulting from special circumstances that nevertheless could set a pattern, food prices, oil prices, all could trigger off higher inflation that then would work its way into wages and become resistant to any decline. Such a ratchet mechanism is a tangible threat.

Further acceleration of inflation almost certainly would, after some not very long interval, lead to renewed increases in unemployment. Thus, there is no other choice but to try to bring down unemployment and inflation simultaneously.

It is largely because of concerns like these that a consensus has developed that the economy must be allowed to grow at only a moderate rate. Idle resources, human and material, can be absorbed only gradually. Moreover, the noninflationary limits to that absorption leave a distressingly high margin of unused resources even in the longer run.

Incomes policies have been suggested as a means of winding down inflation more rapidly. In the general view, however, incomes policies are associated with wage and price controls, or at least are seen as a step in that direction.

This concern has helped to create an interest in a tax-oriented incomes policy—TIP—that cannot be charged with that defect because it is specifically designed to give full effect to market forces.

While numerous versions of TIP exist, their common characteristic is a reliance on the tax system as a means of inducing more moderate behavior of wages and prices. With the committee's permission, I would like to discuss a variant that was developed by Prof. Sidney Weintraub of the University of Pennsylvania and myself a number of years ago.

OUTLINE OF PLAN

The essence of the plan consists of a tax penalty on firms granting wage increases in excess of a guideline. The restraint is on wages rather than on prices. But the tax is paid by the firm.

In this way, evenhandedness is maintained. The plan can be extended to include a restraint on profits if that is regarded as necessary. To begin with, however, I would like to set forth why a plan focusing on wages combined with a tax paid by corporations seems adequate.

A considerable body of research indicates that prices in the long run are basically determined by wages. Nonwage factors such as those mentioned earlier—demand pressures, nonwage costs—may play an initiating role in price movements. But with wages and other compensation of labor amounting to 75 percent of GNP, wages unavoidably are the principal factor in prices. A slowing in wage increases, therefore, will necessarily bring about a slowing in price increases.

If prices follow wages, wage restraint will not lead to any reduction in real wage increases. Given productivity gains of, say, 3 percent, labor will get the same increases in real wages with a 5-percent wage increase and 2 percent inflation as with 9 percent wage increase and 6 percent inflation.

The gains from productivity are all that the economy can give to labor, unless it is to be taken away from someone else. These gains will go to labor at any level of inflation, so long as the gap between wages and prices, as it normally does, equals productivity gains.

Wage restraint, therefore, imposes no sacrifice upon labor in real terms. On the contrary, by reducing the threat of inflation, wage restraint would permit the economy to move to lower levels of unemployment, and move there more rapidly, thereby benefiting both labor and all others who share in the national income.

TECHNICAL ASPECTS

A tax to be imposed on firms granting excessive wage increases could take one of several forms. It could be imposed as an increase in the corporate income tax, as a payroll tax, through disallowance for income tax purposes the deduction of any excess wage increases form of a tax reduction for firms avoiding excess wage increases.

That is known as the carrot approach as contrasted with the stick approach.

Disallowance of excess wage increases as tax deductions has the advantage of having already been on the statute books after World War II and after the Korean war. An increase in the corporate income tax has the advantage that it could be scaled easily in proportion to the magnitude of the excess.

This would help to make the penalty or threat of a penalty effective while largely eliminating controversies over marginal excesses. A rise in the corporate income tax, moreover, would be less easily shiftable than a payroll tax or denial of deductibility. On the other hand, it might more adversely affect the ability of the firm to invest.

Guidelines: The setting of the wage guideline requires a governmental decision. A maximum wage increase equal to long-run productivity gains plus half the current rate of inflation might be appropriate.

The guideline would in no way interfere with the functioning of the market, since firms and unions would be entirely free to make settlements above or below it. Thus, the concern that the guideline would become a first step on the way to a system of controls would be unwarranted.

Likewise there seems to be no good reason for expecting the "maximum to become a minimum," since the guideline would not represent a maximum. The guideline would be lowered periodically as inflation was being reduced.

Coverage: A good case can be made for subjecting only a limited number of large corporations to the guideline and tax. In an inflation such as the present, which is kept going because one high wage settlement leads to another but where there is no excess demand for labor, moderation in the settlements of large firms and some consequent slowing of the price trend would probably lead to moderation for most employers.

Limiting the plan to large firms would greatly ease administrative complexities. However, an alternative and opposite procedure could be envisaged—to cover not only all incorporated, but also unincorporated business.

Administrative problems: The fact that laws disallowing excess wage increases under the post-World War II and Korean war wage and price control legislation have been on the books suggests that the technical problems of measuring excess wage increases have been considered by the legislature and not found to be intractable. There are, of course, a wide range of technical problems to be resolved of which the following are indicative:

In an economy characterized by multicorporate enterprises, how is the taxpaying unit to be defined—a plan, a corporate entity, or an entire conglomerate? How are the excesses to be measured? By total payroll and total employment, by individual categories of workers, with allowance for overtime, for fringe benefits including deferred compensation, cost-of-living adjustments, and health insurance and all the rest?

How are new firms, firms with losses, with multiyear labor contracts, with numerous subsidiaries to be dealt with? Should the TIP penalty be applied for 1 year only, for a fixed multiyear period, or for a lengthy or indefinite period?

On technical problems such as these I am having some work done and a draft report from a well-known tax expert who used to work for the trade and corporate income tax analyzing these difficulties.

I am sorry this document is not yet in a sufficiently finished form to present it here. The overall impression is that this tax is not quite as complicated as some of the things we have had on the books; that, yes, it presents a large number of complications but in the normal course of tax administration, decisions have to be made about alternative ways of settling these difficulties, and in that manner it should not be impossible to resolve it.

A large number of decisions will have to be made in writing the tax regulations. This is the same analysis, however, that firms and unions engage in during wage bargaining sessions, and which at the present time the Council on Wage and Price Stability must also undertake.

Furthermore, the initial evaluation of a wage package, which would form the basis for a pay-as-you-go approach to the tax, can be revised upon eventual aduit by the Internal Revenue Service.

Since the tax penalty would be proportionate to the degree of infringement of the guideline, minor differences between the taxpayer and the tax authorities would not involve large amounts of tax and could be compromised as many differences arising in tax audits are.

A TAX TO RESTRAIN THE SHARE OF PROFITS

It was noted earlier that the wage guideline proposal does not contain a corresponding restraint on prices because prices can be expected to follow wages. However, if the evidence supporting this view is not generally accepted, a supplementary device could be introduced that would serve to restrain, not prices, but profits.

A failure of prices to move with wages would tend to show itself in a corresponding change in profits. Labor would have a legitimate right to expect that no special benefits for profits should emerge from an acceptance by labor of a wage guideline.

To ensure that this expectation is not disappointed, the corporate income tax could be raised so as to prevent the rise in total after-tax profits from exceeding some historical relationship to GNP. This would be a tax proportionate to the "excess profits" of the corporate sector as a whole, but not related to the profits of any particular corporation.

As a practical matter, such a tax increase probably would never be triggered at all. But if it were, the increases in the corporate tax could hardly amount to more than a few percentage points.

Such a tax would be in "incomes policy" in the proper sense of the term, since it would specifically be designed to deal with income shares. The setting of a profit share, presumably in the light of historical experience and the need for business capital expenditures, would be one of the difficult decisions to be made under this approach.

TAX REVENUES

To the extent that the tax measures here proposed are cast in the form of tax increases for exceeding a guideline, rather than tax reductions withheld, some incremental revenues would be collected.

Their magnitude would depend on the nature of the guidelines set and on the magnitude of penalties in relation to violations. These additional revenues could be utilized to reduce the income tax burden. Given the uncertainty of these additional revenues, however, a precise link could probably not be established.

EXPECTED DURATION OF THE PLAN

Since inflation is expected to come to an end under the plan, the arrangements insofar as they do not involve carryovers from the operative period of the plan, should be terminated when success has been achieved.

It might be better to reintroduce the scheme if inflation should revive thereafter rather than to perpetuate it at a time when it is not needed.

Even after termination of the plan, a better understanding of the role of wage increases in price determination should prevail and should make it easier to avoid renewed bursts of inflation.

Alternatively, the arrangements could be kept alive even during a period of stable prices as a means of permanently facilitating lower rates of unemployment. It is the pressure of strong demand for labor which, at low levels of unemployment, tends to give rise to excessive wage increases.

The threat of such increases, employing demand pull inflation, in turn prevents the adoption of fiscal and monetary policies that would lead to such lower levels of unemployment. If the wage-increasing effect is restrained by a tax-oriented incomes policy, the achievement of permanently lower levels of unemployment should be within reach.

It should be clear, however, that TIP cannot serve as a counterpoise to, or justification for, overly stimulative fiscal and monetary policies. The rate of growth of the money supply would have to be reduced in line with diminishing inflaton and eventually would have to be stabilized at a level consonant with the rate of real growth and the trend in velocity.

Fiscal policy would have to limit the Government's demands on the credit markets to whatever could be financed with that rate of money growth at stable prices and interest rates consistent with full employment.

Thank you very much.

Representative MOORHEAD. Thank you, Mr. Wallich.

I would now like to recognize my colleague, Congressman Reuss, who may have to leave before the witnesses have all completed their testimony.

Representative REUSS. Thank you very much, Congressman Moorhead.

Governor Wallich, I congratulate you and Professor Weintraub and others who have been on the TIP kick. I think it is something worthy of being discussed. I have some difficulties with it which can be summed up as follows, really, though it is a little better than outright wage-price controls itself of the same general sort of thing and while I have in the past espoused those particular times in our economic history, it would seem to me that right now to come down this hard on wages and this bureauratic on prices if you have to go to that is straining at a relative gnat while we swallow the camel of our effect on inflation of flexible exchange rates and what they do to import prices.

While we swallow the camel of the farm policy which does result in higher prices to the consumer in things like sugar and many other commodities—while we haven't really done very much to insulate ourselves from the high price effect of OPEC policies and particularly when we are moving in part of the energy bill that has already passed the House to raise oil prices and move up costs across the line.

I am not really asking a question. I am just making a statement. I commend you for this idea but I would not be in favor of adopting it in isolation for the reasons given. However, if you wish to attempt to persuade me to be more affirmative, I will certainly yield to you for that purpose.

Governor WALLICH. If I may say, Congressman Reuss, all the things you have mentioned are sources of inflation. I agree, unlike many, that floating exchange rates can, when the value of the dollar falls, contribute to domestic inflation. So do increases in farm price supports, so do increases in excise taxes on oil, so do other things that the Government is doing.

Nonetheless, the share of GNP of all these things, imports, oil, even farm products, is smaller than the share of GNP going to wages and other compensation of labor which amounts to 75 percent. I would, therefore, submit that TIP focuses on the biggest single component of income in our economy.

Representative REUSS. Let me now turn to a related subject. In the last 6 weeks or so the Federal Reserve has been raising interest rates, the Federal fund rates upon which hang the whole complex of discount rates and prime rates and so on, not only for domestic reasons to get the money supply under control but as alleged by the Fed itself to attract foreign capital here so as to in part redress our hideous overall payments imbalance.

I don't know how you voted on that. Maybe you will tell us. But I put it to you that is an ill-considered policy, that in an economy like ours it doesn't make sense to do that. So far as I know, including the Fed, has figured out the consequences, domestic and foreign, on our balance of payments and on our domestic economy of raising interest rates for such a purpose.

We had here a couple of days ago a witness from the Wharton School who pointed out that raising interest rates for a purpose like this by 1 percent would throw 500,000 men and women out of jobs, would cause 200,000 fewer houses to be built than otherwise were going to be built in that year, would slow up the growth of GNP by a percentage point, et cetera, et cetera, et cetera.

He went on to say, I guess, you have got to do this, I guess you have got to raise interest rates for balance of payments reasons. I don't know where he got that imperative from. He didn't factor in what the alleged benefits to our country of trying to lure foreign capital here, with a $30 billion trade deficit how much extra long-term capital investments are we going to lure here by raising interest rates for just that purpose and not domestic purposes, and what good does it all do?

Suppose we lure $2 billion here, which is a lot of additional investment capital. That doesn't lay a glove on our $30 billion trade deficit. Why ruin our domestic economy? In the end you are going to find, I would think, fewer foreigners wanting to invest here in such a crazy jerry-built economy where we go off on a frolic like this.

So, respond to this criticism of the board, and it may not be of you. I know some valiant soul voted against it.

Governor WALLICH. There were two of us who voted against it, but not I. I voted for it.

Representative REUSS. You are so good you are entitled to err once in a while. Why did you do that?

Governor WALLICH. Ordinarily, I would say exactly as you do, Congressman Reuss, that we ought to look at the domestic economy and in a case of a big country like ours, that is big inside and relatively small outside, monetary policy should be made for the domestic economy and it should not be the tail that wags the dog.

In this particular case, however, the domestic economy was likely, in my view, to be seriously affected by conditions abroad. I take for granted that monetary policy is always made in the interest of the United States and not in the interest of anybody else.

These disorders of the market and the decline of the value of the dollar, which is the basis for the world's financial system, threatened a slower rate of growth abroad—not to call it something worse—because both exporter investment and investment in the import competing industries becomes unprofitable. To the extent that we are trying to urge the Germans and the Japanese to accelerate their economies, this effect of the declining dollar could work in the opposite direction.

In my judgment, the ultimate consequences for the United States from that kind of thing happening abroad would be worse than the relatively minor consequences of a really moderate increase in interest rates.

As you know, even the Council of Economic Advisers predicts interest rates to rise, which is normal during cyclical expansions.

Representative REUSS. Why make it worse?

Governor WALLICH. You might ask, why make it earlier? I don't think the discount rate action makes it any larger. It just anticipates in time what would eventually happen.

Representative REUSS. Let's pause right there. If you did, as the Fed bragged about doing, if you did raise interest rates higher than present domestic credit conditions called for their being raised, I don't see how that is going to be redressed later on unless you go to the opposite policy which I agree would be another mistake.

You can make mistakes both ways. I really do have difficulties with God-playing in this field. Did anybody have any numbers, any figures of this or did someone just assume, dreamily, that the foreign worries about the dollar would be lessened if you started tightening money unnecessarily?

Governor WALLICH. I think foreign worries about the dollar arose from a general perception, erroneous as it is, that either we don't care about the dollar or that we positively want its value to fall.

That has led to a weakening of our currency, which I think, based on its fundamentals, is quite strong. Given this disorderly condition of the market, it seemed necessary to make clear that we do care, that we don't practice benign or malignant——

Representative REUSS. If I may interrupt, I go along with the Fed in its zeal to intervene to combat disorderly conditions. I have not objected to what you in the Treasury have done there in the last weeks. I don't think it has done any particular good because when you stop doing it the same old condition obtains, but tinkering with interest rates, that is something much different.

If you intervene all you have to lose is your shirt, a few billion dollars if you guessed wrong, you have lost quite a bit already but not as bad as France and that we can stand for, but really we cannot stand for ruining the domestic economy just because somebody thinks that it will make a few foreign bankers happy.

Governor WALLICH. Let's keep the magnitudes of this action in sight. If the economy were in such a delicate condition that a half of a point increase in the discount rate could mean the difference between up or down—I would not do it.

Representative REUSS. The Wharton School says it means 250,000 men and women now working thrust out in the street. I don't think you consider that a jolly conclusion to your afternoon's work.

Governor WALLICH. I do not see consequences of that magnitude resulting from this action.

Interest rates will rise over the course of the expansion, particularly if it is accompanied by a rising government deficit. The only question is when will it happen. Will it happen in January, will it happen in April, will it happen in July?

All the Federal Reserve can do to interest rates is to change, slightly, the timing of interest rate movements. Attempting to do only more than that would likely be counterproductive. An effort to hold down rates ultimately leads to more inflation and higher interest rates.

Representative REUSS. I would just sum up by expressing my deep diagreement with what the Fed is doing. My earnest hope that you cease, desist and quit before you ruin the economy, and my opinion that you are all proceeding in this in a very amateurish way without use of any numbers which really ought to be looked at before you embark upon bringing interest rates to a higher level before the economy does so.

So, note my lack of enthusiasm.

Governor WALLICH. I note your lack of enthusiasm, Congressman Reuss.

I hope you have noted my arguments. This was not an easy decision to make.

Representative REUSS. I am encouraged by that as one can always retract a decision which wasn't easy to make and which on reflection appears not to have been the best one.

Representative MOORHEAD. Senator McGovern, do you want to be recognized now or after the other witnesses finish?

Senator MCGOVERN. Either way.

Representative MOORHEAD. I thought maybe we would hear from all the witnesses. If you have to leave, please interrupt at any time.

We would like to hear from you now, Mr. Oswald. I presume you may have some dissenting voice in this discussion.

STATEMENT OF RUDY OSWALD, RESEARCH DIRECTOR, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS

Mr. OSWALD. Congressman Moorhead, I would ask that my prepared statement be inserted in the record. I would like to do two things. One is to highlight some of those issues that we have in our prepared statement and comment on some of Mr. Wallich's proposals in terms of TIP.

Representative MOORHEAD. Without objection, your prepared statement, together with the appendixes thereto, will be made a part of the record at the end of your oral statement.

Mr. OSWALD. Thank you, Mr. Chairman.

I would like to talk about five things in terms of the President's Economic Report and emphasize a few of those things items.

First of all, in terms of the employment policies in the President's Economic Report, we are happy to see the support of the Humphrey-Hawkins bill and its emphasis in terms of making full employment full national policy and its implication that we will get to the reduction of unemployment to full employment levels over a 5-year period, not before.

We are disappointed, however, in the projections of CEA that unemployment will be reduced to only 5.9 percent in 1979. We feel that is much too high a rate and if we put it in perspective that rate of 5.9 percent is a higher rate of unemployment than we have had at any time in the postwar period except for the recession years of 1949, 1958, and 1961, and, of course, the last 3 disastrous years. Except for that, we have not experienced 5.9 percent unemployment and the connotation is that somehow it is an acceptable level in 1979.

We think that is just untrue. Furthermore, if we look at the black unemployment experience in the past year, there has been no improvement at all in the black unemployment level between January 1977 and January of 1978.

As a matter of fact, the unemployment rate for black teenagers has gotten worse in that past year period. Yes, there have been improvements in employment during the past year but no decrease in black unemployment in the past year, and I think that is a serious question that needs addressing by the Congress.

Third, our expansion of employment has been quite mixed, and in my appendix to the prepared statement, appendix III, we have attached a table that shows, I think, part of our concern. If you look at a longer time period in terms of the change of employment, between December of 1973 and December of 1977, while there was a total increase in terms of employees on nonagricultural payrolls of some 5.4 million workers, practically all of that increase took place in what is the service sector, but worse is that we actually had a decrease in manufacturing employment of nearly a half a million workers, so that now, almost 3 years since the recession low point, we still have a half million fewer manufacturing workers than we did prior to the downturn.

We have over 100,000 fewer construction workers. This is a seasonally adjusted data and it is December to December so the adjustment factors somewhat are relatively equal. The emphasis is that on the goods-producing side we haven't recovered and we still have recessionary problems.

I would like to take a minute or two also to talk about the relatively slow rate of economic growth that is projected in the President's CEA report where is proposes real growth next year of 4½ to 5 percent for the next 2 years.

This basically will not have any substantial impact in reducing the unemployment rate and is shown by the very low change in terms of the unemployment rate that are projected over the next 2 years, a half percentage point.

I think our concern is in terms that this very slow rate of growth takes place at a time when we still have very high rates of unused capacity, both in terms of manpower and in terms of industrial materials.

As you know, industrial utilization was running at the fourth quarter at less than 83 percent, 5 percentage points below the prerecession peak and 9 points below the 1966 peak levels. So that there is plenty of capacity to grow at a faster rate wtihout having severe pressures in terms of inflation, which brings me to say that I have serious problems accepting the notion of an underlying rate of inflation of 6 percent.

If we look at the history of 1974 to 1977, we find that the inflation rates have really come down from a 12-percent rate at the end of 1974 to a 7-percent rate at the end of 1975, to a 4.8-percent rate at the end of 1976 before bouncing back up to 6.8-percent rate at the end of 1977. But even in 1977, if we look at the rate of inflation during the first half of the year, it was in a 9 to 10 percent rate and in the second half of the year the inflation rate was only 4.4 percent, or if you look at particular items over the past year, food prices went up 8 percent but apparel prices only went up 3.6 percent and appliances, radio and TV prices went up 2.1 percent.

Used car prices fell 4.1 percent. There are big variations in price changes. There is no single automatic 6 percent change that affects all items across the board.

In term of the President's proposal on wage deceleration, I would like to take, if I can, the committee's time to read three paragraphs from a report of President Meany commenting on Carter's economic message. They are as follows:

The President has asked labor and management to respond to requests for members of my administration to discuss with them, on an informal basis, steps that can be taken during the coming year to achieve deceleration in their industries.

The AFL-CIO and its affiliates have always been willing to meet and confer with administration officials on all matters of mutual concern and we shall continue to do so in the future.

We cannot and will not, however, support the proposition that government should define the terms and results of collective bargaining through any variation of guidelines, generalized or industry by industry.

We are concerned that the administration approach, proposing a two-year average base period for 'deceleration', appears to lead in that direction.

Wage settlements have not been the source of inflation that this country has experienced in recent years, but rather reflected and lagged behind high price levels stemming from a variety of other causes, which are not dealt with by the administration's proposed formula.

We are disappointed that the President's economic report ignored the impact of high interest rates on fueling inflation; high interest rates add to the cost of everything from a loaf of bread to servicing the national debt.

The high cost of money without any standard for allocation of credit creates housing shortages, driving up housing prices, rents, and the general level of inflation. High interest rates are also a major problem for family farmers who need help.

My prepared statement does have evidence indicating the deceleration that has taken place in wages in the last few years, and particularly during the last year, and I ask that that be noted.

Also, we talk about the other elements inflicting inflation during the past year.

The other area of the economic report that I would like to call attention to is the report that deals wtih the international economic relationships. I was disappointed in reading the report to find no emphasis whatsoever on the impact of imports on the U.S. economy.

It speaks not of the $30 billion trade deficit that Congressman Reuss spoke about but rather speaks only of the current accounts balance. Thus, in our view, it does not recognize the impact of high imports on U.S. jobs or on the export of U.S. jobs and technology.

We call attention to a series of policies and programs that the administration does recognize a little bit on page 136 of the Economic Report where it does talk about the restraints that were put into effect during the past year in terms of the orderly marketing arrangements.

That does recognize that particular imports may have disastrous results for particular industries, and I think it is this emphasis on protection for jobs that we would like to see recognized. We also believe that in terms of international economic realities that the world will benefit by overall growth in the United States and in all other economies so that there will be a sharing of abundance rather than a sharing of shortages.

My prepared statement also emphasizes in terms of policies that there needs to be a general stimulus for the economy but that it needs to be balanced between tax cuts and particularly targeted programs so that we can address the high unemployment that continues to exist among blacks and among inner-city residents and among those areas that have lost industries and jobs.

We believe that those targets must be in terms of new public works programs, in terms of public service employment, in terms of particular transportation problems to meet urban mass transit and for railroad rehabilitation, for additional concern with housing, and they are spelled forth in my prepared statement.

If I may take a few minutes to address the TIP issues that Mr. Wallich noted. I would like to, in addition to noting that he has recognized the serious administrative problems of such a policy, say that there are 10 serious problems that we have with the proposal.

First: It would put Government on the side of employers against workers because it does put a tax on employers to withstand those implicitly "greedy" employees trying to get more.

We think that is unfortunate.

Second: It does not take account of special situations that affect negotiations but puts all negotiations in one straitjacket. We don't believe that there is one Government-determined straitjacket that should affect all collective bargaining.

Third: It really denies free collective bargaining, because it has government determining income shares, rather than income shares being determined through negotiations in the private sector.

Four: As I read the proposal, when it really comes down to who it would affect, it would affect only the unionized sector. There is no administrative proposal to effectuate the proposal on executives, on professionals, or on other nonunion wage changes.

Five: The guideline that is proposed is based on one-half of the change in consumer price index increase plus the change in productivity. During periods of rapid inflation, it would mean that workers would have to suffer heavily the burden of inflation as part of Government policy.

Six: It assumes that labor costs are purely wage-related, that labor costs are not dependent on levels of output which influence productivity, and that it is not purely a wage change related involvement.

Seven: The proposal would restrict bargaining in industries that have high productivity changes from using some of those gains from high productivity to protect against worker displacement, and it is particularly in those industries that had high increases in productivity that one would anticipate worker displacement, and we would normally attempt to negotiate some of the elements not in terms of wage changes but in worker protections against layoffs.

Eight: The proposal has no control over the other sources of incomes such as dividends, profits, rents, interests or other types of income receipts.

Nine: The proposal that might take place sometime on profit increases ignores large profits in certain industries or firms. For example, the big increases in profits in the last few years in oil and coal are not fully reflective in the share of GNP that is reported for profits, and yet those would not be affected, but individual workers wage changes would be affected under the proposed guidelines, nor would particular companies such as General Motors that reported yesterday for $3½ billion in profits be affected by the type of profit guideline that eventually might be considered.

Ten: I think the proposal assumes that prices are solely labor related, and while the emphasis is in terms of effecutating, I assume. consumer prices, it ignores that retail prices particularly have a wide variety of markup and are not really immediately very sensitive to changes in labor or wage changes.

I set forth these 10 elements to indicate that there are very serious problems with the proposal that Mr. Wallich has set forth, and I think that Congress should consider these very deeply.

Thank you, Congressman Moorhead.

[The prepared statement, together with appendixes, of Mr. Oswald follows:]

Prepared Statement of Rudy Oswald

Mr. Chairman, my name is Rudy Oswald. I am Director of Research for the AFL–CIO. I appreciate this opportunity to present the views of the AFL–CIO on the current economic situation and on the President's Economic Report.

On January 20, 1978 President Meany made the following comment on President Carter's Economic Report to the Congress:

"The President's report is forthright and candid and we especially commend his commitment to the Humphrey-Hawkins full employment bill. We share his concerns for a strong economic recovery, a simpler and fairer tax system, and for measures to deal with the special problems of the disadvantaged and the unemployed.

"We certainly agree that inflation must be contained and reduced and we applaud the President's rejection of advice to tamper with collective bargaining through wage-price controls. Guidelines, in any form, are, of course, a step down the road toward controls.

"Negotiated wage increases have barely kept pace with inflation caused by events and actions that had nothing to do with wages—such as huge increases in the price of energy, interest rates, food, housing and the continuing inflationary pressures that result from the economic waste created by unemployed workers and idle productive capacity.

"The President has asked labor and management to "respond to requests for members of my Administration to discuss with them, on an informal basis, steps that can be taken during the coming year to achieve deceleration in their industries."

The AFL–CIO and its affiliates have always been willing to meet and confer with administration officials on all matters of mutual concern and we shall continue to do so in the future.

"We cannot and will not, however, support the proposition that government should define the terms and results of collective bargaining through any variation of guidelines, generalized or industry by industry. We are concerned that the Administration approach, proposing a two-year average base period for "deceleration," appears to lead in that direction.

"Wage settlements have not been the source of the inflation that this country has experienced in recent years, but rather reflected and lagged behind high price levels stemming from a variety of other causes, which are not dealt with by the Administration's proposed formula.

"We were disappointed that the President's Economic Report ignored the impact of high interest rates on fueling inflation. High interest rates add to the cost of everything from a loaf of bread to servicing the national debt. The high cost of money, without any standards for allocation of credit, creates housing shortages, driving up housing prices, rents, and the general level of inflation. High interest rates are also a major problem for family farmers, who need help.

"The AFL–CIO Executive Council, at its regular meeting next month, will review and comment in detail on the specific measures the President proposes. There are, however, some key areas which warrant immediate comment:

"1. The President's intention to rely almost exclusively on tax cuts to stimulate the economy is not sound. The proposed individual income tax cut will only prevent a drag on the economy from new Social Security and energy taxes. The proposed business tax cuts will do little to create jobs or help expand the economy and are an unnecessary diversion of needed federal funds that should be used for essential job-creating programs, targeted to the areas of high unemployment and to the crisis-ridden urban centers.

"2. We are concerned about the President's apparent intent to hold the federal pay raise, due next October, to some artificial figure as an example to other employers. Federal workers' raises always lag behind the private sector under the comparability law. Federal workers must not again be made the sacrificial scapegoats as they were during the Nixon Administration.

"3. The President's discussion of international economic policies implies that most of the nation's problems in this area stem from energy imports. This is only partially correct. Equally dangerous to a healthy American economy are the unregulated flood of imports and the continuing export of American jobs, production and technology. Stronger actions than those proposed by the President are essential."

As President Meany noted, the AFL–CIO Executive Council will be meeting later this month and will be commenting in detail on President Carter's specific proposals. However, we believe it is appropriate at this time to state our concern about President Carter's targets for economic growth and for unemployment in 1978 and 1979.

President Carter proposed growth in real output by 4½ to 5 percent in both 1978 and 1979 and he called for reducing unemployment by about one-half of one percentage point each year to reach an unemployment level of 5½ to 6 percent by late 1979.

We believe the economic growth that the President is proposing is too far below the nation's economic potential and we believe the rate of reduction in unemployment that he seeks is far too low. As a result, the unemployment target that he is proposing for the end of 1979 is far too high.

This nation must aspire to a much faster timetable and a more ambitious set of goals in the fight against unemployment and the lost income, lost production, waste and human misery that accompanies high levels of joblessness.

The AFL–CIO is also deeply concerned about inflation. Rising costs of energy, food, health care and housing continue to hold down living standards.

But it is important to bear in mind that these price increases were not caused by excessive demand for goods, by federal deficits, by shortages of workers, and certainly *not* by excessive wage increases.

In fact, a Bureau of Labor Statistics release of January 27, 1978 on major collective bargaining settlements in 1977 show the 1977 settlements were *lower* than the 1976 settlements.

The release says "Wage-rate adjustments negotiated during 1977 averaged 7.9 percent for the first contract year and 5.8 percent annually over the life of the contract, compared with 8.4 percent (first year) and 6.4 percent (over the life) in 1976."

Although settlements covering 5,000 or more workers were up from 8.5 percent to 9.5 percent on first year adjustments, the average over the life of these bigger coverage contracts was down from 6.6 to 6.2 percent.

The total "effective wage rate adjustment"—including current settlements and prior settlements and cost of living escalator adjustments—was *down* from 8.1 percent in 1976 to 7.8 percent in 1977.

I am including in my prepared statement a table which shows how union wage increases have slowed in recent years.

The major causes of continuing inflation have been the rising prices of food, fuel, health care and interest rates. Aggravating this situation has been the slowdown in the rate of productivity growth which results for recession and lagging economy recovery.

Working people and their families are among inflation's chief victims. Inflation can only be contained through measures tailored to its specific causes. The foundation of an anti-inflation program must be full employment and full production that will produce a balanced economy and reduce inflationary pressures by eliminating waste and inefficiency from under-utilized plant and equipment and an underemployed workforce.

The American economy is still operating far below its potential. Millions of American workers and their families continue to suffer hardship and tragedy as a result of persistently high unemployment. Minorities and inner city residents are especially hard hit by unemployment.

Lagging economic recovery in the wake of the 1973-75 recession and slow economic growth have left a huge backlog of jobless workers and have made it harder for new workers to find jobs.

High unemployment causes serious social problems and enormous economic losses—inadequate consumer buying power, low utilization of the nation's productive capacity, lagging private investment, and loss of public revenue. Low level utilization of the nation's human resources and plant and equipment means waste and inefficiency and added pressures on costs and prices that further restrain economic growth.

High interest rates and tight money policies of the Federal Reserve have also contributed to slow economic growth and continuing high unemployment. And the nation's international trade and investment policies have spurred the outflow of U.S. jobs, technology, and capital.

The nation's economy is operating at approximately $100 billion below its potential. That represents an annual loss in goods and services amounting to nearly $500 for each American. In the fourth quarter of 1977, according to the latest Federal Reserve Board estimates, capacity utilization in the nation's manufacturing industries was only 82.8 percent—5 percentage points below levels attained prior to the 1973-75 recession and 9 points below 1966 peak levels. In industrial materials industries, capacity utilization rates at 82.3 percent in the fourth quarter were almost 11 points below pre-recession peaks.

And unemployment—in spite of recent improvements and attempts to redefine the statistics—is still intolerably high in the aggregate and at depression levels for certain groups and people and for certain areas of the country. In fact, during the past year, black unemployment has not improved. It was 12.6 percent in January 1977 and it was 12.7 percent in January 1978. For black teenagers the rate of unemployment actually increased from 36.2 percent in January 1977 to 38.7 percent in January 1978. And in cities like San Francisco and New York City unemployment rates are over 7 percent.

These high levels of unemployment represent a drag on purchasing power generally and a major barrier to increased confidence in the economy. Business sales and profits suffer from high unemployment and lower consumer buying power.

The exceptionally high jobless levels in the nation's innercities add to economic waste, idle capacity, and the many other deterrents to investment—public as well as private—associated with unemployment, poverty, crime, deterioration and abandonment of private and public facilities.

We recognize that the private sector is the primary source of jobs in the American economy. That is why we want a healthy, expanding economy with full opportunity for private business growth and expansion—with opportunity for private business profits resulting from a healthy growth in the buying power of American consumers. This is the purpose of income tax cuts for low and middle-income people—to put more buying power in the hands of America's families.

The right kind of federal tax policies, the right kind of federal spending programs, the right kind of money-supply and interest-rate policies will create the right kind of climate for growth of jobs in the private business sector.

But the right kind of stimulus to private sector job creation is *not* tax give-aways and tax incentives to private business. The Carter Administration's proposed business tax cuts will do little or nothing to create jobs or to expand the economy. They are an unnecessary and misguided diversion of federal funds that should be used for essential job-creating programs, targeted to the areas of high unemployment and to crisis-ridden central cities.

The AFL–CIO will be asking Congress in its budget deliberations and legislation actions to reject proposals for business tax cuts, to weigh the individual income tax reductions more toward low and middle income groups, to enact some reforms especially affecting the taxation of foreign source income and to recommend new or added programs and funds in the following areas:

A new federally aided public works program targeted specifically to remedy major deficiencies in the public facilities of older cities with high unemployment should be enacted. Such a program would increase employment and enhance the liveability of the cities as well as increase the potential for efficient operation of private enterprise.

A separately funded program of "soft" public works is needed to provide jobs for youth and long-term adult unemployed and also help to conserve energy and rehabilitate older buildings.

The Public Service Employment program should be extended to provide substantially more job-training slots than the present 725,000 level. The money should be authorized and appropriated in a timely fashion so that the higher levels can be reached early in fiscal 1979.

Additional funds are needed for urban mass transit, railroad revitalization and rehabilitation, and other job-creating, service-improving transportation programs, including improvement of transportation along the Northeast corridor. Such needed programs would create jobs, and, at the same time, improve transportation service and conserve energy.

We recognize the existence of mass transit and railroad development programs under Administration proposals and under the Railroad Revitalization and Regulatory Reform Act of 1976, but we believe more funds are urgently needed. We also believe that more funds are needed for replacement and repair of dilapidated, deteriorating bridges for rural and urban needs.

Housing programs must be enlarged and there is a particularly urgent need for additional tandem plan support for non-subsidized, non-luxury rental housing, which is in very short supply. Such supply shortages are a major factor in driving up housing prices and rents which in turn contribute to overall inflation.

Under the Youth Employment and Demonstration Projects Act of 1977, some 200,000 jobs-and-training slots for young people have been opened up at a cost of about $1 billion. Congress authorized another $500 million for youth programs in fiscal 1978 under this law, so that, if this additional money is made available by a fiscal 1978 supplemental appropriation, the youth jobs-training slots level could rise to 300,000 in 1978.

We also urge establishment of an Urban Development Bank which would guarantee loans to enterprises that would retain or expand employment in designated cities with high unemployment.

The counter-cyclical fiscal assistance program should be continued for at least another year. This program enacted as part of the Public Works Employment Act of 1976 and extended in 1977 to cover F.Y. 78, provides funds to state and local governments to help maintain basic services.

The measures we propose will entail a higher level of spending than the Administration proposed $500.2 billion and a somewhat higher deficit than the $60.6 billion anticipated by the Administration. By adding funds to programs that efficiently and directly meet problems, those problems will be addressed now—rather than allowed to fester and grow. Unemployment must be reduced faster than the Administration's timetable. Only twice in the post-war period prior to 1975 has unemployment exceeded 5.9 percent—the Administration's target for 1979. This recession level of unemployment must be reduced quickly—not explained away or accepted as something the nation must live with.

The fact is that full employment and the efficiency and increased productivity that comes about through operating at high levels of capacity is a pre-condition for price stability.

The big federal deficits in recent years are *not* the cause but rather the *result* of the nation's economic problems. Every one percent of the unemployment rate costs the federal government some $15-20 billion in lost tax revenues and extra unemployment and welfare costs.

Budget deficits are not inflationary when there is substantial slack in the economy. Rather deficits that come through intelligent planning dampen inflation as they help raise production to more efficient levels, and the economy is not saddled with the costs of unused plant and equipment, and unemployed manpower. Federal programs can also help reduce inflation by meeting supply inadequacies as in housing and energy and by expanding needed public facilities.

America will be much better served, the budgetary position of the federal government will improve much faster and inflationary pressures will be dampened if the Congress focuses its attention on programs that are directly responsive to the job needs of the nation.

America needs more jobs—in spite of the 4.1 million increase in employment in 1977.

In the past four years, non-farm payroll jobs increased by 5.4 million. This gain was mainly in services, state and local government, and retail trade.

Meanwhile, the goods-producing sectors are still in a depression. Construction employment is down 107,000. Manufacturing employment is down 493,000, reflecting a decline in many of the major manufacturing sectors, particularly steel, electrical equipment, transportation equipment, and apparel. And employment in transportation and utilities is down by 17,000.

The big employment gains were 2.4 million in the service industries, 1.4 million in state and local government and 1.7 million in wholesale and retail trade. There were smaller job gains in mining, finance, insurance and real estate, and in the federal sector.

I have attached to my prepared statement a table, "Employment on Nonagricultural Payrolls, by Industry" which shows December 1973 to December 1977 employment changes, and I request that this table be included in the record.

Let us note also that the so-called "trade-off" theory—the immoral theory that you have to fight inflation by creating unemployment—has been thoroughly discredited by the experience of the last nine years.

The inflation that accompanied the 1969-70 recession and the inflation that accompanied the 1973-75 recession and the inflation that has persisted in recent years has not been diminished by high unemployment.

The "trade-off" theory simply is not true. In 1952-55 unemployment as officially reported averaged 4.0 percent and the average annual increase in consumer prices was only 0.3 percent and was actually minus 0.2 for wholesale prices. In the years 1958–66 unemployment was reduced from 6.8 percent to 3.8 percent while the average annual rate of increase in consumer prices was only 1.5 percent and only 0.7 percent for wholesale prices.

We reject the idea that there is an "underlying rate of inflation." Inflation as measured by Consumer Price Index changes came down from 12 percent in 1974 to 7 percent in 1975—and down again to 4.8 percent in 1976 before bouncing back up to 6.8 percent in 1977.

The latest report on the Consumer Price Index shows an 8 percent rise in food prices but only a 3.6 percent rise in apparel commodities. And it shows a 10.4 percent rise in fuel oil and coal prices but only a 2.1 percent rise in appliances, radio and TV prices and an actual decline of 4.1 percent in used car prices.

The important point is that overall price changes reflects a wide range of price changes for specific items. It is nonsense to talk about a so-called "natural rate of inflation" or an "underlying rate of inflation."

We are shocked by the persistent effort of some economists—including some Administration economists—to adjust and manipulate employment and unemployment data to produce some psuedo-scientific theory of a so-called "non-inflationary natural rate of unemployment" or a so-called "high employment rate of unemployment."

They are playing upon fear of inflation to weaken the nation's commitment to full employment.

What they are saying, in effect, is that labor force changes—more women, more youth, more minority workers—mean we should tolerate higher rates of unemployment to avoid inflation—without ever proving that higher rates of unemployment actually do avoid inflation. This is unconscionable downgrading of the basic human dignity and economic needs of women, youth, and minorities. We reject this view and we believe the Congress rejects this view.

In fact, we want to point out that while the AFL-CIO is accused of fighting only for jobs for white males in the private sector, it is some academic and Administration economists who promote this policy—a policy we strenuously oppose.

No matter how this psuedo-scientific theory of high-level unemployment is dressed up in fancy language and formulas and charts, it is still a wrong-headed prescription aimed at minimizing and tolerating high-level unemployment. It deliberately ignores the nation's potential for full employment without inflation—a potential which can be achieved by balanced, healthy growth in the private sector supported by effective public fiscal, monetary, employment and training policies.

INTERNATIONAL TRADE

The international section of the Economic Report does not include any comprehensive discussion of the world economy or the serious impact of international trade on the U.S. economy.

Instead, the chapter on "The World Economy—a Hesitant Recovery" includes vague and self-contradictory theoretical discussions of the recent history of world economic changes—leaving out the less developed countries and the communist countries. There is little discussion of how these rapidly expanding economic powers are affecting either the world or the United States.

Nor is there an analysis of the mounting impact of imports on the U.S. economy. There is no recognition of the export of U.S. jobs and technology. Instead, the report states that the "Administration remains committed to a policy of open markets for both U.S. exports and imports."

This is a head-in-the-sands policy in view of the realities of the trading world of the 1970s. The discussion of OPEC and the inflationary results of the oil embargo directly contradict the concept of an "open" world economy. The discussion of commodity agreements, needed imports restrictions and other Administration programs also contradict this concept of open markets.

Most of the chapter presents European views published by the Organization for Economic Cooperation and Development, rather than an analysis of the United States economic position even vis-a-vis those countries. the emphasis on monetary policy for the OECD countries ignores the real world in which the U.S. and world economy are developing.

We believe the Congress and the Administration should adopt and pursue an international economic policy that will stop the destruction and export of American jobs and the undermining of the nation's industrial base. This means regulation of the export of American technology and capital, eliminating tax and other incentives that encourage U.S. companies to establish and expand their operations in foreign countries, and curbing the flood of imported goods and components that displace U.S. production.

Mr. Chairman, we appreciate this opportunity to present some of the concerns of the AFL-CIO about the President's economic report and the current economic situation. I respectfully request that additional tables and AFL-CIO convention resolutions be included in the record of these hearings. Thank you.

Appendix I. Wage Changes Under Major Union Contracts (1,000 or More Workers)

WAGE CHANGES UNDER CONTRACTS NEGOTIATED IN RESPECTIVE YEARS 1973–77

	1973	1974	1975	1976	1977 [1]
Workers covered (millions)	5.3	5.1	2.9	4.0	3.3
Wages (all industries):					
1st year changes (percent)	5.5	9.8	10.2	8.4	7.4
With escalator	5.2	9.5	12.2	8.4	8.1
Without escalator	5.8	10.2	9.1	8.3	7.4
Construction	5.5	11.0	8.0	6.1	6.5
Over life of agreement	5.2	7.3	7.8	6.4	5.8
With escalator	4.6	6.1	7.1	5.7	5.0
Without escalator	5.5	9.1	8.3	7.3	6.9
Construction	4.6	9.6	7.5	6.2	6.4
Changes in consumer prices (year end to year end) (percent)	8.8	12.2	7.0	4.8	[2] 6.7

[1] Totals for first 9 mo.
[2] Percentage for November.

Source: Bureau of Labor Statistics.

DEFERRED WAGE CHANGES SCHEDULED FOR RESPECTIVE YEARS UNDER PREVIOUSLY NEGOTIATED CONTRACTS, 1974–78

	1974	1975	1976	1977	1978
Workers (millions)	5.4	7.2	5.5	4.5	6.3
Mean percent wage increase	5.2	5.1	5.4	5.9	5.1
With escalator clauses	4.5	4.4	4.2	5.1	4.3
Workers with escalator reviews	4.0	4.6	3.4	3.7	4.5
Without escalator clauses	5.4	6.5	7.5	6.8	6.8

Source: Bureau of Labor Statistics.

Appendix II

CHANGES IN AVERAGE HOURLY EARNINGS AND COMPENSATION, 1973-77

	1973	1974	1975	1976	1977
Average hourly earnings:					
Production of nonsupervisory workers: Total private nonfarm	$3.92	$4.22	$4.54	$4.87	[1] $5.39
Adjusted hourly earnings index	146.5	158.5	172.5	185.0	[1] 203.5
Percent change from year earlier:					
Current dollars	6.4	8.2	8.8	7.3	7.3
1967 dollars	.2	−2.5	−.3	1.4	[2] 1.1
Average hourly compensation: All persons, private business sector (4th quarter to 4th quarter change) (percent)	9.1	8.8	8.1	9.8	[3] 8.7

[1] For November.
[2] For October.
[3] For 3rd quarter.

Source: Bureau of Labor Statistics.

APPENDIX III

[In thousands]

Industry	December 1973 [1]	December 1977 [1]	Difference in December 1973 and December 1977
EMPLOYEES ON NONAGRICULTURAL PAYROLLS, BY INDUSTRY			
Mining	666	713	+47
Construction	4,071	3,964	−107
Manufacturing	20,369	19,876	−493
Transportation and utilities	4,677	4,660	−17
Wholesale and retail trade	16,858	18,511	+1,653
Finance, insurance and real estate	4,153	4,618	+465
Service	13,310	15,676	+2,366
Government	13,938	15,421	+1,483
Federal	2,680	2,722	+42
State	11,258	12,699	+1,441
Total—all nonagricultural industries	78,042	83,439	+5,379
BREAKDOWN OF MANUFACTURING EMPLOYMENT			
Manufacturing	20,369	19,876	−493
Durable goods	12,096	11,746	−350
Ordnance and accessories	177	153	−24
Lumber and wood products	651	663	+12
Furniture and fixtures	537	529	−8
Stone, clay and glass products	708	669	−39
Primary metal industries	1,359	1,212	−147
Fabricated metal productions	1,535	1,495	−40
Machinery, except electrical	2,176	2,252	+76
Electrical equipment and supplies	2,083	1,993	−90
Transportation equipment	1,900	1,821	−79
Instruments and related products	512	535	+23
Miscellaneous manufacturing industries	458	424	−34
Nondurable goods	8,273	8,130	−143
Food and kindred products	1,736	1,708	−28
Tobacco manufactures	81	67	−14
Textile mill products	1,027	993	−34
Apparel and other textile products	1,395	129.6	−99
Paper and allied products	706	709	+3
Printing and publishing	1,111	1,125	+14
Chemicals and allied products	1,045	1,065	+20
Petroleum and coal products	198	213	+15
Rubber and plastics products	687	690	+3
Leather and leather products	287	264	−23

[1] All data are seasonally adjusted.

Source: U.S. Department of Labor, Bureau of Labor Statistics.
Prepared by AFL-CIO research department.

APPENDIX IV

(As Adopted by the 12th Constitutional Convention—December 1977)

RESOLUTION NO. 125—NATIONAL ECONOMY

The American economy is still operating far below its potential. Millions of American workers and their families suffer hardship and tragedy as a result of persistently high unemployment, with minorities and inner city residents especially hard hit.

Lagging economic recovery in the wake of the 1973-75 recession and slow economic growth have left a huge backlog of jobless workers and have made it harder for new workers to find jobs. Unemployment is an intolerable affront to human dignity and a tragic commentary on the nation's economic policy.

High unemployment causes serious social problems and enourmous economic losses—inadequate consumer buying power, low utilization of the nation's productive capacity, lagging private investment and loss of public revenue. Low level utilization of the nation's human resources and plant and equipment means waste, inefficiency and added pressures on costs and prices that further restrain economic growth.

High interest rates and tight money policies of the Federal Reserve also contribute to slow economic growth and continuing high unemployment. And the nation's international trade and investment policies have spurred the outflow of U.S. jobs, technology and capital.

Tax justice is essential to assure a fair distribution of the costs of needed government programs as well as to assure sufficient revenue to pay for these programs.

An excessive pre-occupation with federal deficits and balanced budgets to justify restraining needed government programs ignores the crucial role of government spending in creating jobs, income and public services and facilities. In fact, the federal deficits of recent years reflect the lost tax revenues resulting from high levels of unemployment, recession and lagging economic growth. According to the Congressional Budget Office, each one percent reduction in the unemployment rate would cut the budget deficit by about $19.5 billion. $15 billion in added tax receipts and $4.5 billion in lower unemployment-related social welfare costs.

The fundamental source of strength of the American economy is the American people, their productive potential, standard of living, widely distributed consumer buying power and aspirations for a better life for themselves and their children.

However, the nation's experience over the last nine years—with back-to-back recessions in 1969-70 and 1973-75, both followed by weak, faltering, and inadequate recovery periods—indicates that decisive, substantial and sustained government action is essential to achieve healthy economic growth and full employment.

Therefore, the AFL-CIO urges the following measures:

1. The nation must make full employment its primary goal in economic policy matters. A national commitment to full employment—as set forth in the Humphrey-Hawkins Full Employment and Balanced Economic Growth Act—is essential. Federal taxing, spending and monetary policies must be planned and coordinated to encourage rapid economic growth to achieve and sustain a fully employed economy. The government must be the employer of last resort for those who cannot find jobs elsewhere.

2. Direct government programs are required to provide jobs for millions of unemployed people and meet needs for public services and public facilities. Expansion of public works programs will generate needed jobs directly in the construction industry as well as in industries engaged in the production and distribution of building materials and supplies. Major public works projects must be undertaken to modernize the nation's railroads, meet urban transportation needs, environmental concerns, energy development and other domestic concerns.

The existing accelerated public works program, which helps local communities finance smaller public construction projects and needed repairs and rehabilitation of public facilities, should be expanded by at least $5 billion. Public service employment programs should be greatly enlarged to create jobs for the unemployed and to meet public needs for additional services.

3. Job creation programs must be directed particularly towards meeting the problems of minorities and inner city residents. Such targeted employment stimulation can be best achieved through direct programs tailored sepcifically to the needs of such workers rather than through tax cuts. Each dollar of federal funds used on direct government employment programs has two to four times more job-creating potential than a dollar of tax cuts, and these funds can be directed to the areas and individuals where the need is greatest.

4. Equal access to job opportunities must be assured to every worker. All employers must be required to list job openings with the public employment service or a referral hiring hall that assures equal access without regard to race, creed or color. The U.S. Employment Service should be made an effective program for job placements.

5. Illegal immigration must be stopped. Employers who hire illegal aliens and those who traffic in transporting and placing illegal immigrants should be subject to stiff penalties.

6. The Congress and the administration should adopt and pursue an international economic policy that will stop the destruction and export of American jobs and the undermining of the nation's industrial base. This can be achieved by regulating the export of American technology and capital, eliminating the tax and other incentives that encourage U.S. companies to establish and expand

their operations in foreign countries, and curbing the flood of imported goods and components that displace U.S. production.

7. Low interest loans are necessary to encourage expansion of the housing industry, new business investment in plant and equipment, and state and local public investment. Congress must direct the Federal Reserve to reduce interest rates on long-term and short-term loans used for these priorities and to provide enough expansion of money and credit to assure balanced economic growth.

The structure of the Federal Reserve System must be changed—through such essential actions as a yearly audit by the General Accounting Office, abolition of the banker-dominated Open Market Committee and absorption of its functions by the Board of Governors, reduction of the term of office of the governors to seven years and the chairman to four years, and extension of membership on the governing bodies and advisory committees of the entire system to representatives of major groups in the economy, including organized labor.

8. Government housing programs to help low- and middle-income families should be expanded and strengthened with funding adequate to support 500,000 units annually.

9. Countercyclical federal financial aid to state and local governments hit by high unemployment should be increased. Federal procurement and federal installations should be directed to areas of high unemployment.

10. Tax justice requires closing tax loopholes that enable big business and wealthy individuals to avoid their fair share of the tax burden and stack the tax system against wage-earners and consumers. Tax reform is needed to restore fairness and equity for workers and middle-income taxpayers.

11. Basic inflationary factors recently have been rising costs of fuel, food, health care, land costs and interest rates. Any realistic anti-inflation policy must focus on these areas and must avoid general "quick fix" wage-price controls or unwarranted restraints on government spending. Effective export controls on agricultural and other raw materials in short supply should be established and maintained until inflationary shortages are ended. Adequate stockpile reserves of agricultural goods and other raw materials should be maintained. The Council on Wage and Price Stability, an outmoded remnant of the Nixon economic era, should be abolished. The recent experience with wage and price controls is proof that controls do not work, and we will adamantly oppose any moves to directly or indirectly control the wages of American workers.

12. The nation's energy policy must aim at rapid reduction of America's dependence on imported oil. It must assure U.S. energy independence, without profit bonanzas for the giant international oil companies and with fairness and equity to America's low and middle-income workers and consumers.

13. Congress must block attempts to dismantle federal regulatory agencies that were established to protect consumers from disreputable, unfair and monopolistic business practices.

14. A full-scale congressional examination of the structure of the American economy is needed to inform the Congress and the public on such economic development as business mergers, interlocking relationships among the giant corporations and banks, their domination of key parts of the national economy, their effect on prices and America's position in the world economy, and their impact on American communities and democratic institutions. Detailed information on such factors of American economic and social life is essential for the adoption of appropriate government policies.

15. Increases in the buying power of workers' wages and salaries are a prerequisite for a balanced economy. Increases would provide workers with a share in the benefits of economic progress and establish the foundation for the needed expansion of consumer markets. A balanced economy is not possible without adequate growth of consumer markets, which account for about two-thirds of total national production. The needed rise of consumer expenditures cannot be maintained unless increases in workers' real incomes are achieved. We support union efforts to achieve such increases.

The AFL-CIO supports programs and policies that will provide jobs for all Americans, that will assure a growing standard of living for all Americans, and that will assure a more equitable distribution of the nation's income and wealth.

As 1977 ends, the economy is still in desperate trouble. Unemployment has remained at almost exactly the same high level, month in and month out. Nearly four million more jobs were created during the year, yet the percent of unemployed remains virtually unchanged.

Obviously the nation needs a major economic stimulus to break out of the morass that followed the Nixon-Burns-Ford recession.

Jobs are the answer to America's problems of unemployment and inflation. Jobs will reduce the drain on the economy caused by government payments to those unable to find work. The purchasing power that jobs will create puts the unused productive capacity of American industry back to work, thus cutting unit costs and reducing inflationary pressures.

The stimulus we believe essential to economic recovery must begin with the new year. That means the Congress must reopen the 1978 budget and structure the Fiscal 1979 budget to insure that specific programs, targeted to meet the most essential needs, will be adequately funded to insure essential job development.

We remain convinced that federal programs of investment in the future of America provide a better and more reliable form of economic stimulus than tax cuts can provide. But in early 1978, America faces a special economic problem that makes a tax cut essential. The increase in social security payroll taxes and the simultaneous increase in energy costs must be offset by individual income tax cuts in order to avoid another recession.

Therefore, we view 1978 personal tax cuts as a stabilizing factor, designed to counter a recession-breeding situation, and so support tax reductions designed to particularly benefit those in the lower and middle-income brackets. We do not view such tax cuts as a substitute for the program of economic strengthening we seek but as a necessary added stimulus to purchasing power in 1978.

We call for immediate enactment of a substantial personal tax cut for low- and moderate-income Americans.

We are convinced that businesses do not need added tax breaks to invest and expand. What is needed is customers.

Therefore, we will oppose business tax reductions that are really new loopholes such as tax relief for dividend recipients or general depreciation speed-ups which only widen existing loopholes. Instead of cutting corporate taxes, we urge the President to use federal funds to establish an Urban Development Bank to encourage new development in the nation's decaying urban centers. By earmarking funds immediately to the Urban Development Bank, the specific problems of high black and inner city unemployment can be attacked directly, thus benefiting individuals, communities and corporations at the very same time. Special funds must also be available for hard-pressed communities.

To offset the expected decline in housing construction and to accelerate new construction and major rehabilitation of units under the low-income housing programs, the Administration should release $2 billion more than currently contemplated in Tandem Plan funds which provides 7½ percent mortgage financing and should significantly reduce the minimum interest rate to be paid by low-income home buyers under the Home Ownership Assistance Program. Both actions can be taken without additional budgetary authorization.

After the economy gets stimulus from a 1978 tax cut and these programs, the momentum must be carried forward in the 1979 budget, by concentrating on programs that will create jobs directly.

Public service jobs under the Comprehensive Employment and Training Act must be vastly increased. Thus more workers, who cannot find employment in the private sector, will at least have the opportunity to work and provide needed public services.

In addition, in order to achieve employment in the private sector, and simultaneously provide needed public facilities, the Congress must approve:

1. Additional funds for urban mass transit and railroad trackbed rehabilitation. Improved public transportation, including faster and better movement of people and goods would be job-creating and energy-saving.

2. A new program for public works, targeted to remedy deficiencies in public facilities, particularly in the older urban areas. Such deficiencies are a major deterrent to attracting or retaining industry and jobs. Such funds should be used mainly for basic public capital facilities such as sewage disposal, bridges and repaving of major thoroughfares.

3. The accelerated local public works program adopted early in 1977 must be continued and expanded. The 1977 program has conclusively demonstrated the value of this job creation measure.

4. Continued initiatives must be developed and funded to reduce high youth unemployment. Particularly troublesome is the high rate of unemployment among teenage minorities.

It is our firm conviction that, unless adequate, broad and realistic programs are adopted now, there is a very real danger of a new economic downturn that will mean new hardships for American families. A tax cut that merely offsets the social security and energy tax increases, without job-creating proposals will not be enough. An additional stimulus program, along the lines of the AFL-CIO proposals, will not only prevent disaster but will insure that this nation will finally be on the road toward full employment.

Appendix V

Housing

In order to increase housing production to a level required to meet national needs, place adequate housing within the economic reach of all families, combat inflation in housing and decrease unemployment, the AFL-CIO recommends that the Department of Housing and Urban Development should:

(1) Reduce the minimum interest rate on Section 235 assitsed home-ownership mortgages from 5 percent to the statutory minimum of 1 percent, so that more low- and moderate-income families can participate in the program.

(2) Expedite its processing of public housing project applications in order to approve the authorized maximum of 75,000 units in fiscal year 1978.

(3) Work with state and local governments to consolidate and reduce the number of reviews and clearances of site development plans required before construction can be started.

Further, we urge the Congress to:

Make 6 percent mortgage financing available for moderate-priced home purchases by families of limited income, with additional funds as may be necessary to serve such families:

Assure an adequate supply of 7½ percent financing for rental housing.

These two actions would help bring the total annual level of new housing starts plus mobile home shipments up to a level of 2½ million units. In addition, Congress should:

Authorize and appropriate the funds for an adequate, qualified staff to administer the assisted rental housing programs of HUD in a more expeditious manner in order to provide housing without undue, costly delays.

Authorize extension of the Section 312 rehabilitation loan and the HUD homesteading programs, with adequate funding, in order to encourage rehabilitation of homes owned and occupied by moderate-income families.

Appendix VI

Urban Development

The federal government can directly affect the recovery of urban areas by a commitment to use its monetary and fiscal policies to stimulate the entire economy toward full employment. Specifically, the AFL–CIO supports the following actions:

The administraiton should modify its federal procurement ans facility placement policies to more heavily concentrate federel activities in those urban areas experiencing the most serious conomic problems.

HUD should implement the community development block grant program to assure primary emphasis on activities to assist low- and moderate-income persons and neighborhoods. Cities should be required to develop and submit a comprehensive strategy for planned housing and community development particularly in low- and moderate-income areas. Future community development should be contingent on the community's successful performance toward meeting the stated housing and community development goals.

In selecting proposals for urban development action grant funding, HUD should develop guidelines to limit funding to only those projects where there is assurance of long-term employment retention or expansion upon completion of the proposed project.

To provide needed mobility for all urban residents and improve the quality of life, increased funding should be provided for public transportation to support the construction of new public transportation systems, upgrading existing systems and subsidization of low public transportation fares.

APPENDIX VII

RESOLUTION NO. 126—INTERNATIONAL TRADE

(As Adopted by the 12th AFL-CIO Constitutional Convention—December 1977)

U.S. foreign trade and investment policy must be balanced with America's need for jobs. Foreign economic policy should be geared to America's need for a strong, growing economy. The Trade Act and other legislation should be administered to assure American domestic production as well as to encourage world trade. Fair trade and reciprocal relations are basic to policies that will help America and the world.

Negotiations with other nations should be based on the needs of the U.S. economy, not political expediency. The goal must be an expansion of trade based on fairness, reciprocity and mutual benefit.

New legislation is needed to regulate exports and imports. Exports in short supply should be subject to export controls, import relief provisions must be designed to assure adequate safeguards for the U.S. economy. Tax policies need to be reviewed both in terms of equity and in terms of their impact on trade. Imports of products and parts of products should be made identifiable by clear labeling as to country of origin.

Dumping of foreign-made products in the United States must be ended. Both quick enforcement of existing law and new legislation to assure government action should be adopted.

Countervailing duty laws against imports subsidized by foreign governments should be speedily enforced and no injury test should be required for subsidized imports.

In addition to these unfair trade practices, many foreign governments control their industries and manage their economies. U.S. policy and law have not adjusted to these world changes.

Quantitative restraints on imports are, therefore essential to assure that U.S. industry can develop and remain diversified at home. Like quantitative restraints abroad, such regulations will not be designed to stop trade, but will assure imports in keeping with the nation's well-being.

New trade barriers have been added by other countries in recent years—quotas, tariffs and dumping duties. Most countries of the world have unwritten barriers to trade.

The United States has published laws, public procedures and stated policies. Against this background, negotiations to reduce tariffs are now going on. The AFL-CIO urges the Administration to insure that current negotiations and agreements protect the vital interests of American workers and industry. This means recognizing that U.S. tariffs are already low when compared to those of many other nations and that the U.S. cannot rely on the types of non-tariff barriers that are common practice abroad.

The Overseas Private Investment Corporation (OPIC), a government agency that insures private investment abroad, should therefore be terminated as soon as possible. OPIC has been insuring huge multinational banks and firms abroad and encouraging the export of American jobs.

Imports of textiles and apparel have been subject to a multifibre agreement which is due to expire at the end of this year. This agreement should be renegotiated, improved and the growth of imports should be reduced.

Trade with Communist countries should be regulated more effectively through improved administration of Title IV of the Trade Act and by additional legislation that recognizes the economic and political fact of life that private commercial interests cannot negotiate as effectively with closed and managed economics as governmental negotiators can.

Items 807 and 806.30 of the Tariff Code, which result in the export of American jobs; should be repealed.

Provisions in the Trade Act of 1974—the escape clause, provisions against unfair competitions, etc.—must be improved and enforced to help and build strong American industries and save jobs.

Imports, exports, technology transfers flows and investment must be reported in more detail, monitored and regulated. To this end, Sections 608 and 609 of the Trade Act of 1974, which require reporting of exports, imports and production, should be enforced so that comparisons can be made. The International Investment Survey Act of 1976 should also be enforced, so that foreign technology, investment and other transfers can be monitored and employment effects examined. New laws to regulate the transfer of funds, technology and investment need to be enacted.

Customs laws should be enforced with penalties assessed fairly. More, not less, customs reporting is necessary so that American trade policy can be made on the basis of fact.

Foreign grant, insurance and loan programs should be supervised in terms of U.S. interests at home as well as abroad. This means that Eximbank loans, guarantees and insurance activities should be carefully limited both in amount and in the authority to expand the action.

Title V of the Trade Act, the so-called generalized system of preferences which permits over $3 billion a year in imports without any tariffs at all for many products manufactured by cheap, foreign labor, should be repealed.

Tax loopholes and incentives for multinational companies to move abroad should be ended, the tax deferral halted, the foreign tax credit repealed and DISC abolished.

Adjustment assistance for workers must be completely overhauled to assure that workers injured by imports receive assistance. Adjustment assistance, which is essentially a welfare program, is not a solution for America's trade problems.

The Foreign Trade Zone Act of 1934 should be repealed. Any exemptions from this nation's trade laws must be proven on a case-by-case basis. The U.S. government should seek treaties to end the exploitation of workers in trade zones in foreign countries.

Codes of conduct for the operations of multinational corporations are necessary, but are no substitute for strictly enforced U.S. laws that prohibit bribery of foreign officials and participation in economic blackmail schemes designed to negate American foreign policy. Similarly, international agreements are needed to improve labor standards in those countries that seek to attract industry through the exploitation of workers.

The AFL–CIO supports healthy, fair trade that will build a strong American economy. We oppose the continued export of American jobs and industry, which has undermined the economy. We shall pursue every possible relief for the injury already sustained, as well as new legislation to halt the drain in this nation's economy.

The AFL–CIO with its affiliates will develop a coordinated, effective program for these goals. We will use all departments—legislative, education, research, public relations, publications, organization and field services—to assure protection for American workers' jobs and living standards.

Representative MOORHEAD. Senator McGovern.

Senator McGOVERN. I am glad to have an opportunity, Congressman Moorhead, to make a brief observation now, perhaps also to raise some questions following Mr. Oswald, because I wanted to say, first of all, that I agree with almost everything Mr. Oswald has stated on behalf of the AFL–CIO.

I think it is a much sounder prescription for the economic ills of the country than were being offered by the administration.

I don't want to be misunderstood on this, Congressman Moorhead. This is not a partisan matter. On the other hand, we do operate under a two-party system of Government in this country, and I think we have a right to expect when a Democratic administration wins an election that they are going to carry out a Democratic program.

I would even think that devout Republicans would expect that. What we are being offered, as I see it in the administration package, is a Republican program. That is perfectly respectable, and all Republicans ought to embrace it. But the rest of us who feel differently about it have the right, I think, to raise some questions.

I think that is what Mr. Oswald has attempted to do here. He has not done it in a partisan context, but he has pointed to certain assumptions that are ordinarily made by those who hold the Democratic view.

I have only been on this committee a short time. I am not an economist. But it seems clear to me that we do have the classic outline of what a Republican administration would do right now if they were in power. This is my first impression of this proposal.

Mr. Burns may be gone but his policies haven't changed.

Mr. Oswald said we still have the high interest rate policy. It hurts every home buyer. It hurts every municipality. It hurts every farmer, every small businessman. It is just a drag on the whole economy.

The only people that profit from it are the wealthy moneylenders.

Second: We have got, as Mr. Oswald has said, a very sluggish attitude about this unemployment question. Even if the administration's targets are reached two years from now, we will still be sitting here with 5½ or 6 percent unemployment; that is, if everything works the way they anticipate it will.

Third: We have a tax package that has the effect, if you include what we did on social security last year, of reducing the progressive tax and increasing the regressive tax. It is a $25 billion tax cut for business and individual on the income tax and a $7 billion increase on the most regressive tax we have, the payroll tax.

It is just not a fair and democratic way to approach tax policy. Beyond that we have the third public investment as Mr. Oswald's statement makes so clear here. We are not doing very much about the cities, not doing very much about the high unemployment problems in the urban areas.

We are not attacking the problems of our transportation system. In yesterday's testimony, the Director of the Budget said that one of the themes of the President's budget message is this: "We must meet critical national needs, particularly human and social ones."

It goes on to say another theme: "There is a limit to what Government can do, new priorities must be set and some old priorities must be altered."

Well, one has to ask what are the basic human and social needs that are being met in this budget message and what are the new priorities? We have to give the administration credit for the cancellation of the B-1 bomber. That is one change in priorities.

If that had not been done, there would be another $2.9 billion in the budget. But there is no indication that that saving is being diverted to what has been referred to as human and social needs.

What we have instead, as I look at the budget, is a $10 billion increase in military outlays, about 4 billion of that targeted on upgrading the American involvement in NATO, another 8,000 American troops.

I regret this as almost unbelievable. Way back in 1965, former President Eisenhower wrote an article saying that we ought to cut our ground troop involvement in NATO, that 1 division was just as good as 5 in signaling the American presence in Europe, and he recommended that we reduce that 300,000 troop level by 75 or 80 percent.

Senator Mansfield, following up on that, had about half the Senate cosponsoring a resolution a few years ago to reduce our ground forces in Europe by 50 percent. Why? What has happened since then?

Why does détente with the Soviet Union mean that we have to increase our ground forces in Western Europe at a ccst of another $4 billion or $5 billion to the American taxpayer?

Now, that is money that would contribute far more to the defense of this country if it were spent in the cities and on the farms and in our transportation areas here at home. I'd like to take this opportunity, Congressman Moorhead, to make clear that I intend to use the new budget process to affect the debate prior to the reporting of the first budget resolution on April 15. I intend to offer some transfer amendments to that budget and I hope other Congressmen and Senators have a similar plan in mind, so that we can truly do what the Budget Act says we ought to do, and that is to set some new priorities.

What I would propose is pretty much what Mr. Oswald has suggested here today, that we forget about this $25 billion tax cut, use the savings among other things to undo the damage done last year by increasing people's social security taxes by $7 billion.

We would be much better off to forgo this little tax cut that might mean $100 or $150 or $200 for each one of us and cancel out this increased payroll tax that we voted through last year.

I am glad to see that Senator Nelson and others are talking about new legislation now to undo the mistake we made last year. We really cannot hang that mistake on the administration.

President Carter did propose that we finance some of the social security increase out of general revenues. That could easily be done if he would forget about this $25 billion tax cut and make the social security system whole the way it ought to be done and that is through the general revenues that are raised in a more progressive way.

Another possibility if we had $25 billion instead of frittering it away in this discredited tricklng down theory of economic stimulus, you could do what Mr. Oswald and the AFL-CIO has proposed and that is invest that money in the areas where the country needs it.

It is needed in the cities to provide better services, to provide jobs for people who are unemployed. Part of it could go to the private sector for dealing with the problems of structural employment, part of it could go for public service jobs to improve the services in the cities, part of it could be spent on upgrading our rail lines that everybody knows are a disgrace to the country.

I don't know whether the AFL-CIO would agree with this but I think that some reductions could be made in that military budget.

Now, Mr. Oswald, in that connection, I would just like to ask you, does the AFL-CIO have any research going forward on what we can do if conditions indicate that we could reduce some of the expenditures we are now making for arms?

One of the things we always run up against is if we talk about phasing out a military system, even one that is obsolete, it throws people out of work.

Do you and your associates have any research moving forward as to alternative ways of dealing with that problem so that if we cancel some of these military projects, we could still have jobs in the civilian sector to take up the slack?

Mr. OSWALD. Many of these were related to transportation needs, some of the aircraft manufacturers, as a matter of fact, had already tried to get involved in building railroad cars or mass transit cars, some of the cars even in Washington were built by Rohr Manufacturing.

I think part of the problem is that enough planning has not been made in terms of making this sort of adjustment from military contracts to civilian needs. More can and will be done.

We have been trying to look into some of those aspects.

Senator McGOVERN. I think that is very important if SALT succeeds, and I am sure we all hope it will, that could lead to a reduction in expenditures for strategic arms systems.

If détente works, and we hope it will, maybe we can reduce some of the expenditures we are now making to get ready for another war in Europe.

If President Carter succeeds in his campaign commitment to cut down on military sales that now has the United States the No. 1 arms supplier of the world, and the President says that makes him very uncomfortable, that is going to mean we have to find other jobs for people who are producing all of this military hardware.

I would hope that the AFL–CIO would give that a very high priority because you are right on the firing line, literally, on this whole matter of changing priorities.

I have just one other point, Congressman Moorhead, and I appreciate your yielding to me at this point. We have a serious agricultural crisis in this country. We have good solid farm families that are going broke through no fault of their own.

They are trying to sell wheat at $2.20 a bushel when it costs them $3 or $3.50 to produce it. You cannot stay in business that way. So we either have to make a decision in this country, we are going to let these farm families go under—or eles we have got to respond with a stronger program.

I think some kind of provision to make direct payments to farmers, which wouldn't affect the consumer at all but would cost Federal tax money, is in order.

This tax cut is not going to help the farmers any. If you don't have any income, a tax cut doesn't mean anything. Yet these are substantial solid businessmen, farm operators who have done everything they were supposed to do to give this country a good abundant food production, and they are going broke.

We have everybody in our office and on the Senate Agricultural Committee and elsewhere working on a proposal to find some way to funnel $6 billion or $7 billion of additional income into the pockets of these farm families.

The alternative is to let the corporations take over and then we will really pay for food, we will find out the high cost of food, and we will have these farm families flocking to the cities looking for jobs that are already in short supply.

So, that is just another side of the priority coin that is totally ignored in the President's budget and in this economic report, and one that I think has to be addressed if we are going to avoid serious trouble in agriculture.

Thank you very much, Congressman Moorhead.

Representative MOORHEAD. Thank you, Senator.

The committee would now like to hear from Mr. Joseph Kasputys, vice president, Data Resources, Inc.

Mr. Kasputys.

STATEMENT OF JOSEPH E. KASPUTYS, VICE PRESIDENT, DATA RESOURCES, INC.

Mr. KASPUTYS. Thank you very much, Congressman Moorhead.

I also thank you for your kind introduction. Mr. Eckstein did ask me to send his regrets to you and to other members of the committee. Only a 30-inch snowstorm could keep him away from this forum, as I am sure you know.

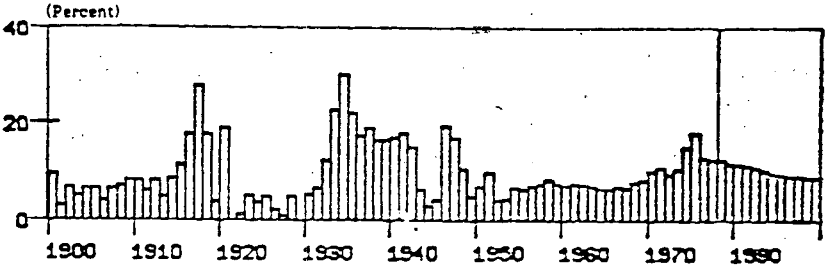
What I would like to do this morning is to present and submit for the record charts from a study which Mr. Eckstein has prepared and go through with the committee some of the conclusions from the charts. I think the best way to do that is for the members of the committee and others to look at the charts that were attached to the study entitled "Stagflation: Is There a Way Out?"

Representative MOORHEAD. Without objection, the charts will be made a part of the record at this point.

[The charts follow:]

CONSUMER WELL-BEING

"Discomfort" Index, 1900-1990

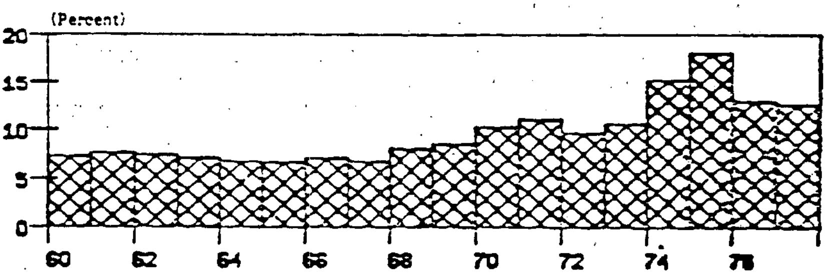


The "discomfort" index, a measure of consumer well-being, is calculated as sum of unemployment rate and inflation rate (implicit price deflator), but not less than zero.

1978-1990 based on DRI December 1977 Long-term forecast.

Data Source: History - NBER, BLS, BEA.

"Discomfort" Index, 1960-1977



THE IMPACT OF ENERGY PRICE INFLATION

The OPEC oil embargo hurt the economy in many ways, but especially through added inflation and unemployment. The table below shows the estimated effect of oil price increases on inflation, unemployment, and the "discomfort" index.

Impacts of Energy Crisis on U.S. Economy

	1974	1975	1976	1977	1978F
Energy Impacts on					
Inflation	0.4	1.1	0.0	0.4	0.7
Unemployment	0.6	1.9	1.6	1.2	0.9
Discomfort Index	1.0	3.0	1.6	1.6	1.6

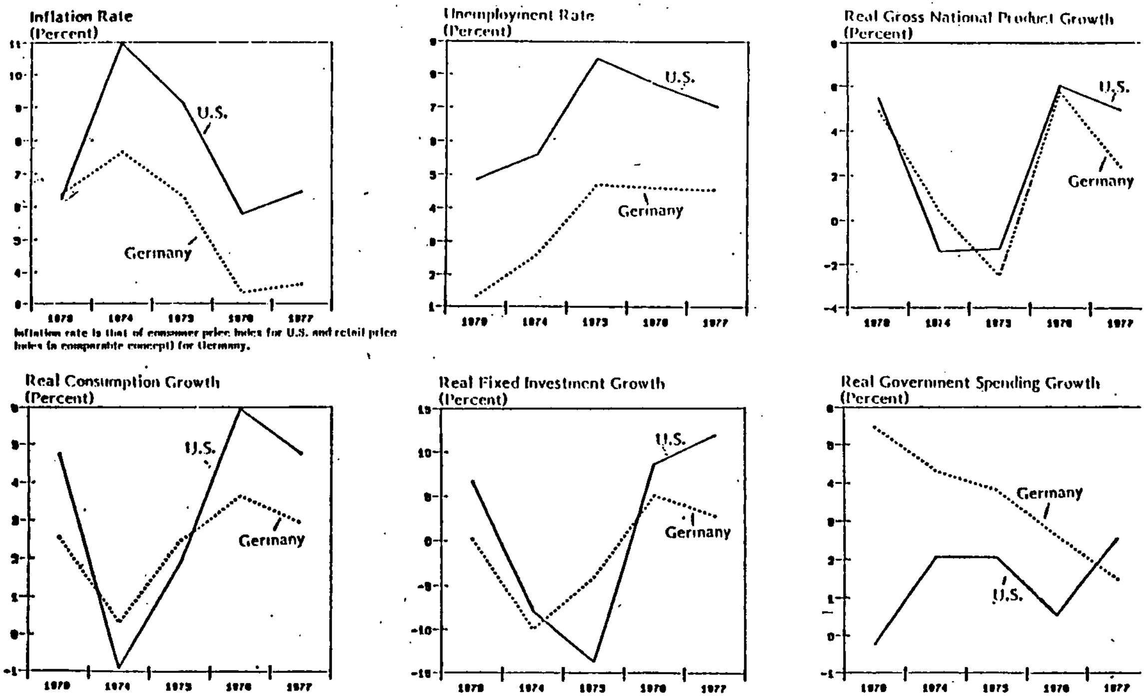
F = Forecast with compromise energy program.

The effects of lower energy price inflation were estimated through the DRI Model of the U.S. Economy. Wholesale prices for fuel and related products, and import prices for fuel, were held to 5% annual inflation rates from 1973 to 1982.

The "discomfort" index is defined as the sum of the unemployment rate and the inflation rate (implicit deflator).

RECENT INFLATIONARY EXPERIENCE AT HOME AND ABROAD

Not all world economies were as strongly hit by the recent bout of inflationary pressure as the United States. Germany, which has followed more restrictive fiscal and monetary policies, has seen inflation rates 1 to 6 percentage points lower than the U.S. since 1973.

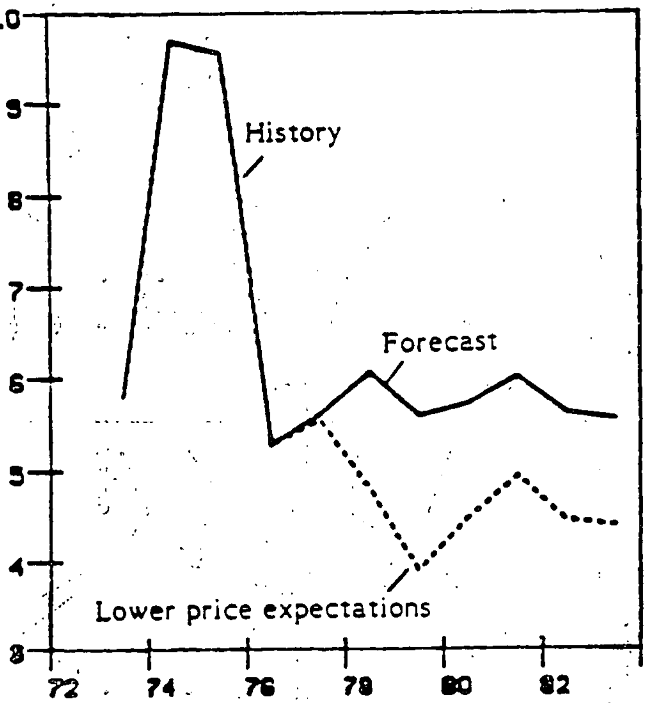


Inflation rate is that of consumer price index for U.S. and retail price index (a comparable concept) for Germany.

Source: BEA, BLS (U.S.), Statistisches Bundesamt, Deutsche Bundesbank, Bundesanstalt für Arbeit (Germany).

EFFECT OF PRICE EXPECTATIONS

Price expectations account for a significant part of inflation. This chart indicates the difference in inflation, from now through 1982, of expectations of 4% inflation, rather than the current 6 to 7%.



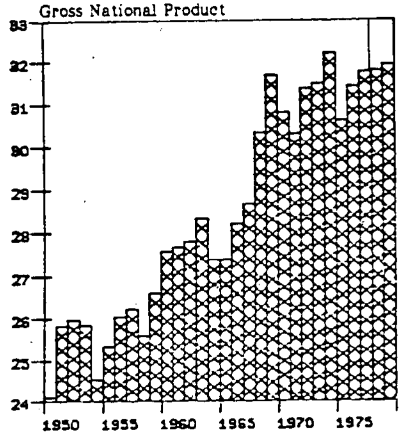
Calculated by model simulation, with 4% price expectations substituted for actual historical experience in the calculation of wage demands. The inflation rate shown is for the implicit price deflator.

Source: History - BEA; Forecast - DRI December 1977 Long-term forecast.

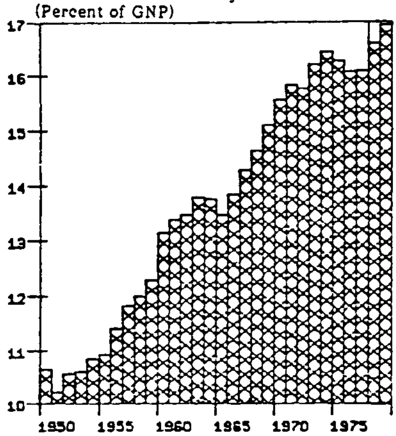
THE RISING TAX BURDEN, 1950-1979

As seen in these four charts, the overall tax burden has risen substantially since 1950. Most of the increase has occurred in the excise, property, and payroll tax categories (upper right), which have a stronger inflation impact.

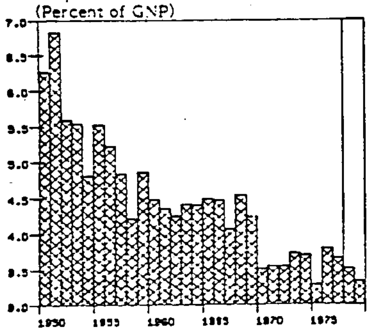
Total Taxes as a Percent of Gross National Product



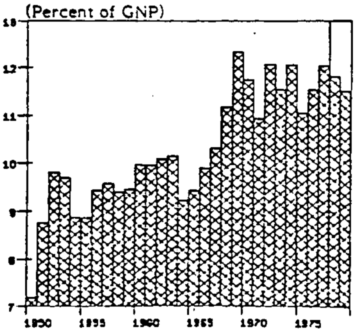
Indirect Business and Payroll Taxes (Percent of GNP)



Corporate Income Taxes (Percent of GNP)



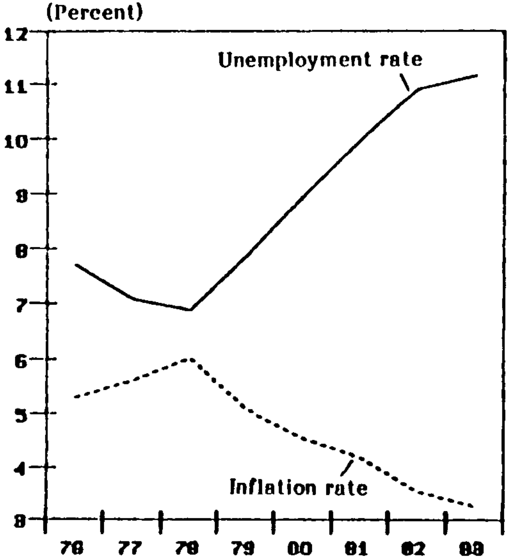
Personal Income Taxes (Percent of GNP)



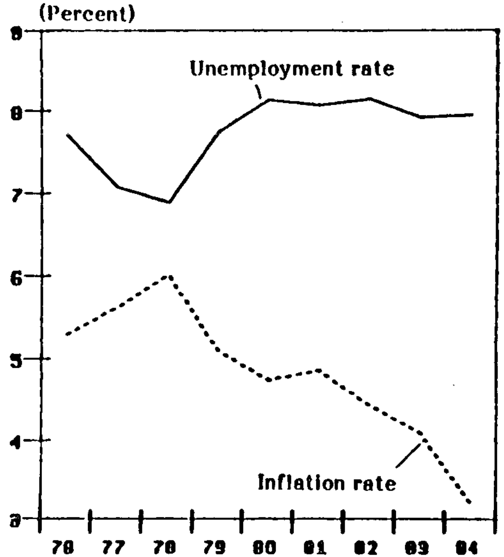
Source: History - BEA; Forecast - DRI, December 1977.

REDUCING INFLATION THROUGH UNEMPLOYMENT

Prolonged unemployment could eventually cut the inflation rate to low levels.



An unemployment rate rising at about 1 percentage point per year would cut the inflation rate (implicit price deflator) to about 3% by 1983.

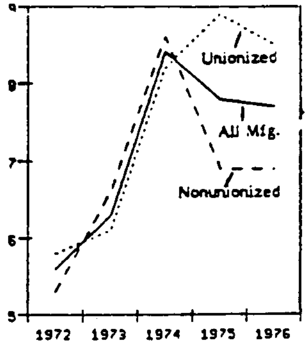


Alternatively, a policy mix which allows the unemployment to rise to 8%, and remain there indefinitely, would not see inflation reach the 3% level until 1984.

Calculated through policy studies with the DRI model.

INFLATION AND LABOR MARKET STRUCTURE

Unionized workers have been obtaining wage increases of 1 to 3% more than their nonunion counterparts. Plotted below are the wage gains (percent per year) for union and nonunion manufacturing workers, and the average for all manufacturing workers.



Source: Bureau of Labor Statistics, "Current Wage Developments."

Nevertheless, econometric analysis indicates that the reason unionized workers get larger wage gains is that they are less sensitive to unemployment, not that they recover real wages lost to inflation faster. Equations estimating wage rates from past consumer price inflation, unemployment, and price control/guideline variables indicate that both unionized and nonunionized workers recover approximately 100% of past inflation in their wage gains, but unionized workers are less than half as sensitive to unemployment.

Estimated Price and Unemployment Elasticities for Heavily Unionized vs. Less Heavily Unionized Manufacturing Industries*

	Short-Term Price Factor	Long-Term Price Factor	Unemployment Rate	Guidepost Dummy	$\bar{R}^2$
All Manufacturing	.48 (3.42)	.60 (2.84)	-3.01 (-3.36)	.68 (1.428)	.6044
Heavily Unionized Industries	.69 (6.54)	.28 (1.80)	-1.55 (-2.31)	1.21 (3.39)	.7645
Less Unionized Industries	.41 (3.81)	.64 (4.02)	-3.27 (-4.79)	.50 (1.31)	.6981

*Equation estimated was

$$\mathrm{Log}\left(\frac{WAGE_t}{WAGE_{t-1}}\right) = a_0 + a_1 \cdot \mathrm{Log}\left(\frac{P_{t-1}}{P_{t-5}}\right) + a_2 \cdot \mathrm{Log}\left(\frac{P_{t-1}}{P_{t-17}}\right) + a_3 \cdot \mathrm{Log}(U)$$

$$+ a_4 \cdot GUIDEPOST + a_5 \cdot CONTROL$$

where WAGE is the manufacturing wage rate,

P is the implicit price deflator for consumption expenditures,

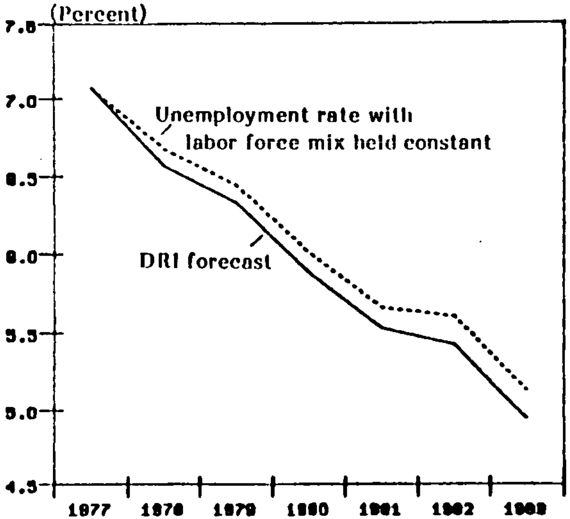
U is the unemployment rate,

GUIDEPOST is a dummy variable to account for the effect of wage-price guideposts during the Kennedy and Johnson administrations,

CONTROL is a dummy variable to capture the effect of Phase I price-wage controls during the Nixon administration.

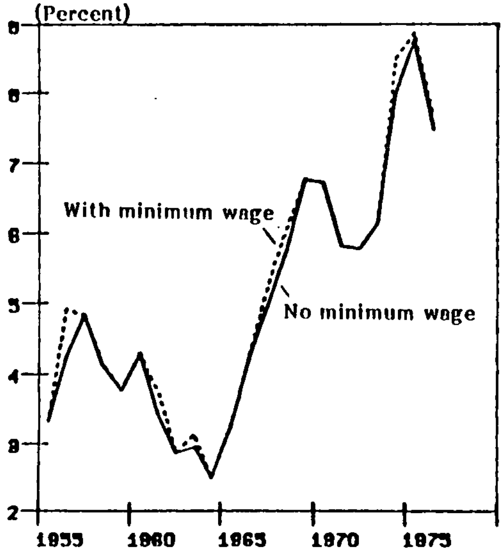
$\bar{R}^2$ is the adjusted multiple correlation coefficient, a measure of the explanatory power of the equation.

Improving labor force structure—fewer hard-to-employ teenagers, in particular—will contribute about 0.2 percentage point to a lower unemployment rate by 1983.



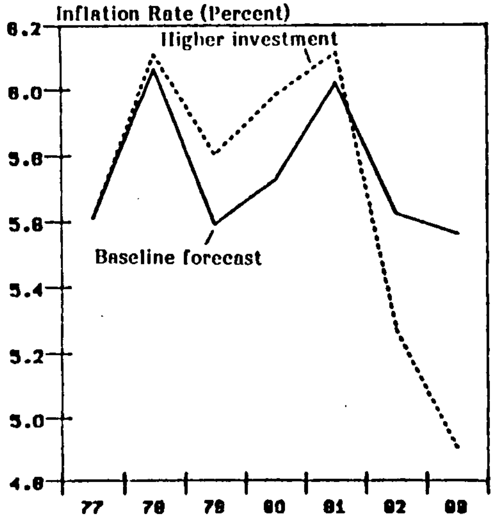
Calculated from an equation modelling the unemployment rate on the GNP gap (potential GNP less actual GNP) and an age-sex weighted labor force concept. This equation was then solved using a projection of the weighted labor force in which the labor force shares of the age sex cohorts were held constant. The weighting scheme was based on average wage levels provided by the Bureau of Labor Statistics.

Minimum wage legislation has had only a marginal effect on overall inflationary experience.



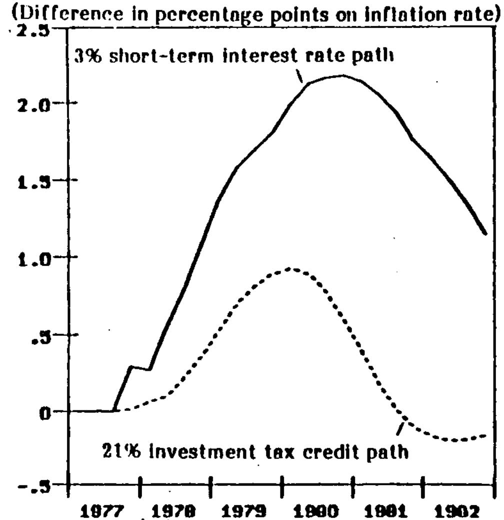
The inflation rates plotted are derived from an equation modelling wage rates in manufacturing (excluding overtime), including the minimum wage rate as an explanatory variable. The equation was then solved with (dot) and without (line) the minimum wage term to measure the effects of the minimum wage.

With the overall economy unchanged, an increase in the investment tax credit, or a decrease in the corporate tax rate, would initially raise the inflation rate, but ultimately lower it substantially.



This effect was calculated through the DRI model by assuming a 25% investment tax credit (effective rate) starting in 1978. The economy (real GNP) was held to the baseline growth path (DRI December, 1977 long-term forecast) by raising the personal tax rate. Lower capacity utilization, after 3 to 4 years, induced by a lowered rental price for capital, reduces supply-side price pressures and permits an easing of inflation. The inflation rate shown is for the implicit price deflator.

With no demand management, an increase in investment will raise the inflation rate, at least for several years. Monetary policy is substantially more inflationary in producing higher investment than is tax policy.

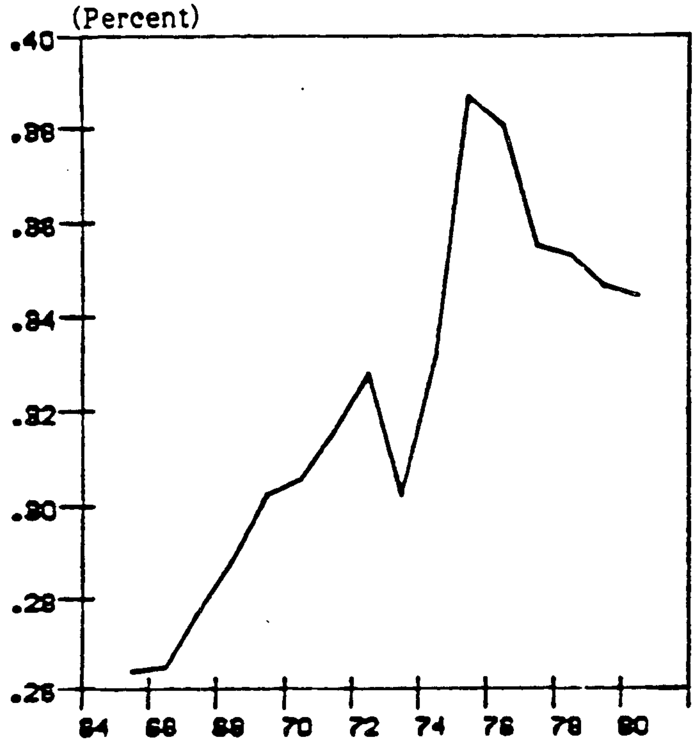


This chart shows the net effect on the inflation rate (implicit deflator) of alternative policies which raise business fixed investment by approximately 20% over the DRI forecast levels. Low short-term interest rates (about 3%) have more than twice the inflationary impact of a higher investment tax credit rate (21% effective).

Calculated with simulations with the DRI model.

EFFECTIVE TAX RATE ON EMPLOYMENT

Increasing personal and social security tax rates combined with rising unemployment benefits have raised the effective tax on employment and reduced the incentives to become employed.



An individual moving off unemployment rolls loses untaxed unemployment benefits and gains wages and salaries net of personal and social security taxes. His disposable income increases by much less than the increase in his gross wages. This difference between gross wages and disposable income is the effective tax on employment.

The analysis assumes the individual was receiving average unemployment benefits and took a job paying average gross wages. The tax rates applied to this income were (a) the average personal tax rate that applied in each period and (b) one-half of the effective social insurance tax rate.

Projections are based on DRI forecast of December 1977, and do not include President Carter's proposal to tax unemployment benefits.

Mr. KASPUTYS. We were hopeful that this will provide some light on the causes of stagflation and help the committee to understand the efficacy of such proposals as the tax incentive program on attacking the problem of stagflation. Let's begin with consumer well-being.

A critical factor affecting the growth of the economy is the consumer's well-being. This state of well-being influences both the consumer's perception regarding his or her individual economic condition and actual buying patterns. Consumer purchasing, in turn, is a key determinant of business activity, directly affecting fixed investment, inventory change and production levels. The "discomfort index" is one of the more direct measures of consumer well-being. The index is calculated as the sum of the unemployment rate and the inflation rate.

The first chart shows the discomfort index from 1900 to 1990. If the post-World War I and II periods and the depression of the 1930's are set aside, the index reached record levels in 1974 and 1975. Although declining somewhat, it will remain at high levels through the early 1980's. The 1960 to 1976 period is shown in the second chart and clearly displays the post-oil-embargo impacts on the discomfort index.

As the table at the bottom of the page indicates, energy changes added 3.0 to the index in 1975 and will add 1.6 annually in 1976 through 1978. The 1978 figure, which assumes that a compromise energy program will be passed by the Congress, includes 0.7 for energy price inflation, which is higher than any year since 1975. Consumer well-being, while slowly improving, cannot be expected to add much to improved economic conditions in the next several years.

Turning to the second chart, this chart addresses the question, "Should the United States have followed the German example?"

It has been argued that the United States may have avoided the current high level of stagflation by following the German example of absorbing the 1974 energy price increases when they occurred and reducing the rate of growth in Government spending. The U.S. and German experiences are contrasted on the second sheet of the study. Beginning with the last graph, Germany has been reducing the rate of growth in government spending, but it has only been in 1977 that this rate has dropped below that of the United States.

The unemployment rate for both countries followed a very similar pattern, although the German rate started at a much lower base due to the lack of comparability in calculating the figures. You can see the pattern is quite similar.

After a modest initial rise in Germany, principally due to energy prices, inflation also followed the same pattern as in the United States. This lower initial rise in prices in Germany followng the oil embargo is exactly what one would expect, since the European countries had already become accustomed to generally high energy costs and were consequently less vulnerable to energy price increases. However, whatever the U.S. shortcomings, real GNP, consumption and fixed investment have done comparatively well when contrasted to the German statistics. In the German experience, the restrictive fiscal and monetary policies since 1977 have not had a material impact on either inflation or unemployment, and appear to slow the growth of GNP and its component parts.

The conclusion we reach is that we would not do very much better following the German example.

The third part is very important, Congressman Moorhead, with regard to price expectations.

The next chart shows that price expectations do indeed play a major role in determining the rate of inflation. These price expectations are important factors in shaping wage claims. If expectations were for an inflation rate of 4 percent rather than the current 6-7 percent, the GNP implicit price deflator would be at least a full percentage lower over the 1978–1984 period.

The value that is assigned to the price expectation variable takes a very long time to formulate and to change and is extremely insensitive to short-run Government actions. Indeed, the data tell us that some 3 years of objective experience are needed before price expectations as reflected in wage claims settle at a new level. Therefore, the critical consideration for the Government is not how to change price expectations in the short run, but rather, to build a long-run record of reducing inflation that will ultimately be reflected in the price expectations included in wage claims over the next several years.

The next chart is on the rising tax burden and how that has contributed to inflation.

As you can see, looking at the lower right-hand corner, while personal taxes have not grown significantly as a percentage of GNP in the past 10 years due to reductions and rebates, and while corporate taxes have steadily declined, the overall tax burden has grown. This is due to indirect business and payroll taxes, which have increased from about 10.5 percent of GNP in 1950 to a forecast level of 17 percent in 1979. Unlike corporate and personal taxes, the indirect and payroll taxes tend to be more permanent and tend to be passed on to the consumer.

Representative MOORHEAD. Could I interrupt to get a clarifying point?

This total taxes, that is more than just Federal? This is Federal, State, and local?

Mr. KASPUTYS. That is the total tax burden.

Please turn to the next chart on reducing inflation through unemployment. Of the three items I have looked at so far, we have seen that following the German example would not have significantly influenced the pattern of inflation, that price expectations cannot be readily changed in the short run and that the economy must bear the cost of continually rising indirect business and payroll taxes. In the face of these pressures, can rising unemployment still be counted upon to cut inflation?

The answer is yes, but only very slowly. As shown in the next set of charts, if the unemployment rate were allowed to grow by 1 percent per year, the inflation rate would be cut to about 3 percent between 1982 and 1983. This would take the unemployment rate to an unacceptably high of 11 percent. Alternately, if the unemployment rate were increased to 8 percent and allowed to remain there indefinitely, the 3-percent inflation rate would be reached by 1984.

I would now like to turn to the chart on inflation and labor market structure.

On the average, since 1974 unionized workers tend to achieve wage increases of from 1 to 3 percent above nonunion workers. As the chart and table on labor market structure show, both unionized and nonunionized workers do equally well in recovering for past inflation in wage settlements, but unionized workers are much less sensitive to the unemployment rate, which became a more significant factor in the economy since 1974. This is due, at least in part, to the higher job security achieved by the unionized worker with seniority, who typically has the most influence on labor's role in the collective bargaining process.

The next chart shows that expected improvement in the labor force structure, specifically in reductions in the number of less employable teenagers, should contribute some 0.2 percent to a lower unemployment rate by 1983.

The final chart in this series shows that the minimum wage legislation has not added a very large amount to past inflation rates, and generally reflected changes that had already occurred in the economy.

I would like to turn to the issue of investment and inflation.

An increase in investment induced by a sharp change in the investment tax credit, or by lowering the corporate tax rate, would produce higher rates of inflation for about 3 or 4 years, but would eventually lower the inflation rate substantially, by nearly a full percentage point. In the early years increased economic activity stimulated by the greater amount of business investment would add to inflation. In later years this would be overcome by the increased capacity that had been created and by reduced supply bottlenecks. So we would see a rather sharp downturn in the inflation rate.

The chart on the same page shows an alternate way to stimulate business investment.

If it is indeed desirable to stimulate business investment, at the very least to ultimately ease inflation, the second chart on investment shows that the investment tax credit is a much less costly instrument than eased monetary policy to accomplish this. Eased monetary policy would have as much as twice the impact on inflation and would remain a factor in the economy for a longer period of time.

The very last chart in the series goes to the cost of working.

Have increases in the cost of working to the individual worker contributed to stagflation? The final chart shows that the effective tax on employment has significantly increased since 1973. This chart includes lost nontaxable unemployment compensation combined with taxes and social insurance, although it has been calculated for an average worker. The cost is less for workers at lower income levels, who pay little or no taxes. The chart shows the logic of President Carter's proposal to tax unemployment compensation.

That leads me to the question, "Is there a way out?"

The study does indeed indicate there are some ways to reduce the persistent and underlying rate of inflation, currently thought to be about 6 percent. Two of these include: Three years of price controls; and unemployment above 8 percent for 4 to 5 years.

These remedies are not only socailly and politically unacceptable, but would also damage the economy in a number of ways that are well known to this committee. Since the cure would be much worse than the disease, we should rule out such drastic measures.

The other major choice available to the Government is to follow a set of policies that attack inflation in a number of small ways on a number of fronts. These actions include voluntary restraints for both wages and prices, encouraging business investment, avoiding inflationary Government measures and liberalizing trade. This is not a very exciting list because it has been repeatedly discussed. Yet the record is not particularly good.

Consider just the past year with the minimum wage legislation, farm bill, welfare reform proposal, social security tax increase, unemployment insurance tax increase, energy proposal and, finally, a fiscal year 1979 budget with a $60.6 billion deficit. While any one of these measures might be desirable on some criteria, each adds in its own way to inflation.

Attacking inflation through more modest Government measures across a broad front is a slow process. However, there is no remedy short of "Phase I" price control that will work quickly and even price control will only have a lasting impact if maintained at great economic cost for several years. It therefore appears to me that we must have the patience and restraint to assure that Government actions for the next several years consistently work toward reducing inflation. Our collective will to do this can perhaps be best strengthened by facing the reality that inflation drives up interest rates, weakens consumer confidence, reduces demand and produces its own unemployment.

That concludes my testimony, Congressman Moorhead. Thank you.

Representative Moorhead. Thank you very much, Mr. Kasputys.

Because the TIP program has received attention in this hearing, I think to complete the record I should include an article by Arthur Okun, "The Great Stagflation Swamp."

Without objection, that will be made a part of the record.

[The article by Mr. Okun follows:]

BROOKINGS

The Brookings Bulletin / Volume 14, Number 3 / Fall 1977

The Great Stagflation Swamp

Arthur M. Okun

Speaking before the Economic Club of Chicago in October 1977, Arthur Okun warned his listeners that the following address would not send them home happy. While in his judgment the economic expansion still has a good deal of vigor and a substantial life expectancy, Okun doubted that the current strategy of economic policy will lead to a happy ending. Contending that we should not rely on more of that same strategy, Okun proposed some remedies for our economic ills, describing his message as a call for action rather than a forecast of gloom.

IN 1977, the United States will record a higher unemployment rate and a higher inflation rate than was experienced in any year between 1952 and 1972. We have not licked either of these two major problems; indeed, they have become intertwined and combined in a way that is historically unprecedented and, by the verdict of many economic textbooks, theoretically impossible. This nation has had serious inflation problems before; it has had prolonged periods of excess capacity and idle manpower before; but it has never previously faced a serious inflation problem after a prolonged period of slack.

The coexistence of stagnation and inflation or, as it has been dubbed, "stagflation," is a new problem. Yet we are dealing with it with old policies that are unlikely to solve it. The Carter administration—in this respect, like the Ford administration—is trying through traditional fiscal and monetary measures to attain both a sustained gradual recovery to full prosperity and a sustained gradual slowdown of inflation.

Arthur M. Okun is a senior fellow in the Brookings Economic Studies program and the author of Equality and Efficiency: The Big Tradeoff *(Brookings, 1975).*

That strategy is not succeeding. The modest recovery targets have been attained reasonably well over the past two-and-a-half years; the economic expansion has been a rather typical, standard-sized advance. But because the recession that preceded it was double sized, it has brought us only halfway back to prosperity. Thus we have paid heavily to keep our recovery moderate, and we have had no relief from inflation during the expansion to show for these efforts.

The basic inflation rate has been stuck at 6 percent since the spring of 1975. Nor is there any basis for confidence that relief is forthcoming. Indeed, in my judgment the inflation rate is more likely to accelerate than decelerate between now and 1979, even with a continuation of a slowly recovering economy. And once it becomes undeniable that the gradualist anti-inflation strategy has failed, I fear that monetary and fiscal policy will be tightened anew to restrain the growth of the economy, thereby courting the next recession.

In my view, a serious effort to deal with inflation and slack simultaneously must go beyond traditional fiscal-monetary policies. It must invoke specific measures to hold down prices and costs in both the private and public sectors. It must break the wage-price spiral that has so firmly and stubbornly gripped the system. I believe that a number of techniques in pursuit of those objectives deserve serious consideration. Let me state emphatically that the worthy candidates do not include a return to price-wage controls, such as the Nixon administration conducted in 1971–73.

Getting Stuck in the Swamp

As an autobiographical obligation, I must record that the most recent unhappy era of our economic history began late in 1965, while I served as an adviser to President Johnson. That is when the critical decisions were made to finance the Vietnam military buildup in an inappropriate inflationary manner. But the historical record will not support any "original sin" explanation of inflation that would attribute our ills of a dozen years to that mistake. Every wartime period in American history has been marked by a severe inflation; indeed, the Vietnam episode was the least severe. But the end of every previous war was marked by the end of inflation.

The unique experience of the seventies is that the end of the war was associated with an intensification of inflation. The double-digit inflation of 1973–74 was the product of many new mistakes and misfortunes: excessive monetary and fiscal stimulus in 1972, the devaluation of the dollar, the mismanagement of U.S. grain supplies, and the OPEC shock to energy prices.

Responding to that rip-roaring inflation, the makers of monetary and fiscal policy adopted extremely restrictive measures that brought on the most severe recession since the late thirties. That recession promptly cut the inflation rate to about 6 percent by the middle of 1975. But there we have been ever since, despite massive excess supplies of idle people, machines, and plants. If our economic institutions responded currently to a slump as they did in 1922 or 1938 or 1949, the recession and prolonged slack would not only have stopped inflation in its tracks but created a wave of falling prices.

In fact, the nature of price- and wage-making has been transformed in the modern era. We live in a world dominated by cost-oriented prices and equity-oriented wages. The standard textbook view of prices adjusting promptly to equate supply and demand applies only to that small sector of the U.S. economy in which products are traded in organized auction markets. And there it works beautifully; the prices of sensitive industrial raw materials *fell* by 15 percent between May 1974 and March 1975.

Elsewhere, however, prices are set by sellers whose principal concern is to maintain customers and market share for the long run. The pricing policies designed to treat customers reasonably and maintain their loyalty in good times and bad times rely heavily on marking up some standard measure of costs. For most products, prices do not rise faster than standard costs during booms nor do they rise less rapidly than costs during slumps.

Similarly, the long-term interest of skilled workers and employers in maintaining their relationships is the key to wage decisions in both union and nonunion situations. The U.S. labor market does not resemble the Marxist model in which employers point to a long line of applicants—"the reserve army of unemployed"—and tell their current workers to take a wage cut or find themselves replaced. Employers have investments in a trained, reliable, and loyal work force. They know that if they curbed wages stringently in a slump, they would pay heavily for that strategy with swollen quit rates during the next period of prosperity. In a few areas, where jobs have a high turnover and thus employers and employees have little stake in lasting relationships, wages do respond sensitively to the level of unemployment. But in most areas, personnel policies are sensibly geared to the long run. Workers seek and generally obtain equitable treatment, and the basic test of equity is that their pay is raised in line with the pay increases of other workers in similar situations. Such a strategy introduces inertia in the rate of wage increase, creating a pattern of wages following wages.

The customer and career relationships that desensitize prices and wages from the short-run pressure of excess supplies and demands have a genuine social function. They are not creations of evil monopolies but rather adaptations to a complex, interdependent economy in which customers and suppliers, workers and employers benefit greatly from continuing relationships. In general, the persistence of inflation is not a tale of villainy. By any standard, and by comparison with other industrial countries, American unions have been remarkably self-restrained in recent years. Business, meanwhile, has kept its markups below levels that would be justified by the current cost of capital.

In combination, business and labor have been raising prices about 6 percent a year and increasing hourly compensation (wages, private fringe benefits, and employers' payroll tax costs) by about 8 percent a year. The 8-and-6 combination allows a typical margin of real wage gains in line with the normal trend of productivity. Precisely for that reason, it becomes self-perpetuating. New wage decisions are made against the background of 8 percent advances in other wages and 6 percent increases in prices. And so they tend to center on 8 percent. Then, with hourly labor costs rising by 8 percent, businesses find their labor costs per unit of output up about 6 percent, and so their prices continue to rise by 6 percent.

There is no handle on either the wage side or the price side by which we can pull ourselves out of this

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stagflation swamp. Nor can any single industry or union provide a handle, except by making an unreasonable sacrifice of its own self-interest. It must do what everybody else is doing in order to protect itself. Analogously, if all the spectators at a parade are standing on tiptoe in an effort to get a better view, no individual can afford to get off his uncomfortable tiptoe stance. Ending the discomfort requires a collective decision.

Production and Jobs

Because prices and wages respond only a little to changes in total spending, production and employment respond a lot. And that is the fundamental limitation of fiscal and monetary restraints as a means of curbing inflation. Those policies clearly can put the lid on total spending for goods and services. The holddown in total spending is then split between a cutback in production and a slowing of inflation. But that "split" is the result of price and wage determination; it is not controlled by Washington. We learned—or should have learned—in the past three years that the split is extremely unfavorable. The reaction to weaker markets is loaded with layoffs, no-help-wanted signs, cutbacks of production schedules, and slashes in capital budgets. At most, it is sprinkled with holddowns in prices and wages. To save one percentage point on the basic inflation rate through policies that restrain total spending, we lose more than five points—easily $100 billion—of our annual real GNP.

The recession and slack of 1974–77 have exacted a toll of $500 billion in lost production of capital goods and consumer goods that could have added to our productivity and our standard of living. That cost should be clearly recognized, although it must be equally recognized that there was, and is, no toll-free route of escape from our problems. In fact, the toll keeps mounting. After thirty months of economic expansion, we have moved only about half the distance from the depths of the recession to a reasonable and feasible level of prosperity or full employment. Serious statistical studies designed to estimate the unemployment rate associated with reasonably balanced—neither slack nor tight—labor markets converge on a range between 5 and 5.5 percent. They demonstrate that with today's structure of labor markets, full employment certainly cannot be defined as a 4 percent unemployment rate. But neither can it be pegged anywhere near our recent 7.1 percent. Since unemployment has come down from 9 percent at the worst of the recession to 7.1 percent, we are about halfway to a reasonable cyclical target in the zone of 5 to 5.5 percent.

"We cannot count on our current policies to pull us out of the stagflation swamp. The evidence of recent years has accumulated and become overwhelming. The time has come to face the likelihood that we have a losing hand, and to deal a new one."

The excess of nearly two percentage points in the unemployment rate is not a structural phenomenon; it is not concentrated in "unemployables," secondary workers, or groups especially affected by government benefit programs. It is instructive to compare the unemployment rates of eminently employable groups today with their 1973–74 average:

	August 1977	1973–74 Average
	(percent)	
Married men	3.5	2.5
Craftsmen	5.5	4.0
Factory workers	7.0	5.0
"Job losers"	3.4	2.1
	(weeks)	
Average duration of unemployment	13.5	9.8

Unemployment remains high because production has not grown enough to generate the jobs required to get us back to prosperity. The behavior of the unemployment rate in recent years poses no mystery. Indeed, it has moved remarkably true to form in relation to the growth of production. Between 1973 and 1977, our annual growth rate has averaged 2 percent, and such a substandard growth performance entails a much increased rate of unemployment. Economists can disagree about whether the nation's "potential growth rate"—the rate of growth of real GNP that maintains a constant unemployment rate—is as low as 3.3 percent or as high as 4 percent, but it surely is not 2 percent. If I use my favorite number, 3.75 percent, for the potential growth rate, the 2 percent average actual growth rate since 1973 would be expected to raise the unemployment rate by 2.3 percentage points, in line with a rule-of-thumb formula that I developed in 1961. That would point to an unemployment rate a little above 7 percent currently, and that is where we are.

The potential growth rate of the economy is influenced by trends in productivity and in labor force participation. In the seventies, a rising fraction of women and young people have chosen to enter the labor force. That increase in "work ethic" permits the economy to enjoy greater growth without encountering tight labor markets. Indeed, in its absence, the rather disappointing trend in productivity would have significantly lowered our trend of potential growth. To be sure, if women and teenagers stopped hunting for jobs and went back to their knitting and ball-playing, respectively, our unemployment figures would be lower. But our labor markets would be tighter, and the potential of the economy would be reduced. The increased labor force participation of these workers is correctly viewed as an opportunity and not as a burden.

At the level required to bring the unemployment rate down to the middle of the 5-to-5.5 zone, our real GNP would be about $100 billion, or 5.5 percent, above its present level. The evidence suggests that our plant capacity could accommodate that extra output without strain, so long as it was broadly spread across sectors. Such a judgment must rest on estimates of operating rates, which are admittedly imperfect. But they are not likely to be seriously biased, either upward or downward. The estimate of capacity may inappropriately include some outmoded facilities, but it is just as likely to omit some rehabilitated facilities.

In short, idle resources and sacrificed output continue to represent an enormous national extravagance. Economists ought to be devoting more of their efforts and ingenuity to correcting that waste and less to talking it away or defining it out of existence.

The Costs of Inflation

Just as 7 percent unemployment is not full employment, so 6 percent inflation is not price stability. For the past two years, inflation has been reasonably steady and relatively well predicted, yet it remains domestic Public Enemy No. 1 in the view of a majority of the American people. I find that entirely understandable. In a system that rests on the dollar as a yardstick, a scorekeeping device, and a basis for planning and budgeting, the instability of the price level adds enormously to uncertainty and risk.

In our institutional environment, most people cannot hedge their wealth or their incomes against inflation. The single-family home has been the only major asset that has served as an effective inflation hedge during the past decade; and it obviously is not a feasible outlet for steady flows of saving. Common stocks have been miserable failures as inflation hedges; savings deposits and life insurance offer no effective inflation protection. A small minority of Americans have obtained cost-of-living escalators that effectively protect their real incomes against inflation. But their escalated wages are passed through into prices and thereby destabilize the real incomes of the majority whose earnings are not indexed. Escalators are a means of passing the buck among groups within our society, not of protecting the buck for the whole of society.

This country has not adapted, and is not adapting, to 6 percent inflation. The tolerable rate of inflation in this society is considerably below 6 percent. In the early sixties, 1.5 percent inflation was generally regarded as tolerable; in the early seventies, a 3 percent rate was widely accepted. If we were now to label 6 percent inflation as acceptable, who could believe that such a decision was the final turn of the ratchet? This country needs an effort to restore the reliability of the dollar, not a set of innovations to replace it; it needs an effort to curb inflation, not a program to learn to live with it.

With current prospects and policies, the basic inflation rate is not likely to drop below 6 percent during the remainder of the present economic expansion. To be sure, the inflation rate fluctuates from quarter to quarter, and minor wiggles and jiggles tend to generate vain hopes and groundless fears. Recent declines in farm prices and a downward blip in mortgage interest rates have generated favorable news. That is genuinely reassuring evidence that the jump in inflation to an 8 percent rate earlier this year was transitory. But the latest figures do not signify a fundamental improvement that is likely to be sustained.

Our chance for some net relief from inflation has been reduced by a new wave of congressional actions that add to particular costs and prices. Employers' hourly labor costs will be raised by hikes in payroll taxes in January 1978 for both social security and unemployment insurance. Further increases in payroll taxes are contemplated to finance proposed reforms of social security. The minimum wage seems slated to move up from $2.30 to $2.65. The first installment of the wellhead tax on crude oil is scheduled to take effect in 1978. Government farm programs have reinstituted acreage cutbacks, deliberately reducing the productivity of our agriculture. Many of these cost-raising measures have some justification. No one of them spells the difference between price stability and rampant inflation. But, in combination, they may well add 1.5 percent to the inflation rate by late 1978.

This wave of cost-raising measures deserves far more attention and scrutiny than it has received. Reliance on such measures is nothing new, but their total magnitude does set a new record. The Congress may have been tempted to load costs on the budgets of consumers and employers in order to avoid loading more onto the federal budget. In several of these areas, the President initially advanced proposals that were admirably restrained, but then compromised in the face of strong political opposition. (When some of the press welcomes such instances as evidence of the President's education in the ways of Washington, I cannot share the enthusiasm.) Meanwhile, the financial and business community has been so preoccupied with Thursday afternoon reports on the money supply and reestimates of the federal deficit that it has missed the big new inflationary ;ame in town.

All things considered, my best guess is that between now and 1979, inflation is more likely to accelerate than to decelerate—and not because of overly rapid growth or excess demand.

With that inflation forecast, a good growth performance in 1979 and 1980 seems unlikely. Bad news on inflation would turn into bad news for prosperity in several ways. First, it would mean higher interest rates. Short-term interest rates cannot responsibly be held below the inflation rate indefinitely. To me, an interest rate on Treasury bills above 7 percent would sound an alarm; it would lead to disintermediation and create a mortgage famine that would starve homebuilding. Second, in an environment of stubborn and intensifying inflation, the makers of fiscal policy would be understandably reluctant to provide any stimulus to the investor or consumer that might be needed to sustain growth. Third, bad news on inflation would heighten consumer anxiety and once again weaken discretionary household spending.

The connection between worsening inflation and a subsequent recession is not magic or automatic, but it is genuinely built into the attitudes and expectations of our public and our policymakers. "Inflation backlash" is a reality. Given that reality, we simply cannot take the risk of doing what comes naturally and hoping for good luck.

Thus, my principal message is that we cannot count on our current policies to pull us out of the stagflation swamp. The evidence based on the experience of recent years has accumulated and become overwhelming. "Patience and fortitude" is no longer an acceptable response to our disappointments. The time has come to face the likelihood that we have a losing hand, and to deal a new one.

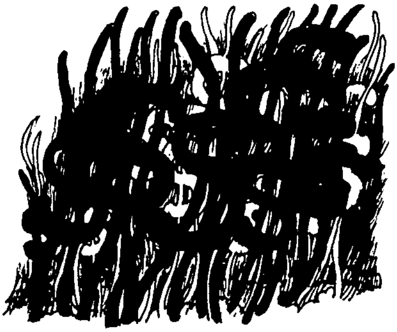
A Fiscal-Monetary Cure?

Some who accept my grim verdict about current policies call for a new monetary-fiscal strategy. And they point in opposite directions. On one side, the argument takes these lines. If a slack economy is not curing inflation, then why take the high costs of slack? Why not try to grow out of the inflation with stimuli, such as large permanent tax cuts backed up by a monetary policy committed to low interest rates, that have reliably spurred growth every time they have been applied in the past?

On the other side, the reverse case is made. If inflation is not abating with 5 percent real growth, isn't it clear that we need more restrictive policies to slow the economy down until inflation responds?

These polar-opposite proposals have in common the justified anxiety that our current act of juggling two eggs may lead to both getting broken. But I fear that they have one other thing in common that is less admirable. They are asking us to kid ourselves. The expansionists are right in that production and jobs are good things—but not because they alleviate inflation. Any major stimulative strategy, taken alone, will hasten the day that inflation accelerates and that inflation backlash sets in. The restrictionists are right in that a big enough dose of restraint would curb inflation—but only at the price of some $100 billion in output per point of inflation reduction.

Some groups in the business and financial community no doubt would applaud a hypothetical announcement that the government was cutting its spending by, say,



$30 billion and that the Federal Reserve was now setting monetary targets aimed at, say, only 7 percent growth of nominal GNP. But when government contracts were rescinded, when banks began closing loan windows, when cash registers stopped ringing, the responses would be entirely predictable: new waves of layoffs, new slashes in capital budgets, a collapse in productivity, and new demands that the government stop imports, shorten workweeks, and launch programs of makework jobs.

Perhaps the most appealing variant of the restraint prescription is the call for a *very gradual*, but consistently maintained, slowing of monetary growth and reversal of fiscal stimulus. As far as I can see, that strategy —taken alone—offers us a long, dull headache instead of a short, severe one, but no smaller total amount of pain. Moreover, its plan to curb demand gently enough to avoid a recession surely sets a new record for finetuning. It reminds me of the story about the Greek boy who thought he could pick up a full-grown bull if he started with a newborn calf and lifted it every day. The first little trimming of total demand is a mere baby calf. It would not do production and employment much harm (nor would it do our inflation performance much good). But, as time progressed, that calf would grow into a bull —and we could not count on lifting it.

A Program for Prosperity and Price Stability

We need an anti-inflation program that is not an anti-growth program, and that goes beyond traditional fiscal and monetary measures. In the past three years, I have assembled long menus of measures that might hold down costs and prices without holding down production and employment. Now I offer a specific set of proposals. I do so uncomfortably—I left the business of packaging four-point programs nearly a decade ago, and I prefer to stay out of it. I do so diffidently—because the facets of the program have not been polished by staff work or constructive criticism. But I do so enthusiastically because I am convinced that the general approach it embodies represents our best hope for getting out of the stagflation swamp.

No net federal cost-raising. First, the administration should set a target of zero net cost-raising measures for 1978, and should report quarterly to the American people on the achievement of that target. Any new cost-raising governmental action that imposed higher labor costs on employers or higher prices on consumers would have to be neutralized by a federal cost-reducing measure—lightening the burden of regulation or providing a cost-cutting subsidy. Thus we would be insured against an encore of the cost-raising actions of 1977.

Sales tax-cut incentive. Second, the federal government should institute a grant-in-aid program that would defray half the revenue loss of any state or city that reduced or repealed its sales taxes during 1978. Mayors and governors obtaining federal aid for sales tax cuts would pledge not to increase other cost-raising taxes during the period (but could raise income taxes). An allocation of $6 billion of federal outlays for this program would fund a 1 percentage point cut in the consumer price index. Sales taxes are part of the cost of living, both genuinely and statistically. Reductions in those taxes would hold down consumer prices and have anti-inflationary effects on wages that are linked, formally or informally, to the cost of living.

Tax relief for price-wage restraint. Third, a tax relief incentive should be offered to workers and businessmen who enlist in a cooperative anti-inflationary effort. To qualify for participation, a firm would have to pledge, at the beginning of 1978, to hold its employees' average rate of wage increase below 6 percent and its average rate of price increase below 4 percent (apart from a dollars-and-cents passthrough of any increases in costs of materials and supplies) during the course of the year. In return for participation, employees of the firm would receive a tax rebate (generally through withholding) equal to 1.5 percent of their wage or salary incomes with a ceiling of $225 per person; the firm would receive a 5 percent rebate on its income tax liabilities on domestic operating profits.

Any firm covered by a collective bargaining contract would be obliged to consult with union representatives before deciding to participate in the program. Typical workers who were counting on before-tax wage increases of 8 percent or less would benefit from participation.

I would hope for strong moral suasion, led by the President himself, to enlist participants in the program. But nonparticipation would be a matter of free choice and not subject to penalty. At the end of the year, each participating firm would file a statement of compliance that would be subject to audit by the Internal Revenue Service.

The total cost in federal revenues of the cooperative restraint program might approach $15 billion; with the sales tax grants, it could total $20 billion. Tax cuts of that magnitude are being widely espoused in the context of the forthcoming tax reform program. I would postpone the tax cuts in the reform package in the conviction that a pro-growth, anti-inflation program deserves a more urgent priority on the nation's agenda.

Obviously, the increase in purchasing power and profitability provided by the anti-inflationary tax cuts would stimulate consumption and investment. Indeed, the prospect of a credible attack on inflation could reduce the uncertainty that now constricts capital budgeting. If the program achieved its objective of a mutual and balanced de-escalation of wages and prices, there would be no overhang of "catch-up" wage and price increases in 1979. But opportunities should be held open for renewing the program (or phasing it out more gradually) in an effort to cut inflation once again.

New GNP targets. Fourth and finally, the administration and the Federal Reserve in cooperation should set forth revised fiscal and monetary targets designed to ensure full recovery *and* lower inflation. For 1978 those targets should aim for an encore of the increase in *nominal* GNP of 1977—about 10.5 percent—with more real growth and less inflation. For 1979 and 1980 they should aim to bring the growth of nominal GNP progressively into single-digit territory. Thus they will call for declining federal deficits and slowing money growth (appropriately adjusting for any further significant shifts in velocity). Such a fiscal-monetary strategy should strongly reinforce the credibility of the anti-inflation program and help to ensure that we don't slide back into the swamp.

Still, the first requirement is to get out of the swamp.

My program is neither a panacea nor a long-run insurance policy against inflation and stagflation. But its approach offers a good chance of bringing about a mutual de-escalation of prices and wages, and an end to the insidious wave of governmental cost-raising actions. It recognizes that traditional monetary-fiscal policies are powerful tools to promote full recovery and to prevent a resurgence of excess-demand inflation. But it also recognizes realistically that they cannot by themselves cure stagflation. That new problem requires the additional help of new remedies, which of necessity are unconventional and unproved. Whether the new remedies become politically feasible will depend on whether knowledgeable Americans face up to the reality that we are likely to remain stuck in the stagflation swamp with current policies, and whether they are willing to consider seriously—and to criticize constructively—alternative routes to noninflationary prosperity.

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Representative MOORHEAD. Knowing that you have a meeting, Governor Wallich, I wonder if you would comment on the comments Mr. Oswald made against the TIP proposal?

Governor WALLICH. For the most part these are points that deserve to be made. I think I could make counter-points on the technical problems that undoubtedly exist. I think they are superable.

There is some degree of Government action involved in implementing the TIP. When looking at the alternative proposals to combat inflation, however, we find that TIP may require the least amount of such action.

I do not believe that TIP straitjackets collective bargaining. It certainly poses a new factor for the bargaining process in that management will be encouraged to resist excessive wage increases and labor, presumably taking its own interests into account, will agree to more moderate settlements.

I can see that this proposal would be difficult both for corporate executives, not only those who deal with labor but corporate executives generally, and for labor union officials. I regard this as part of its evenhandedness. The benefit, I think, is very clear.

The TIP proposal provides a means of reducing inflation and permanently raising the level of employment by lowering what, in Mr. Oswald's testimony, is referred to as the natural rate of unemployment. This would be a major step forward.

These are some of the points I could make. I do want to come back to one thing. Mr. Oswald is quite right, as Congressman Reuss also said, to point to a number of things that also influence prices aside from wages. But when you consider the magnitude of these factors—imports amount to about 9 percent of GNP; oil constitutes about one-third of imports; profits, after taxes, represent about 5 percent of GNP—they are de minimis compared to the 75 percent of GNP that goes for wages and other compensation of labor.

It is a reasonably good distribution of income when labor gets three-quarters of all that is produced. Few countries have that. As a result, however, I think labor has to recognize that movements in wages is the primary determining factor of changes in the price level. One cannot say that changes in the other small factors cause inflation.

Representative MOORHEAD. Do you want to comment at that point, Mr. Oswald?

Mr. OSWALD. I just want to comment on one part of the wage part, the last part of Mr. Wallich's comments. It seems that there is always great concern as I have heard in terms of minimum wage this morning, if somebody's wage goes from $2.30 an hour to $2.65 an hour. I was shocked, myself, in the past year in the number of corporate executives where for the first time a woman went over the $1 million mark in annual compensation in 1976, and the figures are not yet in in 1977.

Substantial increases in wages and total compensation for top executives, and that is not touched at all in the proposals that are made nor does there seem to be much public concern. Yes, there are many more workers who earn $5 an hour, $10 an hour, but in terms of income distribution and in terms of justice, I think there is just as much impact in terms of what happens to high income recipients and they have an impact certainly in terms of the total compensation figures that are reported.

I think that needs to be addressed and looked at as well.

Representative MOORHEAD. I think now I would like to ask all of the witnesses to comment on the inflation program of the administration.

What do you think are the merits and deficiencies on economic grounds of the proposal to ask each industry to hold its wage and price increases below the average of the preceding 2 years? Is this program likely to help in winding down inflation or is the administration engaging in wishful thinking?

You might as well proceed in the order that you testified unless somebody else wants to go ahead.

Governor WALLICH. Before I respond to this, Congressman Moorhead, if it is agreeable to you, I would like to submit, for the record, a response to Mr. Oswald's list. I would be grateful if Mr. Oswald would supply me with that list.

I think it is remarkable that you were able to make such a good list here this morning in such a short period of time. I hope this shows some familiarity with the TIP subject.

Representative MOORHEAD. I would hope you would supply your comments for the record for this committee.

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

I appreciate this opportunity to respond to Mr. Oswald's points concerning the tax-oriented incomes policy (TIP) proposal.

Mr. Oswald notes that "serious administrative problems are admitted." Administrative problems do indeed exist. But according to a recent study, they appear to be no more difficult than the problems of some other complex tax provisions that have been on the books.

Mr. Oswald further notes that TIP "assumes that the inflation problem is basically a wage problem." The evidence from econometric studies is that prices indeed are largely determined by wages. This does not mean that every single price is wage determined, nor that at times demand factors may not temporarily cause prices to diverge from wages. But it seems clear that, if wage movements can be restrained, prices will follow.

My responses to Mr. Oswald's specific ten problems are:

(1) Oswald: TIP puts government on the side of employers against workers.

Response: TIP penalizes business for granting excessive wage increases. The restraint is on wages, but the penalty falls on business. This seems evenhanded.

(2) Oswald: TIP does not take account of special situations—puts all negotiations in one straitjacket.

Response: TIP allows unions and management to make their own wage decisions. The government guideline merely defines the wage increases at which the penalty begins.

(3) Oswald: Increased productivity cannot be used for job security for workers.

Response: Since the Kennedy-Johnson wage-price guideposts, it has been recognized that nationwide rather than industrywide or firmwide productivity gains must be the standard for noninflationary wage increases. If productivity gains of firms or industries were made the standard, wide wage differentials would result that could not be sustained in a labor market with reasonable mobility. Price changes will have to compensate for high and low productivity gains, keeping the return on capital from becoming excessively unequal among industries.

(4) Oswald: TIP negates free collective bargaining—has government determining income shares.

Response: A guideline that is not mandatory does not determine income shares. If the supplementary device of an increase in the corporate tax to restrain a rise in the share of profit in GNP were employed, there would be a tendency to influence, although not absolutely determine, income shares.

(5) Oswald: TIP is restrictive only on the unionized sector—not applicable to executives, professionals or non-union groups.

Response: TIP would apply to all wages and salaries and other compensation paid by a firm, including executive compensation. It could be made to apply to all corporate and unincorporated business, whether unionized or not, but it may be preferable to limit it to large corporations.

(6) Oswald: Guideline—based on one-half of CPI increase—and productivity increase—workers would suffer the burdens of inflation.

Response: TIP should produce no burden on workers at all. As wages are restrained, inflation will come down. Labor's real wage gains will not change. On average, they will equal productivity gains at any rate of inflation and wage increases. Meanwhile, TIP makes a lower unemployment rate consistent with price stability.

(7) Oswald: Labor costs are considered to depend solely on wage changes. TIP ignores productivity or levels of output.

Response: The econometric evidence is that prices depend on wages. Small deviations could arise from productivity changes, including those resulting from changes in levels of output. But with labor accounting for the great majority of costs, prices are necessarily largely determined by wages.

(8) Oswald: There is no control on other sources of income—dividends, profits, rent, interest, etc.

Response: If prices move with wages, profits and dividends should also move broadly in the same way as wages, although interest and rent could deviate more significantly. The supplementary proposal for an increase in the corporate profits tax to keep corporate profits, if they should rise at all, from exceeding some specified share of GNP would protect labor against a decline in its GNP share in favor of profits and dividends.

(9) Oswald: Profit increases—attention to excess profits deferred indefinitely—oil—coal—General Motors.

Response: In a market economy based on investment incentives, profits of individual companies should not be limited. Labor's concern should be with the total share of profits in GNP, which determines its own share. High profits of individual companies, compensated by low profits of others and averaging out to an acceptable GNP share, should not be objectionable to labor.

(10) Oswald: Prices are not solely wage-related—particularly retail prices—that have a wide variety of mark-up.

Response: This point has been answered above. Mark-ups may have to differ in order to produce an approximately uniform rate of return on capital in all sectors since capital intensity and turnover among industries and lines of retailing.

Governor WALLICH. I think the administration's program is a considerable step forward in a number of respects. First, it recognizes that inflation is a major injury in itself and also that, with some delay, inflation causes unemployment. As I read the program, I sense a moderate approach to the future rate of economic expansion. Such moderation is a considerable step forward. It is not long ago, faced with our tremendous unemployment, that many people would have supported a program calling for growth at 8 percent per year, for a number of years. We no longer support that kind of program because we realize it would be more inflationary.

There is also a recognition in the changes of the structure of the labor force that changed the noninflationary rate of unemployment.

However, the Humphrey-Hawkins bill would not be a step toward less inflation. Frankly, I doubt anybody can achieve the objectives of the Humphrey-Hawkins bill without the help of TIP.

We have varying components in the administration's approach to inflation. I am concerned, however, about the very large Federal budget deficits which are expected in the next 2 fiscal years because they occur so late in the expansion. I can only think that this is going to generate pressures in the financial markets. Unfortunately, we cannot exactly predict how and when. There, I think, is the vulnerable part.

Representative MOORHEAD. Mr. Oswald.

Mr. OSWALD. The notion of deceleration set forth in the administration's proposal seems to be aimed primarily at a wage deceleration without similar emphasis on a price deceleration. This disturbs us because thee initial inflationary forces that have pushed the high levels of inflation the last few years were such influences as the Russian grain deal in the early part of the 1970's, the big influence of energy prices and these other things, rather than push for higher wages.

I think the emphasis needs also to take account of general decreasing prices. The deceleration on an industry-by-industry basis on the price side seems to imply that there would be some negotiations prior to price change and yet the only example that I have heard from the administration has been in regard to autos, because the auto industry does have some time period at which it normally changes prices, which is the annual changeover. Other industries basically don't change prices at any set time and therefore will continue to make price changes as they drastically have, I think, even with this proposal.

On the wage side, as President Meany emphasized, we would be more than willing to sit down and discuss issues on an industry-by-industry approach, but are disturbed with the notion of a 2-year average base period for deceleration.

First of all, many contracts have many specific situations that may or may not be the appropriate time period to review in terms of saying what the changes should be made. For example, for people who are negotiating in late 1977 they were looking at the rate of price change of 4.8 percent. They did not anticipate that prices would increase—I am sorry, late 1976, I should say. They did not anticipate that 1977 price changes would be at a rate of 8.8 percent.

Therefore, this sort of acceleration in the past year affects contract negotiations that may have taken place in 1975.

Contract changes in the construction industry have been very modest. Many of the changes in the past year have only been 5.3 percent in terms of the effect of real changes according to the BLS statistics for contracts affecting—in the 100 cities reported for seven crafts in the building trades applied to the Bureau of Labor Statistics. It is not part of my appendix. I would be glad to make the specific data available and insert it in the record at this point.

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

The November 21, 1977, release of the Bureau of Labor Statistics, "Union Wage Rates for Building Trades Workers Advance 0.7 Percent in Third Quarter of 1977," reports in table A the following 12-month increases in wages only of building trades workers:

	1975	1976	1977
First quarter	9.2	8.0	5.8
Second quarter	8.8	6.7	5.8
Third quarter	8.3	6.1	5.6
Fourth quarter	8.0	5.9	

Mr. OSWALD. My point is they have had changes in the past year substantially less than the change in inflation and even less in a change of inflation in productivity. They may need to have larger increases at some point. So one set notion of deceleration may be appropriate for some industries and not for others.

I think it is important to note that there are other policies and programs that need to be undertaken to get at inflation. There has been no discussion this morning about the problems of antitrust and what happens with the growing conglomerates in this country in terms of their impact on prices. We find that there are both growing international conglomerates where in the past few months there have been reports of a number of European corporations buying very large U.S. corporations as well as a continuing use of American corporations to expand by buying other corporations leading to more concentration.

Second, there is clearly a heavy impact on future inflation in terms of increasing interest rates and its depressing impact on future expansion of industry in terms of having the funds available for expansion and making those more expensive.

There is some discussion in the President's Economic Report in terms of stockpiling of shortage goods so that we can mitigate large swings in terms of particular products having its impact on overall price changes and we want that sort of emphasis that would try to mitigate large price pressures from shortages of raw materials or from particular foodstocks so that there may be a more even price emphasis.

I think we have to look toward some of those areas which have been the factors that have caused inflationary pressures in the past as meeting some of the current inflationary problems.

Representative MOORHEAD. Mr. Kasputys.

Mr. KASPUTYS. As I said in my testimony, Congressman Moorhead, I think measures like this are useful measures, but I don't think it will do too much. I think that a deceleration approach on the part of the administration is a good thing to do to create a dialog between business, labor, and Government. It is certainly needed.

But given the strong price expectations that we see in the economy influencing wage claims, I don't think they are going to work out of the system very, very rapidly.

Now adding to that, 1978 is a relatively quiet year with regard to labor negotiations. I believe construction comes up, but there again that industry has not been in particularly good shape for the past few years, although some of the public works projects and that sort of thing are beginning to pick up the construction industry.

I think 1979 would be a year we would consider as a much more important year with regard to this kind of a policy.

Now the administration has established a guideline. The key is going to be what they do with it. I think if they attempt to apply it in a negotiated way on a consistent basis over the long term, it will be helpful. I would not look for it to be a panacea any more than I would look for TIP to be a panacea.

I believe TIP is again something that could be helpful, but I would not expect it to have a dramatic impact on the rate of inflation in the short run; that is, in the next few years. I think, in addition, the most important thing the Government can do is to take a very hard look at the legislative program and what kinds of actions are being proposed by the administration and passed by the Congress and also take a very hard look at the budget deficit.

Like Mr. Wallich, I am very concerned about the size of the budget deficit forecast for 1979. I can see a lot of pressures for that deficit to grow, and we are in the fourth year of recovery in fiscal year 1979 with a highly stimulative deficit on a full-employment basis.

Another concern is if we should go into another recession at some future time, are we starting from a base point where we have a stimulative budget on a full-employment basis? So I think that these things will do as much as a deceleration guideline to determine what happens to the rate of inflation.

I certainly would like to reiterate I think that approach is helpful and it is certainly better than a lot of other things that could have been done.

Representative MOORHEAD. One quick question of you, Governor Wallich, in your testimony you talk about, it appeared to me, that you either had your program which has been characterized as the "stick" or the Okun program which is characterized as the "carrot." Wouldn't it be possible to marry the two so that the penalty would be less, the reward would be less and the cost would be more or less offset?

Governor WALLICH. Yes, I think that would be possible, Congressman Moorhead. The TIP proposal, as described here, can be converted to the opposite; namely, a carrot approach. There are some other features in the Okun proposal which are particularly interesting and in some ways attractive. For instance, Okun's proposal suggests a voluntary approach such that a firm and its union can decide to participate. Under my and Sidney Weintraub's version of TIP, however, there is no choice.

Another feature of the Okun proposal is that getting the carrot depends on whether a firm and a union come in above or below the guidelines. In our scheme, the penalty is proportionate to the transgression of the guideline and, therefore, it is not so critical to define the exact point at which a wage bargaining comes out.

I have no expectation at all that if anything like this were ever legislated, it would be done in exactly the form that anybody is now proposing.

Representative MOORHEAD. Thank you, Governor.

Senator McGovern, if you would, would you direct your questions first to Governor Wallich so he can leave.

Senator McGOVERN. I know you are the Federal Reserve's leading expert on international economic issues. I wonder if you could give just a brief resume of what experience other countries have had with an incomes policy and what lessons those would have for the United States, what success have they had in dealing with inflation and to what extent can they instruct us as to what we ought to do with regard to development of our economic policies?

Governor WALLICH. The most conspicuous incomes policy of late has been that of the British. The British were dealing with very high inflation rates and under these circumstances their policy has been quite successful. But it has by no means eliminated inflation. Inflation is still at a rate higher than the average of other industrial countries. I would not, therefore, take a great deal of heart from what they have done as it might apply to us.

What has become apparent is that wage increases in England are flexible downward as well as upward. In our case, many 3-year wage agreements which tend to overlay make it very difficult to break the wage-price cycle.

Britain has a 1-year wage bargaining technique so that it has been possible and labor has been willing to hold still for a period of 12 months. Whether this is going to last, we do not know. Certainly it is not going to last in its present form.

I would add also that the countries that have been generally most successful in their anti-inflation policies, namely, Switzerland and Germany, do not use these policies. At most the Germans have used a kind of group action in which government, labor, and employers got together in what they called a "concerted action" and arrived at some broad agreements. Even that is not fully operative right now.

Senator McGOVERN. Thank you.

Governor WALLICH. May I be excused, Congressman Moorhead?

Representative MOORHEAD. Yes. I realize we kept you later than we intended to.

Thank you very much.

Senator McGOVERN. Mr. Oswald, in your statement you take strong exception to the notion of a wage-price guidelines policy. Does that reflect the unhappy experience you had with controls of the last time they were applied during the Nixon administration or is this a traditional position for the AFL-CIO?

Mr. OSWALD. Senator McGovern, as you know, during wartime periods the labor movement has cooperated with control programs both during World War I, during World War II, during the Korean conflict, and we stated during the time the Vietnam conflict was heating up that we would be willing to participate in an even-handed control program.

So in terms of wartime, which is a completely different situation than we have in terms of a peacetime economy, where everybody is asked to make sacrifices, we have stated that the labor movement would be willing to make such sacrifices. But in terms of peacetime we had a disastrous experience in 1971 and the years following in terms of the way price controls were put into effect.

They were, in essence, controls only on wages and not on prices, and the record shows them very clearly as one-sided—as did the comments by those people who were administering the program subsequent to such administration—that that was the intent. We don't believe there should be a one-sided approach to dealing with our economic problems so that the workers are asked to bear the full brunt of whatever the country's economic problems are.

Senator McGOVERN. I don't think any fair-minded person could argue with that. Isn't it more an indictment of the way the program was run than it is of the wage-price restraints themselves? You could take any Federal program and administer it in a discriminatory way in such a manner as to alienate an important bloc of people.

Does that mean that the concept of some kind of wage-price restraints is bad?

Mr. OSWALD. Senator, I think one of the problems is economists, business administrators; political analysts have tried to grapple with how do you really administer some sort of a price control system in a free enterprise economy without moving to almost a complete Soviet system of price control mechanisms?

As you recall, at the beginning of the Nixon price control situation, Mr. Grayson, who was in control of the operation at that time, tried to establish a new, unique concept of trying to measure, somehow, profit margins as a means of controlling prices. Profits are only reported long after and are a type of residual and are subject to various accounting interpretations as they are developed.

There are real serious problems. It worked well and we had a large staff, as you recall, during World War II to enforce prices, a whole big Office of Price Administration, and even then you had a situation that everybody was asked to post their prices. Even the smallest businessman was asked to post his prices.

You really had a feeling during wartime on the price side that if somebody raised his prices, he was being unpatriotic, that people were being turned in for raising prices because they were asked to sacrifice by sending their sons and daughters into the war.

You don't have that sort of situation in peacetime. To be truthful, the economists really don't have a good means of trying to control the millions of prices that are established in our marketplace all the time, the ability to change the quality of the product, which is also a price increase, and we just don't know very well how to do that in a free enterprise system.

We talk about it as if it were simple, but if we talk about the administration of that, we really don't know how.

Senator McGOVERN. One of the reasons I raised the question is I noted in your statements you indicated that the contracts labor has negotiated the last couple of years haven't been too favorable either, even in the absence of wage and price restraints. You seem to be saying that labor is not coming out with its fair share, which prompts one to wonder if there isn't some better way to handle the question of wage settlements and on the other side, the pricing arrangments.

I don't know. I have been reading the proposals that are most commonly associated with Professor Galbraith and perhaps doing it on a selective basis, just in the largest industries where you have the greatest degree of concentration, maybe you would avoid the problem you have just mentioned of how you deal with thousands of different prices. I don't know. Do you think that system would have any merit?

Mr. OSWALD. I think we can have only a small glimmering of much of the problem. If you look at the difficulty the administration has been trying to go through in establishing reference pricing on the import of steel, there are so many steel products. The reference prices that are being established bring forth all sorts of questions.

Does it cover this product or that product? What is the product itself? Is it the appropriate price? How does it affect different segments of the steel industry? Does it affect them all the same or does it affect them differently?

And you are talking about an even-handed approach, yet you would think that there is less product differentiation in steel than there is in such a thing as an automobile or consumer products like refrigerators or other products that are produced by large corporations.

It is a very, very difficult question to answer. Nobody really has come up with a good means of even doing it in theoretically large concentrated industries.

Senator McGOVERN. Mr. Kasputys, if you could comment on Mr. Okun's plan to provide tax incentives to those who adhere to the administration's wage-price guidelines, as to what you think the economic impact would be or whether you think it is practical in terms of the program?

Mr. KASPUTYS. It can probably be made to work, but I don't think it would have much impact, certainly not in the short run.

I can see a number of problems with it. First of all, on the overall issue of wages, wages indeed, as Governor Wallich pointed out, contribute significantly to inflation. They are a big piece of GNP and costs, but so do a lot of other factors. These other factors have given exogenous shocks to the economy in the past; import prices, energy programs, and of course let us not forget demand since we don't want to concentrate exclusively on the supply side.

My feeling is that these incentive programs will not change price expectations very rapidly at all. I would just like to add a footnote.

When you were talking about Nixon's phase 1 price controls, our studies have shown that price expectations as a result of phase 1, which was the most complete and which some would call Draconian set of controls that has been imposed, didn't change at all because they were not on long enough. It would take several years of controls to really have an effect on price expectations. In fact, we think it would actually take something in the neighborhood of 17 quarters before you begin to see the full effect of controls altering price expectations which are built into wage claims.

Now one question I would have, if you put the proposal into effect, would labor exercise restraint, recognizing the incentive payment business would receive? Would they exercise restraint on wages? Would they be able to make a deal where they received a passthrough of the benefit that the corporation realized. Or, if both the corporation and labor found themselves in an industry where demand was fairly high, wouldn't they just go ahead and raise wages and raise prices anyway? They would make a tradeoff as to whether they would come out better with a significant price increase if market factors were to permit it or if they would come out better with some type of tax incentive. That is one concern.

A second concern is that you could provide, in some cases, a competitive windfall to businesses that happen to be located in regions of the country where the labor market conditions are significantly different from other regions in the country. I am talking now about wages that would not be set by national agreements, but would be set on a more regional basis. So you could actually disadvantage or advantage certain industries located in certain regions.

Finally, one of the things that does disturb me is that certain variants of the proposal would provide a tax incentive to industries that did not raise wages. I wonder if we wouldn't also be providing a windfall in those cases to industries that just happen to have labor market conditions such that they didn't need to raise wages. There would be something of a windfall built in there.

You add to all of those considerations the administrative complexity, and my feeling is that it would not do a great deal.

Senator, if TIP is used as a way to focus Government, business, and labor attention on the inflation problem, and to keep the focus on the problem, TIP can do that or guideposts can do that. There are many devices that can be used to do that.

I don't think any one of these devices is going to cause a big, rapid turnaround in the rate of inflation. None of the proposals do, I believe, have that impact, but any one of them would be useful to focus public and Government attention on a very serious problem.

Senator McGovern. Thank you very much.

Representative Moorhead. I will be very brief here.

One thing, Mr. Kasputys, you mentioned the back-to-back deficits of around $60 billion. We are going to have to be voting on a tax reform, tax reduction package which would net out at $25 billion. Are you suggesting that that reduction should be reduced?

Mr. Kasputys. Given that we are where we are with the social security increases and other things that have already been done, I think it is very important that there be a tax reduction to keep the economy moving along in 1978. Unless the numbers really surprise us in the first and second quarters of this calendar year, which I would not expect, I would think that we need a big tax reduction, a substantial tax reduction to continue to spur the economy.

I take a tax reduction as a given, logically because I take a lot of the legislative actions that have been taken in the past as givens as well. If someone wanted to go back and unravel some of those very thorny issues and try to put programs back together again in a new way that would have less impact on Government costs, on inflation, and on uncontrollables in the budget, then I would say that might be more desirable.

Obviously the Congress is not going to have time to do that in terms of its action on the First Concurrent Budget Resolution on the fiscal year 1979 budget. We have built so many things into the fiscal 1979 budget—I think my count gives something like $375 billion that I would consider to be very legitimate uncontrollables in the budget—that are there as the result of past programs that have been enacted. I think almost all the real growth in the budget is in the uncontrollables, if you allow the pluses and minuses to net out. There is some increase in defense spending, for example, but there are other decreases in the controllable programs.

I see a lot of pressures on the budget both from greater growth in the uncontrollable area, agricultural price supports through the

Commodity Credit Corporation being a very large, obvious one, that are going to be affecting budget totals.

I would estimate that there will be some sort of a proposal coming from the administration on the urban problem which has been promised in the spring. That is probably going to cost some money. So I see a lot of pressures to raise that deficit total even higher.

I think the Congress has a very real problem in what to do about that, but I don't see that you can do a great deal to affect it in time for the 1979 budget. It is a longer term problem. I would strongly urge that we begin working on the longer term problem so we don't see a 1980 budget with a third very large deficit, because we are well into this recovery period, and we have never gone so far into a recovery period with such a highly stimulative budget on a full-employment basis before.

Representative MOORHEAD. You both mentioned the payroll tax increases which are both inflationary and deflationary, taking money away from people, adding to the employer's costs which he passes on in price increases. One proposal has been—because we had difficulty putting one-third of the whole program under general revenues—to keep the payroll tax to finance the retirement benefits because this gives the worker the feeling that he has paid in and this is his entitlement, but take the disability and medicare out of the payroll tax system.

Do either of you have any comments on that proposal?

Mr. OSWALD. I would like to comment.

I think it would be more desirable if you just have general revenue placed into the social security fund than to try and separate and earmark, because, as you had indicated, there is also the notion that there should be an entitlement for the disability and for the medicare as a basis of right. We are fearful that if you separate it completely, there will be pressures to put an income test into effect, so that we have then only the equivalent of the welfare aid to disabled and the equivalent of the welfare medicaid that we currently have.

We would not like to see those programs become purely a welfare program. There should be some sort of dignity of having a right to an income for people who have worked and become disabled as well as for elderly people without having to plead poverty to become eligible for medicare and therefore we would rather see the equivalent of that same amount of money infused into the system as general revenue rather than separating and earmarking the funds in that fashion.

Mr. KASPUTYS. My personal view is that with regard to payroll taxes and social security in particular, there is already considerable cross-subsidization between the retirement and the disability benefits, each one is not fiscally sound by itself and we have masked from ourselves really the fact of what an employee and employer contribution really goes for. Is it going for retirement or is it going for disability?

I would rather see us segregate the programs in some way so that we would hold out for regular review the degree to which the contributions are going for retirement, the degree to which they are going for disability and then make a conscious decision periodically as to whether we want to subsidize either one of those from general revenues, which, of course, would shift the burden then of who would be paying for these programs. For example, one might think, for whatever reason, it might be more attractive to fund some of the disability from the general revenues as opposed to the retirement along the lines that you outlined in your question, Congressman Moorhead.

Representative MOORHEAD. Gentlemen, thank you very much. We are pleased that the AFL–CIO is also deeply concerned about inflation, because I do think it does affect all the workers, and, Mr. Kasputys, thank you for coming in with the little preparation time that you had to give a magnificient statement like that, which is really inspiring. I thank you both very much.

When the committee recesses, it will recess to meet at 10 o'clock tomorrow in room 5110 in the Dirksen Senate Office Building, and we will hear from Secretary Blumenthal of the Department of the Treasury.

The committee is now recessed.

[Whereupon, at 12:16 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 9, 1978.]

THE 1978 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 9, 1978

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

The committee met, pursuant to recess, at 10 a.m., in room 5110, Dirksen Senate Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Presiding: Representatives Bolling, Reuss, Moorhead, Brown of Ohio, and Brown of Michigan; and Senators Bentsen, Proxmire, and Roth.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director; Richard F. Kaufman, general counsel; G. Thomas Cator, Thomas F. Dernburg, Kent H. Hughes, L. Douglas Lee, George R. Tyler, and Katie MacArthur, professional staff members; Mark Borchelt, 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 very pleased to welcome you to the Joint Economic Committee's annual hearings on the Economic Report of the President. Because your responsibilities span both domestic and foreign economic policy, you are likely to face questions that cover such diverse matters as the impact of the corporate tax cut and the stability of the dollar.

The administration can look back on 1977 with justifiable pleasure. A year that started with the paralyzing chill of a harsh winter warmed quickly to produce steady growth that, in turn, created a record number of new jobs. As a result, unemployment fell throughout the year and landed at 6.4 percent in December, a full 1.4 percentage points below the year-ago figure.

But there was plenty of unfinished economic business. Millions of Americans remained out of work. Consumer prices rose by almost 7 percent, a sharp jump over 1976. The Nation ran a huge trade deficit that shows no signs of abating in 1978.

Looking ahead at 1978 and beyond, the prospect for a continued recovery is not so bright. With that in mind, the administration has presented us with another stimulus package designed to keep the recovery on course. A number of my colleagues, however, remain concerned about the timing and adequacy of the tax cut.

Given the magnitude of inflation-induced increases in Federal revenues and rising social security taxes, the President's proposals contain little net stimulus. We appear to be stepping on the gas and draining the tank at the same time. Nor will a reduction in taxes in the fourth quarter of 1978 do much to offset Federal revenues that will have been rising from the start of the year.

The President's tax program also puts considerable stress on stimulating business investment. Despite broad agreement that we ought to have more capital investment, I suspect that many in Congress question the particular mix of tax cuts proposed by the administration. Earlier in the week, a panel of economic forecasters were unanimous in pointing to the investment tax credit rather than the corporate tax as the more effective defice for increasing investment. Extending the investment tax credit to include structures has raised fears that investment will be drawn away from central cities.

The international economy has presented the administration with another set of complex challenges. The lopsided trade deficit has slowed domestic growth, precipitated serious protectionist pressures, and triggered a decline in the international value of the dollar.

So far I have been both pleased and puzzled by the administration's response to international problems. Recognizing the often harsh impact of imports, the administration has responded to the special problems of several industries with considerable imagination while pressing ahead on the Tokyo round of trade negotiations.

It is your response to fluctuations in the value of the dollar that puzzles me. At first, you were widely accused of both taking down the value of the dollar and then refusing to intervene in the international money markets. More recently there has been a sharp reversal of field. Intervening directly in foreign exchange markets may or may not prove to be the best course of action. But what definitely concerns me is the adoption of high short-term interest rates to help stabilize the dollar. This distortion of domestic monetary policy could vitiate the President's tax incentives for investment and slow the recovery.

Senator Bentsen, do you want to say anything before I proceed?

Senator BENTSEN. I might just add, Mr. Secretary, that there has been so much emphasis on the negative over the last many months, I think it is time we had a little emphasis on the positive, some of the things we have accomplished. We have done much more than have most other countries in providing stability. The growth in our GNP has exceeded that of every other Western nation and democracy than Japan, and if you relate it to potential growth, we have even exceeded Japan.

We have made substantial progress in trying to curb inflation. We have made substantial progress in cutting down on unemployment. We have got a situation of self-flagellation, it seems to me, on the part of the American people. I think it is time that we began to emphasize some of the positive and tried to restore some confidence thereby.

Thank you, Mr. Chairman.

Representative BOLLING. Mr. Secretary, proceed as you wish.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY

Secretary BLUMENTHAL. Thank you, Mr. Chairman and Senator Bentsen. I appreciate the opportunity to come before you and I would be happy to discuss the various points that you have raised and those of any other members of this committee may wish to raise this morning.

I have a prepared statement I would like to submit to you. I will not read it.

Representative BOLLING. Without objection, it will be included in the record at the end of your oral statement.

Secretary BLUMENTHAL. I would like to make some general comments, commenting on my statement and somewhat on the points you have already raised, and then perhaps we can take it from there.

I think you are quite right in saying that 1977, calendar year 1977, was a good year. I do recall upon our arriving on the scene here that the presentation of that stimulus program did call forth a lot of concerns on the part of many of those, including Members of Congress, who questioned our optimism with regard to the trend in unemployment, with regard to GNP growth, with regard to the rate of inflation, with regard to virtually every aspect that we thought the stimulus program would influence positively.

I am happy that you are noting that, so far at least, things have been going reasonably well, not in every regard, but in most regards.

I would think that the program which the President has presented to you in January will likewise prove to be, on balance, a good program. It does attempt to deal with all of the questions about the economic policy of this country and of the Carter administration that were raised in the course of 1977. It, therefore, is comprehensive or tends to be comprehensive in nature. It attempts to be, and I believe is, consistent, and I would have to say it is conservative.

It is not a program that takes big chances, because I don't think that is necessary nor do I think that is desirable at the present time. As you have pointed out, it is not a program designed to get us out of the doldrums. We are not in the doldrums. We are doing well. We are moving ahead.

As Senator Bentsen quite correctly pointed out, that is a fact that does seem to be lost on many people, including the very people who are benefitting from being in pretty good shape at the present time. I meet a lot of businessmen who complain about the state of the economy and at the same time when we questioned them about their results in 1977, about the state of their profit and loss statement, and about their plans and prospects for 1978, they assure you they plan to have another record year on top of the record year they have had in 1977.

So there is a curious dichotomy here between reality and confidence and I think it is not a joking matter. It is a serious problem and I think the emphasis of this program is designed to act positively on that situation.

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We had an unemployment rate that came down to 6.3 percent based on the latest figures, a rate of inflation that is still too high, but declined from the almost double-digit numbers that we began to see at the beginning of last calendar year, again, with unemployment in total numbers reduced by 1.2 million, with an employment increase of over 4 million, with retail sales in the third quarter very strong and in the fourth quarter with an annual rate of increase in real terms of over 11 percent, which is very high, and with housing starts going into the new year 2.3 million, which certainly is a very high level indeed.

So the program the President is presenting is designed to build on these strengths and set some targets for the future, I think realistic targets, 4.5 to 5 percent real growth, which is slower than we have had, but clearly that was not sustainable in 1977, targets to get unemployment and inflation down further, but to do it gradually because we feel that any kind of shock treatment in the present situation runs too many risks and is likely to be ineffective anyway.

But to couple macroeconomic approaches, if you will, with attacks on the specific structural areas, particularly in the unemployment field for young people, for minorities, people in the cities that need special attention, is our goal. The philosophy that underlies the President's program and that dictates the kind of specific policies that have been selected for recommendation to the Congress is, I think, quite clear, and I am happy to note that in the statements made by representatives of the Business Council and the Business Roundtable that philosophy is recognized and generally recognized, and I hope that others will give equal recognition to that; namely, that we are relying on the private sector.

The President is not recommending a major increase in Government spending. Indeed, he wishes to reduce the percentage Federal outlays represent to total GNP down to 21 percent from the 22.6 percent that it has been. He wishes to see that the additional jobs that are created are created by private industry and that the stimulus to do this is effected by the tax system, by returning resources directly to private individuals and to businesses so that they spend both for consumption and for investment purposes in order to create the jobs that are required.

The tax program therefore is the centerpiece of the President's economic program presented to the Congress. I will not outline it in detail on the assumption that it is by now well known to you.

I do want to emphasize, however, that it does again reflect two or three philosophies, if you will. One of them is that the emphasis is indeed on lower and middle-class income taxpayers. It is not on the higher levels, and clearly if we had had more money at our disposal, if we felt we could go above $60 billion in deficit, we might have gone further in looking at middle- or upper-middle income groups and done more in that area. We simply had to work within the limits of the resources that we felt we could responsibly recommend to the Congress be allocated for these purposes.

The second philosophy was ont of providing emphasis, incentives to the business community, designed to maximize their investment programs over the foreseeable future, for investment is too low and should be running about 12 percent of GNP. It is only running at about 10 percent. That is, in terms of postwar period, too low a figure. Productivity growth has been running at 2 percent or less when it should be running 3 percent. Indeed, we have had years, recently, when it has been well below 2 percent.

That clearly is unsatisfactory and profitability—that is the return on capital—particularly when measured in real terms has been much too low. The specific tax programs that we are recommending for business are designed somehow, to some extent, to remedy that situation.

Another philosophy that I think is important is what we recommend be permanent in nature. One thing that I heard in my consultations with members of the business and financial community over and over again is that to provide greater confidence, don't do any fine-tuning, don't do any temporary stimulus, any tinkering. Give us an opportunity to see as far ahead as is possible.

Of course, they would like to have total certainty for a long period of time, and I have been clear in saying to them that this is beyond the capacity of the Government in this uncertain world, but to the extent that we can do it, we try to provide for programs that are permanent in nature. That is why the President rejected the idea, which he considered, of a temporary increase in the investment tax credit, but on the contrary, made recommendations with regard to the investment tax credit to (a) make it permanent at 10 percent and (b) to make certain recommendations for liberalizing the applicability of the investment tax credit and to make these permanent.

So clearly that particular request of the investors, the business or financial community has been met, I think, in the President's recommendations, as has the overwhelming request for a reduction in the corporate tax rate as compared to various other techniques, not only increases in investment tax credit, but also elimination of double taxation of dividends. It is not that the business and financial community would not have been happy to see that, but I refer you to the study recommended where I think 500 business etablishments were asked, based on a sample, as to what their relevant preference was to these various approaches, and I think by a factor of two to one a reduction across the board in the corporate tax rate on a permanent basis was their preferred solution, and that is why the President decided to recommend to the Congress a reduction in the corporate tax rate, first, by three points and then by a fourth point by January 1, 1980.

Just as a footnote to that, another element underlying the President's philosophy that is reflected in the tax program is that it is not just big business that we are concerned about, it is also medium-sized and small business, which, after all, represent a very, very important factor in our economy. That is why we selected the kind of tax cut for business that involves a 2-percentage-point reduction at the bottom, that is for small business firms up to $50,000 of income, and the other 2 percent at the top.

I will not here go into the specifically targeted programs that are a part of the President's budget. They, I am sure, have been laid out to you. I will certainly be happy to respond to any questions relating to these except to mention that the overall budget is a tight one. With a real increase in Federal outlays of a little over 1 percent, we are certainly recommending a tight budget with a lower increase recommended than we have had for some time.

I think it may be useful in that regard to deal briefly with the question of whether such a budget implying a deficit of $60 billion will or will not crowd you. I find as I gain more experience in my job that that is a concern, legitimate concern. It is one that is regularly raised at budget time. It was raised repeatedly with me a year ago, and, of course, based on the excellent briefing I had from my staff I spoke eloquently to the fact that it would not crowd out and I am happy to see it did not.

Again looking at the numbers, I am confident that a $60 billion deficit in our more than $2 trillion economy—looking at the overall credit market in terms of both the sources of funds and the demands on those funds—is sustainable and should not result in any significant increase in interest rates as a result. I think one of the reasons is really that a large portion of the increased demand for investment funds or credit has already occurred. We are operating at 2.3 million housing starts up from a much lower level. We are hardly going to have 3 million housing starts, at least not for any sustained period of time. If we did, we would have a number of other problems that would be interesting to discuss. So it isn't that a great deal of additional demand has occurred.

Borrowing in 1977 increased from $6 to $36 billion, a huge increase. We are unlikely to have another huge increase on top of that.

Consumer credit went up from $23 to $34 billion and whereas there may be some additional increases, they will not be of this magnitude. States and localities prefunded their debt, which put pressure on the market, amounting to some $15 to $25 billion, which may continue but not at the same rate.

Last year Federal borrowing in that situation actually dropped its share of the total credit down from 22 to 15 percent. In 1978—I am now talking about calendar 1978—we believe that the Federal borrowing will have to increase about $10 billion over 1977.

Against that we estimate that personal savings increases alone will be about $20 billion. If you put alongside that the lower increases that we expect in these other areas I have mentioned, in business short-term borrowing, consumer credit, housing, mortgage credit, we think that with savings increasing, with continued foreign investment in this country, given the basic strengths of our economy and, as you have noted, or Senator Bentsen noted, the relatively greater strengths of this economy compared to other countries, we think that we will be able to finance the deficit without any undue strain.

Finally, I'll say a word about the international situation, then I will stop my detailed comments and respond to particular questions that you may have.

We clearly have some problems going into 1978. The dollar has been under pressure and we have taken some steps to eliminate disorderly conditions in the exchange markets. These steps have had a positive result. We continue to have, and that is a key element in this, a very large deficit in our balance of trade. That has been due to two factors, first, the huge appetite we have for imported energy, with a $45 billion bill to pay, and second, the differential growth rates between ourselves and other countries.

We were the only country that more or less met its targets for growth that we set amongst ourselves at the London Summit. The others fell woefully short of that, the Japanese, the Germans, other countries in Europe. That situation should improve somewhat. We estimate that the Japanese, who have set a growth rate of 7 percent in real terms as their target for their fiscal year beginning in April, should certainly be able to accelerate their growth in terms of domestic growth, and not just export growth. The OECD estimates that growth for the OECD countries generally will be faster in 1978 than it was in 1977 by at least 1 percentage point.

That narrowing of the differential in growth rates between ourselves and our major trading partners, including those developing countries which have been going through stabilization programs like Mexico and Brazil and which are important export markets for the the United States, will result in allowing us to increase our exports more rapidly than our imports. That will be helpful.

I would hope that early action on the energy bill—and I am very concerned that that does not yet seem to be forthcoming—would also have an important effect on the dollar and on attitudes with regard to the future prospects of our foreign accounts. While it would not have an immediate effect on our trade balance, it would show the world that we are serious.

I cannot overemphasize to the Congress the concern that is felt all over the world over this difficulty and over our repeatedly postponing resolution of the problem. That, more than anything else, has in the recent past caused these disturbances in the exchange markets. I think it is very important that this situation be improved.

There are other factors that should improve the situation. The already very substantial depreciation of the dollar relative to certain currencies, notably the yen and some other European currencies, clearly will have a positive impact on our balance of trade later in 1978 and beyond.

I hasten to add that, although we have been accused of it, deliberate depreciation of the dollar is not and never has been a policy of the United States. That is not what we wanted. That is not what we set out to do. That is not what we said in public we wanted to happen.

Nonetheless, the fact that it has occurred clearly will have a beneficial impact not immediately, but later this year.

Also the efforts that we are making to expand exports through providing greater resources for the Export-Import Bank and for agricultural exports which we expect to improve in 1978 more rapidly than they did in 1977, and the general emphasis on export growth in a variety of Government programs, should show some positive results on the trade deficit in the course of 1978.

I should finally make one comment, and it is my last one by way of introduction, Mr. Chairman. It has to do with the importance of the Congress acting quickly to authorize our participation in the so-called "Witteveen facility." This is the supplementary financing facility that has been negotiated carefully over the last few months within the IMF, in order to provide the resources necessary for that organization to do its job of helping countries in temporary balance-of-payments difficulties. Congressional authorization is critical. It is critical to this country. It is critical to the position of the dollar, to the stability of exchange markets, to the maintenance of export markets for American products, and to the general position of leadership of our country in a world economic context.

It is not foreign aid we are talking about here. It is collaboration in the International Monetary Fund. The IMF facility, the "Witteveen facility", is unique. As the Congress so often recommended, it provides for the first time for a virtual 50–50 sharing between the OPEC and exporting countries and the developed countries. It is quite different from the proposed OECD "safety net" that was originally thought of, which would not have had that provision. It involves a pledging of a subscription of $1.7 billion by the United States that we can draw on. I should add that we have drawn on the IMF 23 times since the end of the postwar period. So, this is not an idle or theoretical benefit that we have here. It is designed for developed as well as developing countries.

Incidentally, when our contribution is called upon, we earn more than the cost of borrowing to the Treasury, so not unimportantly, as the Secretary of the Treasury I assure you that we are going to make a little money on this.

My concern is that the authorization not be delayed any longer than absolutely necessary and that we do not get hung up on such issues as human rights, commodity exports of various kinds, palm oil, and what-have-you. These are all very important matters, to be sure, but none that fit properly into our participation in the joint effort to keep international monetary affairs orderly and exchange rates stable and to help countries that are in balance-of-payments difficulties.

Mr. Chairman, that was a little bit longer than 10 minutes, but there is a lot of ground to cover. I will be happy to answer any questions you may have.

[The prepared statement of Secretary Blumenthal follows:]

PREPARED STATEMENT OF HON. W. MICHAEL BLUMENTHAL

Mr. Chairman and members of this distinguished committee, it is my pleasure this morning to continue the Administration's discussion with you on the President's economic program for 1979, and the implications of this program for Federal outlays and revenues.

The President's program is comprehensive in scope. It addresses both the need to support and sustain the economic recovery we are now enjoying, as well as the need to undertake the major structural changes that will assure adequate and balanced growth in the years ahead, and more equitable distribution of the benefits of growth.

In 1977, the economy regained its recovery path, after faltering in 1976. The year turned out to be one of balanced, sustainable growth, free of most of the strains and stresses which have in the past marked the third year of many recoveries. Real GNP growth of 5-¾ percent was close to the target set by the President in his Budget message last February, and the reduction in unemployment—to a rate of 6.4 percent in December—more than met expectations.

Overall, an extraordinarily large number of jobs was created—4.1 million between December 1976 and December of last year. The number of unemployed was reduced by 1.2 million.

While progress was not even throughout the year, the year ended on a strong note, as the lull of the summer gave way in the fall to renewed vigor of consumer and business spending. The strength of the economy at year-end is underscored by a few statistics:

Retail sales increased by 11½ percent, in real terms, between the third and fourth quarters of 1977.

Orders placed with manufacturers of durable goods—responding to the good performance of retail sales—advanced at a very high rate, in real terms, in the fourth quarter and were 11 percent above levels of a year earlier.

Total employment jumped 1½ million during the final three months of the year.

Starts of new housing units were at a 2.3 million annual rate at year-end, the best since the 1972-73 housing boom, and 21 percent above a year earlier.

The economic program proposed by the President is designed to sustain this good economic performance. Let me stress the verb "sustain", for there is some misunderstanding as to the objectives of the program.

We start with the premise that a growth rate of about 4½ to 5 percent in real gross national product is about the right pace for our economy at this stage of recovery. Such a rate of growth will permit steady improvement in the utilization of labor and capital resources—that is, a steady reduction in unemployment and a steady increase in industrial plant utilization—without fueling a resurgence in inflation.

Our economy is, today, progressing along such a growth track. We intend to keep on this path. The risks in stimulating the economy to an even faster growth track are great; we still suffer from a much too-high rate of inflation to afford actions which could push the advance in prices even higher.

But we also recognize that there are many forces that could pull us down from our safe track. Potential hazards include:

The sharp increases recently legislated in taxes for social security.

The impact of inflation on effective tax rates.

The impact of inflationary expectation on consumer and business spending plans.

The inequities in the current distribution of the total tax burden.

The levelling off in the thrust provided by the economic stimulus program enacted last year.

The large drain on our economy of payments for imported fuels.

The inadequate rate of business capital formation.

The inadequate employment opportunities for important segments of our society, particularly minorities and youth.

The slowing in our rate of technological innovation, which threatens the technical supremacy of the American industrial system.

Our basic strategy in overcoming these potential roadblocks rests on three fundamental principles:

The enormous strength and vitality of our private sector must be freed from the burden of excessive taxation and unnecessary regulation. As the President stated in his Economic Report, "We should rely principally on the private sector to lead the economic expansion and to create new jobs for a growing labor force."

The rise in government spending must be restrained. The more our nation's resources are usurped by government, the less is available for the private economy.

Within this restraint, total government spending must be redirected to focus on the major social and economic problems of our society.

The proposed implementation of this strategy is spelled out in the various messages the President has transmitted to the Congress in recent weeks. Central in this strategy is the proposed tax program, which will offset an imminent rise in the burden of taxation and assure a more equitable sharing of the burden.

Prompt tax relief is particularly necessary in light of the recent changes that have been made in social security taxation. To restore the financial integrity of the social security system, which was battered by the severe recession and severe inflation of recent years, and to insure social security benefits for future generations, large infusions of revenues are needed. But the taxes enacted to provide these revenues will represent a significant drain on the current purchasing power of American workers. To sustain an adequate rate of economic growth, the drain of higher social security taxes must be offset by income tax reductions.

In addition to the rise in social security taxes, inflation has been levying a growing but hidden tax. Under our progressive income tax system, inflation pushes individual incomes up the tax rate schedule and into higher tax brackets, resulting in a higher tax toll even though real purchasing power of incomes may remain constant.

The income tax reductions proposed in the President's tax program will offset both the rising social security tax burden *and* the effects of inflation on effective tax rates. We estimate that for the consumer sector of the economy, the combined drain of social security and personal taxes—which together absorb about 14 percent of personal income—will be about the same in 1979 as it was in 1977. Without the proposed tax cut, the tax drain would rise by about one percentage point.

Most of the proposed income tax relief is directed toward low-and middle-income families. The President is committed to the principle that the net tax reductions should be focused on those individuals who need tax relief the most—low- and middle-income Americans. Through a combination of substantial tax cuts and needed tax reforms, the Administration's tax program lessens the burden significantly on those individuals who now shoulder a disproportionately large share of the burden of public support while providing lesser relief—or, in some cases, raising the tax liability—for those persons who now make use of unjustified tax preferences to escape paying their fair share of taxes. Over 94 percent of the proposed tax relief is provided to families making less than $30,000.

By offsetting the fiscal drags that threaten to reduce consumer purchasing power, the tax program promotes continuation of strong markets for the goods and services produced by American business. In addition, the tax program provides specific encouragement for the business investment that will enable our industrial society to meet expanding demands and provide the tools of production for a growing labor force.

Over the past decade, the growth of our productive capital stock has not kept pace with the expansion of the economy or of its labor supply. Capacity growth in manufacturing has declined from a growth rate of about 4.5 percent during the period 1948 to 1969, to 3.5 percent from 1969 to 1973, and to 3 percent from 1973 to 1976. Real business fixed investment in the fourth quarter of 1977 was still 3 percent below its previous peak, reached in the first quarter of 1974.

We are simply not allocating enough of current output to provide the capacity for future growth. Several years ago, a study by the U.S. Department of Commerce concluded that in order to build a capital structure adequate to support a full employment economy by the end of the decade, we would have to allocate at least 12 percent of national output to business fixed investment. In recent years, we have been allocating less than 10 percent of output to investment. The lagging rate of capital growth has impaired our productivity, threatens capacity bottlenecks and price pressures in the years ahead, and fails to provide adequate job opportunities for our growing labor force.

Many factors have combined to restrain the rate of business investment. One of the most important has been the low rate of return on capital. Reported profits do not accurately measure the true return on capital, for convention accounting practice does not adequately take into account the costs of replacing the capital equipment and inventories used up in production. If the reported figures are corrected for the inflation in these costs, it will be seen that the return on capital has been very depressed in recent years, and is still at levels well below that of the mid 1960's.

The tax program we are proposing addresses directly the urgent need to provide more adequate incentives for investment. The key element is the proposed reduction in the tax rate on corporate incomes—a reduction of 3 percentage points to become effective on October 1 of this year, and an additional reduction of 1 percentage point on January 1, 1980. Intensive discussions with business leaders from many industries affirm that this form of tax relief will be very beneficial as an incentive for long-term productive investment.

In addition to the reductions in corporate tax rates, we are proposing several modifications of the investment tax credit. By making the present 10 percent rate permanent, rather than reverting to the 7 percent level that is now scheduled to apply after 1980, businesses can plan ahead with greater certainty of the tax benefits that will be associated with projected capital expenditures.

Further, it is proposed to extend the investment credit to utility and industrial structures. The current ineligibility of structures results in an unbalanced industrial expansion. It should be noted that the extension of the credit is not only for new structures, but also applies to the rehabilitation of existing buildings, to avoid the possibility of an anti-urban bias.

In addition, the eligibility for the full 10 percent investment tax credit would be extended to all pollution control facilities. Also, the ceiling on the extent to which investment credits can generally be used to offset tax liabilities would be raised, from the present ceiling of 50 percent to a new 90 percent of tax liabilities. The extension of the tax liability ceiling should greatly broaden the range of business which can benefit from the industrial expansion. Finally, a number of specific measures of tax relief for smaller businesses are proposed. Together, this package of proposed tax reductions will provide powerful incentives for business investment, enabling American industry to put into application the latest and most efficient technologies.

Some have argued that the amount of the proposed tax reduction will not be large enough to meet our national objectives, particularly in reducing unemployment. Arguments have been advanced for a more expansive fiscal thrust, either through deeper tax cuts or higher expenditures, or alternatively, for a much more stimulative monetary policy.

It seems to me that these arguments rest on an inadequate perception of the fundamental strength of the private economy, and also an inadequate appreciation of the inflationary pressures than can derail the economy from an appropriate growth path.

Our calculations, based on a careful assessment of the economy's strengths and weaknesses, and on reasonable assumptions as to the course of such key variables as business investment and personal consumption, indicate that the combined expenditure/tax reduction program encompassed in the Budgetary proposals will keep the economy growing at a satisfactory rate.

And this would be a sustainable rate, for it should not engender new inflationary pressures. After all, we are starting from a base rate of inflation in the 6 to 6½ percent range, with more of the risks of deviation on the up rather than the down side. Proposals for mass ve fiscal or monetary stimulus would, even before their realization, set off expectations of a renewed surge of inflation that would result in rising interest rates and business and consumer retrenchment, rather than expansion of outlays.

Moreover, some of our major economic problems are more amenable to specifically targetted solutions than to purely macro economic techniques. To be sure, resolution of these structural problems—such as the need for more investment and the need for greater employment opportunities for youth and minorities—requires a strongly growing economy that creates the markets for the output of new factories and the jobs for those in need of skill-training. But we cannot depend only on rapid aggregate growth to solve structural problems without risking an unacceptable rate of inflation. It is essential to achieve both an adequate growth rate in aggregate and to put in place specific programs addressed to structural difficulties.

The President's economic program does just that. It does not rely solely on aggregate fiscal policy to address the unemployment problem, which has strong structural characteristics. The Budget before you requests funds for specific programs targetted on major pockets of structural unemployment, such as among youth and minorities, where unemployment has remained unacceptably high despite the improvement that has occurred in the overall economic environment. These include extension of the public service employment program, more sharply focused on the long-term unemployed and the disadvantaged, and expansion of programs directed at youth.

Importantly, a new initiative is being launched to encourage the involvement of the business sector in local employment and training programs. The Administration recognizes that, for the long-run, private sector job creation is the right answer to our unemployment problems.

The 1979 budget calls for an increase in outlays for direct employment and training programs of almost $2 billion, to a total 18 percent more than 1978, and almost 100 percent more than was spent in 1977. Outlays for job placement and other supportive services are also up. Thus, a substantial share of our budgetary resources are being focused on meeting the employment needs of our society.

As a consequence it is anticipated that federally supported employment by the end of 1979 will increase by 700,000 as compared to 1977 levels. A major share of these expanded job opportunities will go to youth, minorities and disadvantaged groups.

In addition, a considerable expansion of job opportunities will result from the expanded local public works program enacted in 1977, from which further impact is still to be felt. The Department of Commerce estimates that direct on-site employment associated with these programs will increase by 45,000 in 1978 and by 35,000 in 1979. Moreover these projects will create about an equal number of additional jobs in the industries that supply the goods and services to the construction industry. Thus we fully expect that the combination of overall economic growth of 4½ to 5 percent, coupled with present and proposed specifically targetted employment programs, will be sufficient not only to bring down the overall unemployment rate, but also to reduce the persistently high unemployment rates among youths and minorities.

Countering the concerns of those who fear the tax reduction program might prove inadequate are the concerns of those who fear that with the economy advancing at a vigorous pace, a $25 billion tax reduction would over-stimulate demand and accelerate inflation. This is often coupled with the concern that financing the resultant deficit will impact financial markets adversely, with a resultant rise in interest rates that could negate the stimulus from tax reductions.

Such fears are understandable, but not warranted. The proposed tax reductions have been gauged so that, in aggregate, they offset the scheduled rise in social security taxes and the drag on purchasing power from the inflation impact on effective tax rates. The intent is to maintain the satisfactory growth rate of the economy, not to accelerate activity to an unsustainable pace.

Moreover, the effects of the proposed tax reductions must be evaluated in the context of the entire fiscal program submitted by the President. On the expenditure side of the Budget, the President proposes an increase, in real terms, of only a little over 1 percent, the smallest rise in five years and a third less than the average annual increase in spending in the 1969 to 1976 period. The Federal government's demands on the nation's resources will decline; the ratio of Federal outlays to GNP will drop from 22.6 percent this year to 22 percent in FY 1979, and decline further in the years ahead.

With this restraint on spending, the $60 billion deficit projected for 1979 does not threaten serious upward pressures on wages, prices or interest rates. We would not, after all, be running a deficit in an overheated economy. With slack still remaining in labor markets, and a substantial margin of industrial capacity still available, a deficit of this order of magnitude in FY 1979 would reflect appropriate tax and expenditure policies.

Financing a deficit of this size should not present serious problems for financial markets. Treasury financing requirements—in the order of $65 to $70 billion in FY 1978 and FY 1979—will represent a smaller share of total credit market flows than in 1975 or 1976, and not much higher than in 1977. It must be remembered that the volume of savings flows grows along with the rise in economic activity—personal savings alone is expected to rise by about $20 billion this year—and we expect that our financial markets will prove attractive to foreign investors.

Savings institutions, the major source of funds for the rapidly growing residential housing market, are in much better financial position to withstand the tug of competitive market rates than they were in the 1973-1974 period. Thrift institutions still have a comfortable margin of liquidity, and a larger proportion of their savings is in high-yielding longer-term certificates, which do not shift readily as relative rates of return vary among financial instruments. Moreover, these institutions still have a considerable margin of unutilized borrowing power.

Thus, as we gauge the prospective flows of credit demand and supply, we see little basis for concern over the possibility that Treasury financing needs will "crowd out" private sector financing. And the Administration's tight control over Federal spending, along with the initiatives we are taking to reduce the rate of inflation, will alleviate some of the burden on monetary policy.

One very important element of the President's economic program is the effort we are mounting to reduce the rate of inflation. The prudence evident in the President's spending plans is assurance that the government's demands on the nation's resources will not be a source of inflationary pressures. The tax program's strong incentives for investment in new production facilities will reduce the possibilities of shortages or bottlenecks as the economy reaches higher levels of resource utilization. Similarly, the jobs-training and employment opportunity programs proposed in the Budget will develop a reservoir of skills we will need as demand for workers continues to grow.

The President's tax program also includes proposals to reduce excise and unemployment insurance taxes, modest steps but ones that will contribute directly to reducing costs and prices. The development of larger grain reserves will also contribute to price stability, by providing a buffer against food price changes in the event of bad weather. Legislation has already been submitted to limit the rate of increase in hospital care costs.

A vigorous program is being launched to reduce the burden of government regulations which add unnecessarily to costs and prices. Steps taken this past year have already reduced the number of regulations, and the paperwork burden involved is complying with regulations. The program is being expanded through the development of procedures that encourage regulatory agencies to apply the most cost-effective solutions in accomplishing their regulatory objectives, and by a careful review of the economic justification of major new regulatory proposals. An interagency committee has been established to review the adequacy of the economic analyses underlying such regulations, and to assure that all alternatives have been explored in the search for the least costly means of achieving the objectives. We are also undertaking an assessment of the impact of regulation on the economy as a whole, to find ways of setting priorities among regulatory objectives.

A major element in the Administration's efforts in restraining inflation is a cooperative program with business and labor to lower the rate of wage and price increases. Because this program is voluntary, rather than mandatory or coercive, and because it does not rely on a single standard of wage and price behavior, it has been dismissed by some as ineffective.

Such premature judgments appear based on a lack of understanding of the inflation process, a process in which wages have been vainly chasing prices which have been vainly chasing wages, in an escalating cycle with no one the victor for long. We believe it is possible to reduce the rate of escalation in almost every market, and we intend to work closely with business and labor leaders in every major industry to achieve this.

If we can all cool off in concert, everyone will benefit. Reduction in the rate of inflation will encourage business and consumer spending plans, stabilize financial markets, and improve our ability to compete in international markets. The price deceleration program we are initiating, which involves a collaboration of government, business and labor, will substitute *ex ante* consultation for *ex post* confrontation, and we are confident it will achieve a significant degree of success.

The success of our efforts to promote domestic growth, reduce unemployment and curb inflation depend importantly on maintenance of an open, prosperous, world economy. The continuation of large imbalances in international payments is, however, placing a strain on the international monetary system which threatens a further slowdown in the world economy and resort to trade restrictions.

All nations must cooperate to reduce these payments imbalances, and to increase the world's ability to cope with them. Strong domestic economic growth in major industrial societies is a prerequisite to achieving better international balance. The Administration's economic program will assure that the U.S. remains a source of strength in the world economy. It is important that other strong nations join us in comparable efforts, if we are to sustain economic recovery throughout the industrial world.

The persistence of large international payments imbalances has become a source of disturbance in international exchange markets. Toward the end of 1977, the foreign exchange market became increasingly volatile, and the United States has intervened more forcefully to counter increased market disorder.

Our objective is the limited one of checking speculation and re-establishing orderly conditions. I believe we are making progress in calming the situation.

The measures that have been taken are designed to deal with a particular market situation. They are not a substitute for action to correct the root causes of international trade problems.

For the United States, the trade deficit is not the result of an overheated domestic economy that must be restrained through sharply higher interest rates. It primarily reflects two factors: excessive U.S. dependence on imported oil, and slow growth abroad. The solution lies in implementing a strong U.S. energy policy and in the restoration of maximum sustainable non-inflationary growth in other countries. World economic recovery and confidence in the dollar will be better served by a dynamic rather than a stagnant U.S. economy.

The Administration's fiscal program will support dynamic growth. But, concomitantly, we must intensify our efforts at reducing the drain on our domestic economy of much-too-high a bill for imported fuels. Prompt enactment of an effective energy policy, one that will enable us to limit our fuel imports as we substitute more abundant, more reliable domestic sources of energy, is undoubtedly the single most important step we can take to reduce our international payments deficit and to assure, for the longer-run, domestic economic growth.

Adjustment of the world's international payments to a better balance cannot be an instantaneous process. In the interim, it is important to ensure that financing facilities are in place to permit orderly adjustment.

Last year agreement was reached—with strong support from the United States—on a major improvement in the world's ability to cope with payments imbalances, through establishment of a $10 billion Supplementary Financing Facility in the IMF. By assuring that adequate official financing is available if needed, this Facility will enable and encourage countries to correct their imbalances in an internationally responsible manner.

Legislation to provide for U.S. participation is now before Congress. Our share of approximately $1.7 billion represents an appropriate and needed investment in a sound, open world economy. Prompt action by the United States is required to bring the facility into operation, to reduce present uncertainties that are unsettling to markets and and to preserve the important U.S. leadership role in the international financial area. We are consulting closely with the Congress as to the appropriate budgetary treatment of U.S. participation in the new Facility.

One of the Administration's highest priorities in the international area, is the request for funds for the international development banks. These banks represent an extremely effective channel for U.S. assistance to the poorer countries, which are of growing importance to us in both political and economic terms. They assure full burden-sharing by other donor countries, who now contribute $3 for every $1 contributed by the United States. They represent an extremely effective instrument for improving overall North-South relations, because they engender true partnership among the developed and developing countries. They support basic human needs around the world, promote international respect for human rights and increase world production of food and energy. The Administration considers it essential that the funding requested be made available to the development banks this year.

Let me summarize, Mr. Chairman, by noting that the economic program proposed by the President will make possible solid progress towards achieving our goals of steady growth, reduction in unemployment, fuller utilization of industrial capacity, and strengthened international confidence in the U.S. economy. Our projections indicate that, with this program, there will be five million additional persons employed by the fourth quarter of 1979. Moreover, about 700 thousand fewer persons will be faced with the frustrating experience of being unable to find meaningful work; the overall unemployment rate will drop to about 5¾ percent. Real gross national product will be almost 10 percent above fourth quarter 1977 levels, and real disposable personal income per capita will be about 8 percent higher.

By emphasizing expenditure restraint, and relying on tax reductions to promote growth, the Budget puts us on a path that will permit a balanced budget in the future, as we achieve a high-employment economy. Under this Budget, the share of GNP absorbed by the Federal government would decline. This will permit an increase in the share of our national output to be devoted to the private sector's decisions, and particularly to fixed investment—the basis for increased productivity and expanded future consumption. This can be accomplished without accelerating inflationary pressures.

I trust you will agree that the Administration's program represents a balanced, effective response to the nation's major social and eeconomic needs. I will be happy to respond to any questions you may have.

Representative BOLLING. Thank you very much, Mr. Secretary. That is a very interesting statement.

We will proceed under the 10-minute rule.

Senator Bentsen.

Senator BENTSEN. I agree with you very strongly on the fact that we have a limited investment by business in fixed capital as related to output. I seriously question that what seems to be proposed is going to accomplish the objective.

One of the things, it seems to me, we have to try to do is balance out the cost burdens of some of our regulations for pollution control and OSHA protection, which are very worthwhile objectives. Could not we have a much more accelerated depreciation on those types of investments, as do some other nations?

Secretary BLUMENTHAL. I think that clearly this needs to be looked at at all times. We did in the context of the shaping of the tax program examine whether we could provide benefits for these purposes that are particularly directed at this area. Of course, it is a matter of alternatives. That can become very expensive and we decided that we would rather go for the general tax cut for everybody instead of targeting for certain specific purposes.

We do have some provisions in the tax proposals that we are making that are designed, however, to improve that situation: For example, making the antipollution equipment available for the full investment tax credit of 10 percent, even though they are already subject to accelerated depreciation, which was not previously the case.

So wherever we could, we have included this, but we have not allocated a great deal of resources for that purpose because we thought we had better put it into the overall general corporate tax cut.

Senator BENTSEN. Mr. Secretary, I am particularly concerned with structural unemployment, as I know you are. I saw in the budget some $400 million allocated to that purpose.

You have talked about new initiatives for the private sector. What specifically is being done with the private sector to try to get these people into jobs that are not dead end jobs?

The problem we have today, as you well know, is that as high as 40 percent of our minority youth are unemployed.

You have a different situation from years ago, three generations lived together and one learned from the experiences of the others. Today they learn from the experience of their colleagues. We have a horizontal situation instead of a vertical one. These young people, if they are shelved for 3 or 4 years, develop a particular lifestyle and I think we pay a very serious long-term social, political and economic price for it. I think it is time for some very innovative and creative, courageous attempts to see if we can't break through that.

Secretary BLUMENTHAL. I am under some difficulty in responding to you specifically other than to generally agree with what you are saying in that the specific program is going to be a part of what the President is going to be sending to the Congress and announcing somewhere around March 15, I believe, as part of his urban program, in which there will be a number of initiatives that will be directed specifically toward unemployment of young people that is so heavily located in the cities, not exclusively, but heavily there. This $400 million for a private initiative is designed to work through business organizations such as the National Alliance of Businessmen. We had hoped that Bill Miller, who is now moving to the Fed, would be spearheading this, and we are working closely to get somebody to take his place to do this.

However, the thrust of that is to deal particularly with young people and with minorities together with the urban program. I think we will have quite a bit of resources there in the budget. Beyond that, as you know, there are provisions not only to maintain the 725,000 public service jobs, but also I think there will be an increase in the Job Corps and other youth employment programs of something like up to 458,000 years of service in fiscal year 1979, as compared to 376,000 in fiscal year 1978, and 271,000 in fiscal year 1977.

Adding it all together, there is something like, if I happen to remember the number correctly, a 22-percent increase in fiscal year 1979 over fiscal year 1978 for training and employment programs which will be heavily focused on young people. I think putting it all together, we are putting as much money in it as I would like to see.

Senator BENTSEN. I hope we can come through with some new ideas and not just the application of money.

Mr. Secretary, as one who has had a long-term interest in Mexico, I look at a situation there where we are seeing millions of young people coming across the border. The yearly estimates are from 6 to 12 million and because of the very nature of the problem, we don't know how many. We have the undocumented workers bill, which I coauthored at the request of the administration, but that is just a bandaid. We have to get to the root causes of the problem and it is the high unemployment in Mexico itself, principally in about five rural States.

When you talk about international aid funds, I hope that we can direct our attention to working something out with Mexico in a joint long-term development project where we can fund some light industry in those areas where those people can find jobs at home and stay at home.

That is the only long-term solution to the problem. The illegal alien bill, as such, won't resolve it by itself. They have 63 million people. In 19 years the population of Mexico will double. By the year 2025, if we extrapolate the mortality and birth rates of our two countries, Mexico will have more people than we have.

I think it is something that is terribly important to address our attention to.

Secretary BLUMENTHAL. I agree, Senator Bentsen. I have to point out there are some real dilemmas here. You refer to light industry.

I think you know what I am referring to. The problem that we have is that we are getting a lot of pressure on imports of such products into the United States. In fact, this whole question of foreign investment and the attitude of the labor movement toward such investment is in my judgment heavily colored by that problem, by the existence of border plants, for example. Every time I have come forward with ideas within the administration on this point, I am confronted with this concern.

There is a dilemma. On the one hand, how to collaborate on economic development because it does have the very beneficial impact of perhaps slowing down the rate of illegal immigration to the United States. On the other hand, how to avoid adversely affecting jobs in this country. It is very difficult. It is a tough political problem.

I must say I haven't found an easy way to deal with it. I tried, for example on the question of the deferral of taxation on foreign source income, which is a controversial issue. The President has recommended that it be eliminated and its elimination is part of the tax program.

The concern about foreign investment on the part of many people in this country is related directly to runaway plants. The moment you say "Why don't we deal with that issue?" you think, "Aha, now we are dealing with Mexico." If you cut out those provisions in the Customs Code which allow the establishment of a plant in Matamoros or wherever, what you are going to do is cause more illegal immigrants to come in. So you have this kind of tradeoff and it is politically hard.

Senator BENTSEN. We are facing another one now on the question of buying gas from Mexico. They have developed reserves that are possibly a rival to Iran's reserves. Here is a solution for them if they can find the time to get to the deliverability of the gas. Here is an assured source of gas supply for us.

I think that some people in this country don't fully understand the attitude of Mexico and how strongly they react to anything that appears that we are dictating what they do with their natural resources.

Across northern Mexico today on bridges and on highways, signs are being painted and sprayed, saying, "Don't sell our birthright to the United States." "Don't sell our resources to the United States." But the Government down there wants to work with us in working out that kind of deal and we ought to get on with it and try to do it.

I think it works to our advantage to secure that supply. In addition to that, it provides an economy stability to Mexico that is desperately needed.

I see my time has expired.

Representative BOLLING. Senator Javits.

Senator JAVITS. Thank you, Mr. Chairman.

I apologize to the Secretary; I had another hearing downstairs and since I am the ranking member of the Human Resources Committee, I was unable to be in two places at once, but I chased up here the moment I could.

Secretary Blumenthal, I am sure that you have discussed—because my staff tells me you have—both the international situation, which troubles me deeply, and upon which I made a major speech before the Senate yesterday, and the validity of the tax cut.

You will forgive me if I have not actually read your prepared statement, but I think I know your thinking. I would like to ask you about both of those things.

First, on the international situation, the position has been taken by the administration right along that although there is great danger in the international situation, the increases in the capital of the

IMF, the World Bank, and the Witteveen facility will enable the storm to be weathered.

The thing I would like to ask you is what does the administration base its confidence on in view of the fact that even the Witteveen facility seems to be having very serious difficulty here in the Congress?

Secretary BLUMENTHAL. You are right, Senator Javits. Much to my surprise there are questions being raised about the Witteveen facility which I cannot understand. It is such a good deal for us.

Senator JAVITS. I thoroughly agree with you on that.

Secretary BLUMENTHAL. However, my faith in the good judgment and good sense of the Congress remains so high that I have no doubt that as we explain the facility more fully—for example, at our meeting with 80 Congressmen today, we will get approval.

Our confidence in the system is really based on a combination of judgments. First, we are recommending measures that will enable the development banks to expend their assistance to the poorest countries. Second, the Witteveen facility will strengthen the IMF's capacity to deal with general balance of payments problems. Third, maintaining growth in the strong countries will help reduce payments imbalances. These measure about the maximum that the legislatures are likely to be willing to countenance under present circumstances when unemployment is high in their own countries and when some governments are relatively weak.

We think that the resources that the IMF will have at its disposal and the kind of increases—say, 4 or 5 percent in real terms—that are being put into the development banks, will be sufficient to keep the situation on a relatively even keel, particularly if the OPEC countries continue to invest their resources partly in the developed countries and partly in direct lending to some of the developing countries such as Egypt and elsewhere.

It is not an ideal solution, but it seems to us to be the politically most feasible approach to what will continue to be a difficult problem into the middle 1980's.

Senator JAVITS. Mr. Secretary, the thing that troubles me, and I would like your judgment on it, is that we are not behaving as Churchill behaved at the beginning of World War II.

He sent his best armored division to North Africa because he realized that you have to run risks if you want to win wars.

We are not running risks. We are playing it safe, when the situation is very serious, and you know it and I know it.

Indeed, the President, even in his economic report, summed it up very well and then he said that somehow or other we will handle it.

Now, don't you agree with me that the banks which have been the intermediaries for the OPEC countries are going to be compelled to either slow down or perhaps quit new lending to the less developed countries simply because our regulatory authorities will no longer let them run these risks as they are getting outside their capital, and doesn't that immediately pose a new program to us that we haven't had before, when these banks have been lending roughly $20-odd billion a year to those who needed it?

Secretary BLUMENTHAL. So far, the private banks have not—except in perhaps one or two instances—run into any difficulty or over-extended themselves on foreign lending. Indeed, their experience with repayment of foreign loans has been better than on some domestic loans. Regulatory agencies have been more concerned with some aspects of domestic lending than with the international areas.

So, in my judgment, there is no necessary concern that the resources will not be available.

I think if the loan demands were to increase substantially, your concerns would begin to worry me a great deal more.

Senator JAVITS. Mr. Secretary, I think the difference here—our time is very short for questioning, so I would like to lay it before you and before our President, whose good will and feeling of patriotism for what we need is as strong as mine.

I have no quarrels with him on that.

It seems to me that we must lay the emergency on the line if we expect the character and quality of action which this requires.

That has not been done. I do not agree with the administration that the way to proceed is to say somehow we will work it out; we will take care of it.

I do not believe that legislatures, even though they have a lot of troubles including our Congress, are really going to cooperate unless this emergency is made as vivid as it actually is.

You cannot, Mr. Secretary, skim, as they say in Las Vegas, $45 billion a year off the industrialized world's economy and just have it handled on short-term credit, in essence, and what you say about the OPEC countries, we have to lean heavily on the OPEC countries, politically, diplomatically, in security, because it cannot be the exception that Saudi Arabia and the Emirates are coming through for the Witteveen facility when they will have over and above, for military requirements at the maximum, a $25 billion surplus this year, and all they are going to do is put that on short term, mainly to U.S. banks who are going to have to assume the credit risk of relending it.

Mr. Secretary, it just cannot continue. I believe that the big difference between me and the administration is that we have got to give it to the world and face it together as a dire emergency or the next thing you know, we will have a depression in this country and in the world.

It won't be long in coming.

Secretary BLUMENTHAL. Senator Javits, I would like to say the following:

The President did say we had an emergency on energy. He said it last April 20. We are now in February. Look where the Congress is.

I spent a lot of last year and the beginning of this year pleading with the Congress to approach these totally inadequate amounts that you castigate us for not being more imaginative about for the international financial institutions.

I just spent the most discouraging 3 hours you can imagine with the House Appropriations Committee explaining and defending our participation in the Witteveen facility, which involves a 50-percent participation by the OPEC countries.

Where is the Congress on this issue? If we are going to come to the Congress and not only ask for this thing, which we have the greatest difficulty getting, and for the development banks, which in fact we didn't get fully last year so that we have arrearages, then I don't know how we are going to make up in our commitments—where is the Congress if we say to them they should increase that substantially.

On the present basis, they won't even listen to us.

Senator JAVITS. Mr. Secretary, it is the people of the country whom you have got to arouse.

They feel a deep disquiet that there is something wrong. That is why you have an erosion of business confidence which goes down to the lowest small business levels. They feel there is something wrong.

The President has to give tongue to what they instinctively feel.

I have sat in the Congress a long time, Mr. Secretary, and I heard the most ardent isolationists vote "aye" for foreign aid and for the Marshall plan when the people were convinced.

We haven't convinced our people as yet, and I believe in order to convince them we have to give the situation the emergency coloring which it really has.

Again, I repeat, you and the President are just as patriotic and just as diligent as I am. I claim no premium on that as far as I am concerned but I certainly urge upon you the new way to approach it, which is to really tell the people how perilous this situation is positioned.

Mr. Chairman, before I yield, I did want to say this, and I forgot to do it, I would like to express my sympathy in support for Mexico's gas.

I think the real danger is that the Mexicans could divert from producing, or waste it, or burn it up, and I think that would be a tremendous mistake diplomatically as well as from the point of view of conservation.

Representative BOLLING. Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

Thank you, Mr. Secretary.

As I heard your oral presentation, you said one objective was to get inflation down gradually.

As I read the prepared statement, you talk more about curbing inflation, avoiding the resurgence of more risks on the up side than the down side.

What is the objective?

Is it to get inflation down or merely to hold it where it is?

Secretary BLUMENTHAL. The objective is clearly to reduce it. The present level of inflation of 6 to 6.5 percent is much too high, and our effort is to reduce it. The anti-inflation program as well as the tax program designed to stimulate increases in industrial capacity are designed to do that.

Representative MOORHEAD. Thank you, Mr. Secretary.

Turning now to the IMF, I think you said that it was not an appropriate vehicle for human rights legislation. I agree with you but I would like to ask you why you say that.

Secretary BLUMENTHAL. The IMF is the institutional structure for collaboration among the nations on maintenance of order in international exchange and payments markets.

Since its inception, politics has been kept out of it in the common interest of all of the participants in that institution.

If any country begins to introduce political considerations other countries will introduce political considerations, and the international payments system will suffer and collapse as a result of it.

We cannot work on exchange rate problems and on monetary stability problems on the basis of the political views of a particular member country.

Representative MOORHEAD. The IMF is not a development bank or a foreign-aid institution; isn't that correct?

Secretary BLUMENTHAL. That is correct. In the IMF, we are not giving somebody foreign aid.

I think the issue is somewhat different from the development bank. In the bank a member of Congress or anyone could say we are giving our money, and could legitimately question why can't we attach some strings to our money.

That is not the situation in the IMF where we are all partners with capital that we draw on.

We have drawn on it 23 times ourselves, and how would we like it if we have a problem and some other country says, "Well, I have some political considerations before you could draw on your own money."

It is our own money in there.

In the IMF, both rights and obligations of members are involved. That is quite a different situation from the development finance institution.

A country that is not permitted to exercise its rights when it needs to do so will refuse to carry out its obligations—for example, to provide foreign exchange when it is needed by other members.

These rights and obligations are the basis on which countries join the institution. You destroy the organization when you withhold their obligations in return.

Representative MOORHEAD. Turning to the domestic scene, you mentioned the urban program. Does the administration still consider the possibility of including in that something in the nature of the domestic development bank?

Secretary BLUMENTHAL. Yes.

These things change from time to time. The discussions are still going on, but the proposed program has not been completed. However, I think there is every chance, based on the latest reading I have had from Treasury representatives who participate in that effort, that there will be a proposal for a national development entity bank of some kind designed to be particularly helpful to urban areas.

Representative MOORHEAD. Will it consider making loans to private industry or only to State and local governments?

Secretary BLUMENTHAL. The design of that entity is still one of the issues being worked on and debated.

My own preference, and hence that of the Treasury, is clearly that this entity not perform another handout.

This does not make it another aid institution, another Government spending activity. It would be specifically designed to promote, to be the glue that holds together projects for economic development in the city. Clearly economic developments in the city, in my judgment, are best done by private entities.

So, my hope would be that it would be lending for commercially viable projects in which private entities play an important part.

Representative MOORHEAD. Turning now to the investment tax credit, I am concerned about the fact that it seems to benefit mostly the expanding firm.

What about the firm that is not making money? Is there any consideration to having a refundability of the investment tax credit so that the corporation in trouble will still get some benefit if it tries to improve its situation?

Secretary BLUMENTHAL. There are a number of problems with the refundability.

First of all, it is terribly expensive. Refundability means that you are handing out money that is a credit on taxes which haven't been paid.

You really have a buckshot approach when you do that because you are handing out money to firms and business entities that probably should go under.

It is, in my judgment, a negation of the very private enterprise principle upon which our economy is founded, which is that the bottom line, more than anything else, determines whether or not you have a viable entity.

For the Government to give a firm that can't make a profit, to say we will give you money so you can invest it and add more inefficient resources on which you will lose more money, is hardly a good way for the United States to use its scarce resources.

What we are doing with the investment tax credit under this up to 90 percent of all profits and then you have the carryback and proposal is to increase its applicability up to 90 percent, not 100, but carry-forward provisions, so you really are including, Congressman Moorhead, I would think, all determinations, all business entities that have any legitimate claim based on their success in business on getting some kind of break.

That means a substantial amount of additional resources are made available. The limitation goes from 50 to 90 percent, but to hand it to companies that haven't made any money, and apparently have no prospect of making any money, is, I think, a very expensive scheme and not one that will apply resources in this country efficiently.

Representative MOORHEAD. Thank you, Mr. Secretary. I will shift now to the payroll tax situation.

As you know, there has been a lot of criticism about that. You have expressed some of it in your testimony. Recently, there has been a proposal to treat retirement separately from disability insurance and medicare, financing the latter two out of general revenues but keeping the payroll tax for retirement—you pay in a tax on your wages, you get out retirement funds—have you given that proposal any consideration?

Secretary BLUMENTHAL. Not yet. That has been a very recently proposed thing, I believe in the very last few days, and in fact I read it in the paper within the last day or so.

Such bills have been introduced or are about to be introduced. I think generally speaking I would agree with those who say the whole issue of social security and social security financing requires another look and that the increases that were voted by the Congress are a heavy burden for certain groups of taxpayers, and need to be reviewed.

The problem, as always, is that they are a heavy burden but they also provide certain benefits and the alternatives are no more attractive, or it is not easy to see what alternatives you would choose to keep those funds whole that are all that much more attractive from general economic viewpoints.

That having been said, I do think that the burden is heavy for particularly those at the middle-income level, and even though there is a greater benefit that is attached thereto in part, I would hope that the administration will take another look at it and will come forward with some proposals within the next year or so and I am sure the Congress will also want to take a look.

I don't think that we should let the proposals for income tax reductions be clouded unduly by this problem which is a long-term problem of the social security fund.

We have never sought to make reductions in social security, in income taxes with a view toward taking care of all of the economic problems we face in this country.

People are saying make income tax reductions to account for social security tax increases, make income tax reductions to account for inflation, make income tax reductions to account for energy, for pollution, for tuition, for helping people in colleges.

These are all important national issues, but if we continue to seek to make reductions to deal with all of these problems, I think it would be very easy to calculate, and certainly I have to do that, that the budget deficit is not going to be $60 billion; it will be $160 billion very easily, and clearly we will have inflationary problems and other problems in the economy.

We just can't afford that. So, the income tax reductions of $24.5 billion are designed importantly to stimulate spending and stimulate investment.

They do offset for people below $20,000, roughly, all of these immediate concerns of inflation and payroll taxes. They do not do so for people above, for the simple reason that there is not enough money to do that.

I would be the first one to be in favor of that if we had the resources, but we don't.

Representative MOORHEAD. Mr. Secretary, to the extent that the Congress does not enact the revenue-raising reforms, should we, in your opinion, reduce the amount of the tax reductions so as to come up with, again, close to that $25 billion figure?

Secretary BLUMENTHAL. Well, the revenue-raising reforms amount to about $9 billion.

I think if the Congress were to decide that it does not wish to enact any of those revenue-raising reforms, the Congress and the country has a $9 billion problem on its hands.

The problem is that we have a dilemma of either having a $70 billion deficit instead of a $60 billion deficit, which I would oppose because it is too big in my judgment, and the President would oppose this, or having a smaller tax cut for individuals, which means that even less individuals are going to have payroll tax increases offset or businesses will have less money available for investment purposes.

I hope that is not an either/or choice. I hope the Congress will see that the reforms proposed are desirable, they are fair and just.

Even if the Congress makes changes in the reforms, I would hope that the large portion of those reforms can be accepted so that we are not talking about nine or zero, but that we are talking about eight or seven or something of that sort, or even six.

Then you have a much smaller problem. Then you have a $2 or $3 billion problem. I hope that is the realistic issue we will be facing.

I think $60 billion is the right deficit, and I don't think it ought to be higher. I can't sit here and say if it is either $58 or $62 billion that will be a catastrophe.

I am not, by saying so, changing the position of the administration and saying I am in favor of a higher deficit.

I think $60 billion is right, but I think that is the issue the Congress will have to face.

Representative MOORHEAD. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Representative BOLLING. Congressman Brown of Michigan.

Representative BROWN of Michigan. Thank you, Mr. Chairman.

Mr. Secretary, the thing that has bothered me about the President's tax proposal is that it is pictured or portrayed as providing stimulus for continued or increased economic growth.

Yet, I think most people in the business or commercial area would agree the greatest deterrent to economic growth is uncertainty plus the known.

If we look at what is known, and if you can believe Data Resources, we find that the increases in the unemployment tax, the social security taxes will be $6.4 billion in 1979; $12.5 billion in 1980.

Offsetting those will be the Carter tax reductions, which will be 2.4 in 1978; 5.7 in 1979; 7.2 in 1980; and 6.7 in 1981.

That would mean the net increase in business taxes would be, 1978 to 1981, respectively, $4 billion, $6.8 billion, $7.9 billion, and $13.6 billion.

Those don't include the impact of your tax reforms on business whereby you say you are going to pick up revenues.

I think that it is suggested in your testimony that those reform costs will amount, as far as business is concerned, to over $2 billion.

I presume that is in 1978, and I don't know what it will be in 1979, 1980, and 1981.

So, in short, you are talking from $6 to $20 billion, somewhere in that area, for those years of increased impact of taxes on business.

That is what is known if the President's program went through.

Now, unknown is what is going to be the cost to business and commerce of the energy program, the conversion tax, and the crude oil equalization tax.

What is going to be the cost of all the regulatory measures that are incorporated in the energy program?

My staff found there were some 100 new areas of guideline setting, standard setting, rulemaking, et cetera, in the energy program.

We don't know what the inflationary impact will be on depreciation allowances, replacement costs, et cetera, which are going to be additional costs to business over this period of time depending on what the level of inflation is.

On the other side, offsetting that, we say, "Well, we will probably have to do something more in further tax reductions but no one knows what is going to be done.

They do know what these things are, they do know what they face with an energy program. How can business and commerce have any confidence?

Secretary BLUMENTHAL. Congressman Brown, I think that this program does about as much as possible to provide certainty, because through 1979, it does provide substantial relief and actual net reductions.

Regarding some of the measures that you have referred to, future regulations that have not yet been promulgated or energy taxes that have not yet been voted, clearly the intention is to try to, when that happens, if it happens and when it happens, to take another further look, as you indicate, and to see what else then needs to be done.

I think it is important to recognize that we have a total cut of $24.5 billion, that all of the payroll taxes that are imposed on individuals and business alike, I believe, come to something like $14.9 billion in 1979, so that with a tax cut and total payroll taxes of $14.9 billion we still have a significant net stimulus going to the economy.

If you look at the individuals only, all of the payroll taxes for 1979, both those that already went into effect and as a result of the 1977 law, amounts to $5.7 billion and we are recommending tax reductions on income of $16.8 billion, so there is a net reduction there for individuals.

If you, of course, include inflation in those numbers, then the net stimulus is much less and is roughly a wash, if you take those things together.

Then I have to reiterate again that we are not talking about an economy that is in the doldrums and that we have to give a lot of necessary stimulus to, it is in effect an economy that is doing well and that you would wish to have continue to do well.

I would agree with you that we need to take another look, once we know what the energy program is and what some of these regulations are, and to adjust the system further.

Representative BROWN of Michigan. Mr. Secretary, we just looked at business and commerce, but in that same area, we look at the impact of the tax program on individual taxpayers and we find, I think you said, 94 percent of the tax reductions insofar as individuals are concerned are for those making $20,000 or less.

Secretary BLUMENTHAL. $30,000 or less.

Representative BROWN of Michigan. $30,000 or less, excuse me.

It is said that in 1975 that taxpayers reporting adjusted gross income of between $20,000 and $50,000, paid 40 percent of the taxes collected and in contrast those making between $10,000 and $20,000 paid 30 percent of the bill.

Why I point this out is that it appears that this program is like programs that have been going on, not only in this administration but also previously, which look at the demand side only and give tax reductions to those who by and large purchase, et cetera, rather than those who save and provide investment capital.

It just appears to me that most savings and really your productivity advances occur in the so-called middle-income group which is relatively and comparatively not enhanced in its tax-paying position compared with others.

Why not a more significant reduction in the middle-income tax group and above, like the Kennedy proposal that dropped the rates down across the board?

Secretary BLUMENTHAL. In the first place, on income taxes, there is a reduction for every group up to $100,000.

Representative BROWN of Michigan. You are not saying they proportionately share when you consider the fact that people are moving to higher brackets as well as increased rates?

Secretary BLUMENTHAL. That is true.

We are as of 1979, however, by a proportionately lesser amount as you move on up, reducing taxes somewhat for every group with income up to $100,000, by virtue of reducing the maximum tax rate from 70 to 68 percent, and making some of the other changes.

The numbers indicate that you are quite right, that the percentage distribution of tax liability out of the total for those with incomes of $20,000 to $50,000 is very large.

The reduction on the tax liability for those with incomes of $5,000 to $10,000 is 22.6 percent. For those with incomes of $10,000 to $15,000 it is 15 percent, and for $15,000 to $20,000, only 12.4, and when you get to $30,000 to $50,000, there is a 4.8 percent change which, obviously, is much less than that at the other levels.

It is also true that the percentage of taxes paid by those in the $30,000 to $50,000 income class increases somewhat compared to the total.

Representative BROWN of Michigan. Do those figures contemplate the change from exemptions to tax credits and all the savings, also?

Secretary BLUMENTHAL. It includes those but it only deals with income tax. It does not take into account payroll taxes.

It is only the income tax proposal. It does in that context include the revenue creating reforms as well as the reductions, the substitution of the credit for the exemption and all of those.

Representative BROWN of Michigan. Did you do that kind of study? Looking at what happens, did you raise the base on social security taxes as well as the rate, how it applies to, say, that middle-income group?

Secretary BLUMENTHAL. We have some charts. I would be glad to submit them to you.

We have some data that shows what happens at the $30,000 to $50,000 level, for example.

Representative BROWN of Michigan. Can you describe it for a couple of years as they move us and what you expect inflation to do to shoving people into higher brackets, increasing the base of social security as well as the rate and what that tax impact is on those individuals?

Secretary BLUMENTHAL. For 1978, for calendar 1978, including income taxes and social security payroll taxes but not inflation, there is a net reduction up to the $25,000 level, and there is essentially a washup to the $50,000 level.

That is for 1978. For 1979 there is a net reduction up to the $20,000 level, including now income taxes and social security for calendar 1979, and there is a net increase ranging from $119 at the $25,000 level to $359, for example, at $50,000.

That comes about because there is a relatively small income tax decrease which is offset at the higher levels by the full $439 of payroll tax increase.

We have not added the effects of inflation because you cannot really ascribe inflation's impact to people in different tax brackets because people in different tax brackets are affected differentially by inflation; some people live in subsidized housing, others do not.

Representative BROWN of Michigan. Not at the $25,000 bracket.

Secretary BLUMENTHAL. In New York City there is a lot of rent-controlled housing which does not exist in other parts of the country.

Now, here we have a table in which we show the effects of inflation. It shows that up to income levels of $17,000 for 1979, income tax reductions offset by payroll tax increases and by the impact of inflation create a net reduction, a $37 reduction at $17,000, and begins to result in net increases above $17,000.

At $20,000, there would be a $36 increase for the year, roughly a wash, and at $25,000 it goes up to $216.

So, if you include inflation, it reduces the break-even point to about $17,000 for a four-person, one-earner family.

We will be glad to submit some of these figures and statistics to you so that you have them for the record.

Representative BROWN of Michigan. I would appreciate it if you would.

Mr. Chairman, could they be made a part of our record?

Representative BOLLING. They will be.

Will you submit those for us, Mr. Secretary?

Secretary BLUMENTHAL. We will, Mr. Chairman.

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

NOTE FOR THE ATTACHED TABLE ON THE EFFECT OF INCOME AND FICA TAX CHANGES ON EFFECTIVE TAX RATES

The attached table demonstrates for the years 1977 and 1979 the combined effects at various income levels of social security taxes, inflation, and the proposed tax cuts of the President. Taxes in 1977 reflect social security and income tax liabilities calculated under the tax law then in effect for income levels which are equivalent in real terms to somewhat higher income levels in 1979. Taxes in 1979 for these higher income levels are based on the social security taxes that would then apply and the Administration's proposed income tax reductions.

For each year, the effective tax rate—equal to combined income and social security taxes as a percentage of the appropriate income level—is calculated. If the combined effective tax rates so calculated remains constant, then the real tax burden of the taxpayer does not change. In other words, a constant effective tax rate means that if nominal income rises by say six percent, then taxes will also rise by six percent so that the after tax income of the taxpayer increases by six percent as well, leaving him exactly as well off in real terms 'that is adjusted for the price increase).

Similarly, an increase in the combined effective tax rate means that the taxpayer is worse off in real terms (his tax in percentage terms has increased by more than his income). A decrease in the effective tax rate means that the taxpayer is better off in real terms (his tax in percentage terms is increased by less than his income).

The President's tax proposals have been designed to provide sufficient stimulus to maintain the current economic recovery while at the same time keeping the size of the deficit manageable. In achieving these objectives, the tax program illustrated in the attached table, has also lowered the real tax burden of four person families with less than $17,000 of income. Even at $30,000 of income, the increase in the effective tax rate is less than one percentage point, and this is due to the increases in social security enacted by Congress last year.

THE EFFECT OF INCOME AND FICA TAX CHANGES ON EFFECTIVE TAX RATES, 1977 LAW TO PROPOSED 1979 LAW (4-PERSON FAMILY, 1-EARNER)

1979 income level	1977 taxes [1]					1979 taxes					Combined tax liability with 1977 effective tax rate	Change in tax	
	Equivalent 1977 income [2]	Income tax [3]	FICA tax [4]	Total tax	Combined effective tax rate (percent)	1979 income	Income tax [3]	FICA tax [5]	Total tax	Combined effective tax rate (percent)		Amount	Effective tax rate (percent)
$5,000	$4,440	−$356	$260	−$96	−2.16	$5,000	−$300	$306	$6	0.12	−$108	[6] $114	2.28
10,000	8,880	259	519	778	8.76	10,000	134	613	747	7.47	876	−129	−1.29
12,000	10,656	567	623	1,190	11.17	12,000	502	736	1,238	10.31	1,340	−102	−.85
15,000	13,320	1,070	779	1,849	13.88	15,000	1,072	920	1,992	13.28	2,082	−90	−.60
17,000	15,096	1,345	883	2,228	14.75	17,000	1,430	1,042	2,472	14.54	2,509	−37	−.20
20,000	17,759	1,788	965	2,753	15.50	20,000	1,910	1,226	3,136	15.68	3,100	36	.18
25,000	22,199	2,603	965	3,568	16.07	25,000	2,830	1,404	4,234	16.94	4,018	216	.86
30,000	26,639	3,503	965	4,468	16.77	30,000	3,910	1,404	5,314	17.71	5,032	282	.94
40,000	35,519	5,606	965	6,571	18.50	40,000	6,630	1,404	8,034	20.08	7,400	634	1.59

[1] Tax law in effect Dec. 31, 1977.
[2] Assumes a 12.6 pct increase from 1977 to 1979.
[3] Assumes itemized deductions equal to 23 pct of gross income in 1977 and 20 pct of gross income under the proposed 1979 law.
[4] Calculated under 1977 wage base ($16,500) and tax rate (5.85 pct). Employee share only.
[5] Calculated under 1979 wage base ($22,900) and tax rate (6.13 pct). Employee share only.
[6] Under the administration's welfare proposal, taxpayers in this income class will have a net tax reduction from the liberalized earned-income credit.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Representative BROWN of Michigan. Let's return to energy for a second since you have said you think the Congress has been treating it with benign neglect, as Senator Moynihan might say.

I would say the administration has done likewise. It seems to me that serving on the Ad Hoc Energy Committee in the House and as a conferee that the administration hasn't realistically reappraised its program in light of what has been happening in the country.

I think now it is self-evident. You are going to have deregulation of natural gas. The proposals that are floating around at the present time contemplate that and you are going to have it.

Nevertheless, and everything that I have heard the administration spokesmen say, they still kind of cling to the idea that there won't be.

Wouldn't it be better to just acknowledge that there will be, and get a program and get it as soon as possible, get the crude oil tax, find out what that is going to be? I think if a lot of that were done, then some of the uncertainty which exists wouldn't exist in the business areas.

Secretary BLUMENTHAL. It is my impression, Congressman Brown, the natural gas issue seems to be the No. 1 roadblock that has to be removed.

The people are actively working on that.

Representative BROWN of Michigan. We knew that from the very start, Mr. Secretary.

Senator Russell Long made that abundantly clear along with others.

Secretary BLUMENTHAL. I haven't been able to do much on the tax front until that issue is resolved, although we are waiting in the wings, we are ready to go.

My impression on natural gas is that the administration and its representatives are working very actively with the responsible Members of Congress in order to try to find an acceptable compromise solution and an acceptable compromise to the issue of deregulation.

There is a lot of contact and interchange and the administration is doing all it could to facilitate some kind of compromise solution, but that has been very difficult to effect because of the well-known problems that exist.

Representative BROWN of Michigan. Mr. Secretary, my time has expired, but I would just say that up until recently there hadn't been that kind of movement on behalf of the administration.

I think they were stonewalling it for much too long when it was obvious that they were not going to be able to maintain their position.

In fact, I think it would not be in the best interests of the country if they did sustain the position.

I trust that it will come forward and be much more aggressive in seeking a reconciliation or a compromise in the situation.

Thank you, Mr. Chairman.

Representative BOLLING. I must comment. I am also a member of the Energy Committee in the House and I must say that although I knew Senator Long's position, I had not equated that with the Senate until the Senate had acted.

Senator Proxmire.

Senator PROXMIRE. Mr. Secretary, you appeared before us after a year of substantial success in one big area. We have had a growing economy and an economy that has 4 million more jobs than a year ago, an economy that has a lower unemployment rate.

That is all very welcome.

You set forth a program which the witnesses who have appeared before this committee so far by and large seem to feel is too optimistic for a number of reasons.

Those reasons seem to me to be reasonably sound. For one thing, the growth last year slowed down in every quarter, was 5.7, 5.2, 4.7, 4.2, a relentless drop of one-half of 1 percent a quarter.

If we carry that on, we would grow less than 3 percent in 1978, and there are reasons to expect that may be the case.

You pointed out that housing is unlikely to expand, it may drop. Automobile sales may go down. I don't see that we are likely to have a big expansion in foreign sales.

We may but that does not seem to be very likely.

You put all this together and you are confronted with a situation in which we may not have anything like what you expect to have and what you hope to have.

What do you propose we do if we don't get the kind of recovery that you foresee? What do you recommend?

Secretary BLUMENTHAL. Of course, you have put a question to me which is based upon a hypothesis which I don't believe is a realistic one.

Senator PROXMIRE. It is the hypothesis that is before the committee by and large from the testimony of other witnesses.

Secretary BLUMENTHAL. It is difficult for us to design programs based on assumptions which we think are erroneous. Allow me to give you one important reason why I think they are.

What has happened in the fourth quarter, the lower rate of growth in real GNP in the fourth quarter of 1977, calendar 1977, is almost entirely or largely due to the drawdown of inventories, final sales, which is what you really have to look at, held up very well. Indeed, the rise of nearly 7 percent annual rate was the most rapid in the entire expansion.

Consumer spending held up very well. Indeed, all the indications are that they are very strong as we go into the beginning of this year. They would probably have been strong in January of this year to the extent we can judge what would have happened without the severe weather.

Senator PROXMIRE. I understand you disagree with this analysis.

You may be right. You have excellent economists working with you on this, but my question is: What do you do if you are not right? What do you do if you are wrong? What do you do if by the middle of the year we are not growing as you expect us to grow?

Do you have any kind of proposal in reserve that you can make?

Secretary BLUMENTHAL. The President has always taken the position that if he finds that there are substantial new factors that come into the picture and that the economy is not performing well, that unemployment rises again, that the growth is very slow or if inflation rises too rapidly that he would not hesitate to recommend additional programs.

There would then have to be programs for additional spending or for tax cuts of one kind or another.

I would have to confess that we do not spend a lot of time figuring out what do we do if, because we do believe that the programs with a $500 billion budget and with the effect of the stimulus enacted in the spring of last year still are making themselves felt in the economy through the first half of this year, that we are on pretty safe ground, but if it turns out that it is not the case, we would have to take another look at taxes and at additional targeted spending programs.

Senator PROXMIRE. It would seem to me you would have some kind of alternative available and some notion of a timetable as to when you might propose it if the economy does slow down rather than indicate if necessary the President will come forward with a further tax cut or further spending proposal.

It would be more comforting if we know that you had the emergency fire department ready to go and all the engines were not out of the firehouse.

Secretary BLUMENTHAL. Senator, the fire meets every Thursday morning at 8 o'clock in the room next to my office.

It met this morning. We look at the numbers every week.

Senator PROXMIRE. I know you look at them, but you don't have any proposals in the event the numbers don't look good.

Secretary BLUMENTHAL. It would not be that much of an effort to put something together and as I say we monitor it weekly so we have the smoke detectors out and we know what can be done.

Senator PROXMIRE. Mr. Secretary, let me turn to the other side of this thing that concerns a lot of people: Inflation.

We have had a lot of proposals to counteract inflation from Republican and Democratic administrations over the last 20 years, but I can't recall any administration that had as vague and indefinite proposals as this administration has.

It reminds me of Lincoln's definition of homeopathic soup: Soup that was made from a shadow of a pidgeon on a moonless night that had starved to death.

It seems to me to be very unsubstantial.

If you look at the prospects in the coming year, 1977 was a worse year than 1976 or 1975, from an inflation standpoint, 5.9 percent; the general price level rose compared to 5.5 percent in the first seven quarters of recovery, consumer prices increased 6.7 percent during 1977 compared to a 5 percent figure from March 1975 to December 1976.

Then, when you look at the elements that are likely to push up prices, first of all, labor markets are becoming tighter; second, trends in productivity are down; third, we have an increase in the minimum wage, which I supported, and the social security taxes, which, again, I supported, that are likely to push prices up.

Fourth, a deterioration in the value of the dollar to increase the price of imported goods, and given the very serious pressure on prices, do you feel the administration's anti-inflation program such as it is will have any effect?

Secretary BLUMENTHAL. I think it is a stronger program than we have had.

Senator PROXMIRE. Than we had when? There are no guidelines.

I don't know of anything in that program that would give us any assurance that it will hold prices down or wages down.

Secretary BLUMENTHAL. It is very difficult, Senator, in my experience, to deal with this problem, if you take all of the various conflicting concerns into account.

If you rule out wage and price controls, which I certainly welcome our having done, and rule out the kind of encouraging and armtwisting which has been tried before and has not worked, because it tends to be counterproductive since expectations are that this is going to lead to mandatory control——

Senator PROXMIRE. Those guidelines worked very well in the 5 or 6 years until the airline situation protruded and the Vietnam war happened.

I thought they worked extraordinarily well. We had a period of price stability then and of recovery and economic activity that was most encouraging.

I don't know why we turn our backs on it and say it didn't work.

Secretary BLUMENTHAL. This program of deceleration based on cooperation between labor and management with the Government backed up by a number of specific programs including the reduction of some excise taxes and unemployment insurance taxes, and an effort to get a much better handle on the inflationary Government regulations, together with an effort to get wage and price increases made at levels that are less rapid then they were in the previous year, should give us a reasonably good chance. This is a kind of a stand that we can apply and will apply, together with an effort to have these discussions with business and labor early, not at the last minute, and we are starting those.

I think it will give us a chance to keep inflation under better control.

Senator PROXMIRE. I hope so.

I understand the difficulty. It is great.

Both management and labor oppose any action and I think we are going to have to take action they don't like. I don't call for wage and price controls. I would agree with you that they didn't work, but I think we need something of much more force than we have tried to do.

I have talked to Mr. Bosworth, as I am sure you have, and I think he is an extraordinarily able man, but he seems very frustrated, he seems not to be able to find a way that he can put together a program and get support, and really do the job.

Secretary BLUMENTHAL. I think we need to give it a try, Senator.

I am absolutely convinced, based on my experience in this job and my previous work when I was in private industry, that unless you get something, unless you can find a way in which you get labor and management to cooperate or at least to acquiesce, if labor and management in this economy is actively opposing you, you haven't got it.

Senator PROXMIRE. Let me ask you: You have been quoted in the newspaper directly. You have been quoted as conceding that the balanced budget and the eventual surplus projected in 1980 and 1981 obviously is not going to happen.

This committee has been convinced for some time that the balanced budget goal is not realistic and in fact published a staff study which reached that conclusion last August.

Have you not been reported actively in the press that we will have to forgo the balanced budgets?

Secretary BLUMENTHAL. No, sir, the particular quote which you recite is inaccurate.

What I said, I was referring to the fact that past 1979 the figures that we presented in the Budget and that were discussed in the Economic Report of the President, would show a surplus of about $8 billion in fiscal year 1981 and rising above $40 billion in fiscal year 1982—those are pretty obviously not going to happen automatically.

Those are projections of what would happen based on present circumstances if nothing else changes, if there were no additional taxation, no additional spending programs, purely a projection out into the future.

It is not a prediction of things to come. I said that is obviously not going to happen automatically. What I did further say was that the present recommendations for fiscal 1979 do not preclude the President from moving in that direction.

They have not removed the option to the President for moving toward budget balance in 1981. It is a judgment he then has to make in light of existing circumstances.

I think that if the economy performs well he has an option, even with further tax cuts to bring about a substantial reduction in the deficit; whether it actually means balance or not, I really don't know.

Senator PROXMIRE. If you say that, it seems to me you are backing away from it, if you say you don't know, that is not the assurance we got from the President that the budget would be balanced in 1981.

Secretary BLUMENTHAL. The President is as committed as ever to seek to achieve that goal. Whether he can actually achieve it depends on what happens to the course of the economy.

It is a judgment he has to make a year from now again as he presents his next budget. I doubt whether he will want to go ahead with choosing the option of balancing the budget if it means pushing the rate of unemployment up substantially.

I think you would be one of the first ones to criticize us for that.

Senator PROXMIRE. I think that is right. It seems to me that it is quite clear that is going to happen and the President is not going to be able to balance the budget.

Secretary BLUMENTHAL. You may well be right. He has not made that decision. He wants to move toward balancing the budget. He has the option to do so.

He is going to look at the economy and make the decision of to what extent he wants to recommend a further tax cut or other spending action or to what extent that is not necessary because, as it turns out, the projection is right and the economy is moving well.

Senator PROXMIRE. My time is up, Mr. Chairman.

Representative BOLLING. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Mr. Secretary, in your prepared statement you rightly included No. 1 among the forces that could pull us down from our safe track, what you call the sharp increases recently legislated in taxes for social security.

I completely agree with you that Congress did a monstrous thing in December and the President shouldn't have signed it, but happily this institution is showing some signs of self-corrective possibilities and there are movements afoot to go back and do it right, and not to bring on stagflation by increasing the tax.

I think that one could keep the tax at its 1977 level for an ultimate annual expenditure on the order of $8 billion, and I hope as the first order of business that Congress makes a move and does that.

If Congress does come to its senses and takes from the general revenues that which is needed to keep the social security fund actuarially sound, you would immediately want, would you not, to reduce your tax reduction program by an equivalent $8 billion?

Secretary BLUMENTHAL. I think that the question of social security taxes should be reviewed again. I agree. I am not sure that it should affect the action that the Congress should take this year with regard to the program of income tax reduction that the President has proposed.

Some of these taxes, social security taxes, will go up only in subsequent years, and I think there is some time in the future to do that and to do it right this time.

Representative REUSS. Why wait? If you go looting the revenues by a tax cut, you will not have the wherewithal to repair the social security fund, and, of course, the tax cut is a terrible mismatch.

The working poor guy who doesn't pay income taxes has to pay his increased social security tax; he makes $6,000, and that is murder.

Secretary BLUMENTHAL. At those levels, we have substantially reduced the income tax.

Representative REUSS. He doesn't pay one now.

Secretary BLUMENTHAL. In fact, we have raised the level at which there is no income tax liability rather substantially. So, we have provided considerable offsets there.

At one level, at the $5,000 level where there is no income tax, there is a $14 increase in payroll taxes, so there is a net increase of $14.

But, at every other income level up to $100,000 there is a substantial reduction.

Representative REUSS. The businessman, too, has not been helped. If he doesn't make any income, the income tax cut doesn't help him, yet he is still paying that 5, 6, or 7 percent on social security.

You are the first one to admit that it is a monster. You want it rectified.

What I am saying is that you don't really rectify it; why not switch gears and ask us as the first order of business to do it right.

I think Congress is hearing enough from outraged small businessmen and workers, so we will have the incentive.

Secretary BLUMENTHAL. I think it is a matter that ought to be looked at separately. I think it ought to be done with care.

I would not call it an outrage and a monster, but I would say it is a serious problem which needs to be looked at.

I don't think the income tax proposals should be affected by it in any significant way because they have, among other things, the very important goal of providing more incentive for business to invest which creates jobs, which provides opportunities for people that are not employed to get jobs or to start paying some income tax and having some benefits on that side, and also for providing relief to the not only lowest but also the lower middle and middle income levels, which is important.

So, I think those two things both need doing. I think we have some time for the second go-round to do it right, and I would hope that the income tax program can go forward roughly along the lines we have recommended.

Representative REUSS. I guess we differ. I wish you would undertake the task to explain to a teed-off worker who now sees what is being done, why he should pay a regressive tax so that a corporation or a person in the 70-percent bracket can pay a lesser tax.

Let's turn to something else.

Another thing in your package which bothers me is the proposed extension of the investment tax credit to industrial structures, factories, plants, buildings.

We have had plently of trouble in our part of the country with factories leaving home now for the suburbs, the exurbs, the Sunbelt and whatever.

If you place an additional incentive, or a decision to go build a whole new plant, I am not sure we will have anything left in Milwaukee.

Secretary BLUMENTHAL. Congressman Reuss, the relative situation between city and suburb or rural area is not really changed by this proposal at all.

We make the investment tax credit applicable to new structures and to the refurbishing of existing structures. So, they are both included.

They are included wherever they are located. If the return to capital was there, it will not be here, but the relative position will not change.

I really don't think that will mean that there will be a greater exodus. I think it will mean just as much that investors or businesses in the city will have more money available to fix up their place and they won't have any more money available if they go outside.

That differential will not be affected.

Representative REUSS. I think you are mistaken, unhappily. Any investor who gets any kind of an incentive to move out to the suburbs, exurbs or the Sun Belt for a factor is going to do just that. He is already inclined in that direction.

If you give him a bonanza for doing it, he is over the hill and you will never see him again.

Secretary BLUMENTHAL. Even if he gets the same bonanza for staying?

Representative REUSS. Yes. He is lured by the warm Sun and docile labor out there.

I think you are committing a dreadful mistake. Why don't you give an investment tax credit for structures to people who will put up a plant in an area where more than "X" amount of unemployment exists?

That would help people everywhere. That would help Atlanta and New Orleans as well as Milwaukee and Detroit, but you could do it right.

Secretary BLUMENTHAL. I don't believe that a locational decision is made on the basis of an investment tax credit.

I believe the locational decision is made on a combination of factors, many of which are a great deal more important than the one credit, and even if we could say, "Well, you get a little more if you stay within a certain area than if you go out of it," I don't believe that would have any impact on the locational decision.

It is in terms of where your market is, where your labor is, where your people want to live. There are factors that really outweigh this by a large margin.

Representative REUSS. I didn't say you would get a little more. I said you would get a lot if you locate in a high unemployment area and you would get very little if you locate where there is full employment.

Secretary BLUMENTHAL. I think that is important. I think that has to be done through the kind of urban program that the President is getting ready to send to the Congress in March where you deal with direct economic development incentives for urban areas and direct payment programs of some kind.

We don't use the tax system particularly to target that. It is very hard to target that for taxes.

Representative REUSS. Record my distress that regarding the urban program we are going to recapture the foolishness committed in a tax bill. So be it.

A third thing: The Federal Reserve has recently been embarking on an experiment that doesn't please me, either. They have been raising domestic interest rates, Federal funds, all across the line, in order to protect the dollar.

Do you approve of that? Do you approve of raising interest rates higher than they would otherwise be for domestic reasons in order to attempt to lure to this country a billion or two of foreign investment?

How is that going to improve our $30 billion budget trade deficit?

Secretary BLUMENTHAL. As a general proposition, no, sir. I think as a general proposition, interest rates and monetary policy should be directed first and foremost to the goal of maintaining strong stable full employment economy in this country.

I do believe that we must work closely together with the Federal Reserve in assuring the strength and integrity of the dollar and that there are sometimes circumstances under which some action may be taken or tip the balance or the direction being taken because there are important international factors which in turn have a beneficial impact on the domestic economy.

I don't want to comment on the particular decision that has been made. It wasn't made by me and no particular purpose would be served.

Representative REUSS. That is precisely why you should comment when the Federal Reserve is independent but it is not a separate government.

It is part of the United States, and it seems to me that the Treasury and the President ought to blow the whistle on the Fed, if the Fed takes steps to bring about stagflation in the domestic economy in the mistaken belief that luring a billion dollars or two over here in extra foreign investment is going to make the slightest difference to a dollar weakened by quite different things.

Secretary BLUMENTHAL. A number of things happened in the last few weeks that have had an impact on the international situation.

It is very difficult for me to tell which of these factors has had what impact. I think none of us can really tell that.

I really can't tell whether the raising of the discount rate did or did not have an impact.

That is one of the things that happened. The disorderly movements that existed in the exchange markets clearly were a worrisome thing to all of us.

Representative REUSS. So, modest intervention for the market purposes was fine. We all said OK to that, but I don't think we said OK to raising interest rates.

Who thought that one up?

Secretary BLUMENTHAL. As a general rule, I certainly believe that interest rate policy and monetary policy should direct itself toward achieving the domestic goals and I think the domestic goals are closely related with the international ones, because I happen to believe that investment in the country and the strength of the dollar is importantly in the final analysis affected by the strength of our international economy.

Representative REUSS. If that is your view, and I commend you for it, why don't you notify the Fed today to knock it off and stop it?

Then they could tell you to go to hell, but at least we will know who is doing his job.

Secretary BLUMENTHAL. I have regular, frequent communication with the Fed on this and all of these matters. We make our views known.

Representative REUSS. This has not been our most satisfactory exchange, but I am with you on the Witteveen facility.

Secretary BLUMENTHAL. Thank you.

Representative REUSS. Thank you, Mr. Chairman.

Representative BOLLING. Congressman Brown of Ohio.

Representative BROWN of Ohio. Hello, Mr. Secretary. It is nice to see you.

I want to talk to you a little about the question of the bottom line.

As I understand, you have told the other Congressman Brown from Michigan, that given the social security tax increase and the proposed tax reductions of the President, a family making $17,000 a year will really come out with a net tax payment similar to what they have now.

That confirms what I have been telling my constituents. They ask me how they are to know if they are in the middle class, and I say "You know you are in the middle class if you are promised tax reduction and then, when it is announced, you wind up paying the same or more."

I think that is a fair statement if a $17,000-a-year income really gets no benefit in terms of net tax reduction from the combination of social security tax increases and Presidentially proposed tax decreases.

The figures I have indicate that the increase in taxes in the year 1985 over what we are paying today will run about $40 billion for social security, and $50 billion on the inflation bonus that the Government has built in—that is, $7 to $10 billion a year, but between the baseline of now and the figure that we will be paying in 1985, if we are all escalated into that extra 2 percent each couple of years, we will wind up paying $50 billion more annually by 1985—and the energy taxes which the President proposed I think netted an increase of about $39 billion new taxes by 1981.

Now, I don't have the 1985 figures because, unfortunately, in the new energy plan, they all were dropped after 1981 or 1982, and it just wasn't clear as to what would be done after that time.

Even the House did not do that. The House only put in $29 billion of taxes; they knocked off about $10 billion. So, somewhere between $120-$130 billion of new taxes will be added on to the society by that time.

I guess what I am trying to get at, since billions of dollars are so hard for us to figure, is what that is likely to amount to for the average taxpayer in the way of increases by 1985. Do you have that figure on a per-person or a per-family basis?

Secretary BLUMENTHAL. No, I don't.

Representative BROWN of Ohio. Well, I figured it out—I thought maybe you might not have it. I figured it out to be somewhere between $2,000 and $2,500 a year in additional taxes per tax-paying family, average.

Now, of course, a lot of people don't pay taxes and some people pay more than others, so for the middle-income guy who never gets any of these decreases, I would assume that he will have it somewhere higher than $2,500 in additional taxes.

Is that fair?

Secretary BLUMENTHAL. I can't just agree with your calculations, because I would have to go back to them and look at the numbers.

Representative BROWN of Ohio. They are based on this thought that every $1 billion the Government spends or taxes from us costs each individual $5 and each family $20, so that when we have a $50 billion tax increase, that is $1,000 per family.

Secretary BLUMENTHAL. I would like to make a couple of general comments before getting to the specifics.

In the first place, I don't believe it is fair to say that the President promised, in putting forth his income tax proposal, that these were designed to involve reductions on net for all taxes, including social security and energy and income through 1985.

Representative BROWN of Ohio. Can you give me the net for some year?

You can pick the year and tell me the net. We got into this once before on net, trying to figure out what the net taxes on energy were and you told me you could give me the gross but not the net.

I had a lot of trouble with that.

Secretary BLUMENTHAL. I can give it to you in the following way: For 1979, the total of all Federal taxes, in other words, income and payroll and social security, will be roughly the same percentage of personal income as it was in 1977, about 14 percent.

Representative BROWN of Ohio. That is the beginning of the social security tax increase.

I would like to get it out there somewhere when it really gets up there.

I am getting complaints and my people are shocked about the social security tax increase. I am able to handle it pretty well because I voted against it.

My people are beginning to complain now and I keep saying to them, and they don't believe me, that you really haven't seen anything yet because the real impact is out there.

Secretary BLUMENTHAL. Right.

Representative BROWN of Ohio. And it is after the 1980 election; isn't it?

Secretary BLUMENTHAL. On that one, I would say, first of all, I certainly think the administration and the Congress should take a look at the social security taxes, particularly as they affect out years; second, on energy taxes——

Representative BROWN of Ohio. Did you not look at them then when the President made a recommendation?

Secretary BLUMENTHAL. They were looked at in the same way the Congress looked at them.

Representative BROWN of Ohio. Which was what? That we were unaware of the impact?

I saw the figures ahead of time. You knew what the impact was going to be, didn't you, on the average social security taxpayers, or didn't you?

Secretary BLUMENTHAL. Certainly.

Representative BROWN of Ohio. What has changed, then?

Secretary BLUMENTHAL. The change is, in my judgment, necessary because the impact in the out years appears to be so heavy that the question of whether or not some changes in it should not be made and different forms of funding them might not be desirable ought to be reviewed.

Representative BROWN of Ohio. Weren't those impacts apparent when the President made his recommendation?

Secretary BLUMENTHAL. Yes. the President's recommendations were somewhat different. They were different than those which the Congress voted.

The Congress increased the impact on the average taxpayer. You may not have voted for it but many Members of Congress, enough to pass it in fact, made that impact considerably worse than we recommended.

Now, you can't castigate us——

Representative BROWN of Ohio. Mr. Secretary, the President signed it. So, my question is: When he recommended it or when he signed what the Congress actually did, did no one look at those impacts out there and see what they would do to the individual and also what they might do in macro-impact terms to the whole economy?

Secretary BLUMENTHAL. I think the impact on the whole economy is a matter that is sufficiently in the future in 1982 to 1985.

We have a chance to take a look at that and to make the changes.

Representative BROWN of Ohio. Mr. Secretary, I don't want to be rude, but you are not answering my question. The question was: Did you look at it, and what has changed your view between the time you looked at it and recommended, I assume, that the President sign it, and now, when you are telling me that we ought to look at it again?

What has changed in that interim period? It has only been a couple of months.

Secretary BLUMENTHAL. What has changed my view is that it would appear that the same Congress that went further than we did now feels, apparently, that maybe that was not a good decision and that we ought to see now that we have a little more time, whether there are other ways of dealing with it.

I think that is a good idea.

I am guided by all your colleagues, Congressman Brown, who suddenly have changed their mind and I say if they have changed their minds, let's take another look.

Representative BROWN of Ohio. So, the reaction is a political one rather than an economic one?

Secretary BLUMENTHAL. I don't think it is fair to say it is a political reaction. I am saying that the Congress who voted for it said we should take another look and I say let's take another look.

Representative BROWN of Ohio. Can you tell me where you think the energy taxes are going to come out?

The President, as I said, in 1981, recommended a program that would be $39 billion of new taxes in energy, net new taxes; as I understand it, the House passed $29 billion of net new taxes.

Do you still think those energy taxes are desirable at either the level recommended by the President or the level which the House approved?

Secretary BLUMENTHAL. I don't have the same numbers you do.

The net impact of the President's program, assuming the bill is enacted will be $4.6 billion in calendar year 1981.

The effort, of course, is to return virtually all of those taxes back to the economy. There was no intention to have a net, except in some small areas.

Representative BROWN of Ohio. The President recommended a 5-cent gasoline tax; remember that? Five cents a gallon on gasoline as a tax that was going to increase every year and we didn't pass that.

That explains the $10 billion difference between the $29 billion and the $39 billion in 1981.

In 1981, you have all of the coal taxes, you have the automobile taxes, you have those that relate to conversion, somewhere your $4 billion and my $29 billion need a little rationalization.

Secretary BLUMENTHAL. I think they certainly do. The taxes that would have been collected, if any, I think you are referring to the standby gasoline tax——

Representative BROWN of Ohio. Yes, sir.

Secretary BLUMENTHAL. First of all, it is a question if they would have been collected because that related to the notion of how much would be consumed.

The goal was to make sure that Americans collaborated sufficiently to reduce consumption so that it would not be collected.

I guess you have made the decision that Americans would not have collaborated and therefore the full tax would have been imposed.

It would have been fully rebated and that would have ranged up to the following maximum amount which, in 1981, would have been $3.5 billion.

Again, I don't know where your numbers come from and we can work on them and see how they fit.

Representative BROWN of Ohio. They come from the 5-cents-per-gallon-per-year increase.

My time is up, but maybe we will have the opportunity to continue with this later on.

Representative BOLLING. Senator Roth.

Senator ROTH. Thank you, Mr. Chairman.

Mr. Secretary, it is always a pleasure to have you up here.

I expect that you feel that it is an experience that is warm and worthwhile, but I think it is important that we have the opportunity to exchange ideas.

As you recall last January when the new administration first came in, I was fortunate enough to have breakfast with you and at that time I expressed my concern about the direction of the economy and my belief that it was important that we take some bold, imaginative steps to get the private sector moving again.

I urged upon you, and as I have in the past upon the President, that we do now what Jack Kennedy did in the sixties, and that was to provide some real incentive to the private sector to move ahead.

In all candor, I am disappointed in what is being proposed here because basically it is sort of a stand-patism approach.

Your budget really goes up a little, there are spending increases, and no programs are dropped. We are really providing no major incentives to the private sector to invest, to modernize.

I think the administration, in many cases, has said it is very important to do something about investment.

I am concerned about the fact that we have the largest trade deficit in our history.

Yet we see a proposal that at best is merely a rebate of other new taxes and it doesn't fully offset them.

Jack Kennedy cut taxes in the sixties. Mellon did it earlier.

Why won't this administration take some real steps to get the economy really moving again?

Secretary BLUMENTHAL. I am not delaying my answer. I just want to finish this note. I'm sorry, Senator.

I think we have had a good year, going back to a year ago January. There were some—and I think you may have been one of them—who were sort of concerned about 1977. I think we had a good year in 1977.

We had good growth, we had a good reduction in unemployment. We contained the threat of increasing inflation. We didn't bring it down enough.

We actually, on that first budget, had a smaller budget deficit than estimated. The effort, therefore, is not, Senator, to make a huge push forward because that would mean a large budget, a lot of Government involvement, a large deficit, but rather to keep this good momentum going forward.

You said correctly the budget goes up only a little. I am rather proud of that. I am rather proud of the fact that it is only a little more than 1 percent in real terms of budget growth.

I am rather proud of the fact that the President didn't overreact and didn't just keep going on the old track.

The second issue is the major incentive for the private sector. I have spent a lot of time talking to business and financial community representatives to find out what they wanted.

As a matter of fact, many of your Republican colleagues were making this point to me. In this regard, the President really reacted very positively by choosing exactly what was recommended, an across-the-board cut in the corporate tax rate, which was rather substantial.

He did not engage in fine tuning, in any temporary measures to give greater confidence. He chose the private sector rather than more Government spending.

He is keeping the budget deficit from going above 60. I would like to see that come down. So. I think when you add it altogether, I guess my answer is that you don't need these huge programs——

Senator ROTH. Are you satisfied with the $27 billion deficit in trade?

Secretary BLUMENTHAL. No; not at all.

Senator ROTH. Let me make one comment, Mr. Secretary. I am very disappointed with the budget, to be candid about it.

The administration puts in zero budgeting and I am a supporter of that. I think it is a step forward, but not one single program, as far as I can determine, has been dropped or deleted.

Now, what bothers me is that we still have very serious unemployment, we have to have something like 15 million new jobs by 1985, and I don't see how the economy is going to satisfy that need.

It is curious that the administration's position now is that the economy is doing all right, but 6 months or a year ago, they were saying the very opposite.

Let me ask you this question: During the campaign a year and a half ago. the President said that he was not going to raise taxes on the working people of America, and of that you could be certain, or words to that effect.

I don't have the exact quote in front of me. Now the National Journal of February 4. 1978, points out that even if President Carter's proposed $25 billion tax cut is enacted, most individuals and families of four will pay a greater percentage of their income in Federal taxes in 1978 than in 1977, assuming that their salaries rose with the cost of living.

So, the average American is faced with much higher taxes than before.

Middle America is finding it increasingly difficult to keep up their standard of living.

Newsweek had, a few months ago, an article pointing out that we faced for the first time with downward mobility. Yet your tax proposal is doing very little or practically nothing to help working Americans; in fact, they are faced with higher taxes.

Now, we know that your tax package, with the social security increases and the increased inflation in the future, will mean that during the next 5 years you will be taking out something like $27 billion more than you are taking in, and if the energy package goes through with the crude oil equalization tax, that will rise to something like $70 billion.

What bothers me is that we are really doing very little for working America to meet the problems of inflation and in fact once again they are the forgotten man of America.

I wonder if you care to comment on that.

Secretary BLUMENTHAL. I think, in the first place, Senator, it is true that we have to choose between the things that we want to do and many of the things we want to do in this country do cost money and the Congress is not bashful about suggesting and passing programs that cost money.

It has to come from some place. However, it is true also that the tax program which the President is recommending will involve very substantial income tax reductions, which essentially, 94 percent of which, in fact, go to people who make less than $30,000.

The National Observer is wrong when it says it will not benefit most people. Most taxpayers are at those lower levels. If you take social security and income taxes together, that means that even for persons with income of $20,000 there are net reductions in 1979, and, I believe that 84 percent of all taxpayers have income of $20,000 or less. In 1978, for close to 90 percent of all taxpayers, those with incomes of $25,000 or less, there are net reductions.

It does not mean that people in the $30,000, $40,000 or $50,000 brackets, even though they will have a reduction on income taxes, will also have a reduction if you take into account payroll taxes.

That is true. By raising the wage base on social security, they will have higher benefits. We can't have higher benefits and not find a way to pay for those.

Senator ROTH. There are two things that bother me. As I look upon the whole package, it is a real ripoff on middle America. There are some in Washington who think anybody making more than $20,000 is affluent and well-to-do, yet the Labor Department at this very time is saying that $20,000 is the minimum income a family of four can have to afford any decent standard of living whatsoever.

As a matter of fact, the person who makes $20,000 today has the equivalent of roughly what 10 years ago was $11,000 or $12,000.

Very frankly, if we don't get out of this course, it will take roughly $35,000 in another 10 years to have the equivalent standard of living and, of course, that means higher rate of taxes.

The only people paid off by inflation is the Government. President Kennedy didn't consider that people who made $20,000 were wealthy. He had an across-the-board tax cut.

I really urge the administration to go back. Those who are making $20,000, $25,000, $30,000, believe me, do not look upon themselves as rich.

Senators complain about making $57,000, if you listen to them in the cloakroom.

The second point I would like to make is the question of Washington making all the choices of where the spending should be.

Anyway, what bothers me most is by continuing all the programs we are not doing what many of us who successfully ran in the fall 2 years ago were saying—let's have less regulations, less Washington. We are in fact saying, "Bring the money to Washington; we will make the choices".

I do hope the administration will give some careful thought to the practicality of an across-the-board cut, which I think would pay off handsome dividends for the Federal Government as well as the economy as a whole.

Secretary BLUMENTHAL. Senator, I take due notice of what you are suggesting, but there are some tradeoffs that we are going to have to make. You pointed out that the budget went up very little and there was nothing bold about that, and then at the same time you want a large tax cut.

We are going to have a huge deficit.

Senator ROTH. It went up 8 percent.

We did not drop or delete one program. We are continuing countercyclical funds at the very time when State budgets are in balance as a whole and the Federal Government isn't.

I don't see where the hard decisions were made in the budget to hold down spending.

Secretary BLUMENTHAL. We are holding the budget down to a smaller increase than it has been in a good many years.

On countercyclical, we are in fact reevaluating it to see what we can do to it, or to retarget it or reduce it in some way or another.

As the need for it declines, I want to go back and see on the zero-base budgeting, as a result of the first year we have had a good start on, to present to you what in the way of programs has been changed or reduced.

The point is, we can't have major reductions and not have a huge deficit. There are a lot of people worried that it would start inflation up again.

I am concerned about that. I think $60 billion is really enough.

Representative BOLLING. Mr. Secretary, I am aware that you have a time problem. As you know, I have asked no questions.

I am going to ask a couple, one relatively technical, and the other one very general.

I have said of the President's economic program that I thought that the centerpiece of that program was the unenacted energy bill, not the tax bill, which is so frequently described as the centerpiece.

You mentioned, in your statement, that one of the reasons, if not the principal reason, for the disturbance in the exchange markets and the problem with the dollar had to do with foreign perception, other countries', other people's perception of our lack of will.

You didn't say it exactly that way. I don't want to put words in your mouth—our lack of ability to deal with an energy problem, not over a period of a year of this administration but over a period of 4 or 5 years.

Am I incorrect in my perception that the energy policy is the most important thing that affects this country economically at the moment?

Secretary BLUMENTHAL. You are absolutely right, Mr. Chairman. I said it here and I and others have said it in every public statement we have made.

It is the prerequisite for the achievement of any of the other things that we are talking about, particularly over a multiyear period.

I have no doubt, based on my intimate contacts with finance ministers in other countries and my involvement in that constantly, that the fact that the Congress has not passed an energy bill, that we have not got that on the books at the moment, is considered to be a symbol for our difficulty in taking action in this area, and therefore people say, "Well, not much is going to happen; therefore, with regard to reducing their deficit and it is going on for an indefinite period and the dollar will continue to be weak, so they start selling the dollar short".

That is what has happened.

I think it is very important that the energy program question be solved.

Representative BOLLING. My other question is on an entirely different subject.

The report of the Council on Economic Advisers states that the most fundamental change in the proposed income tax is the replacement of the $750 personal exemption in the general tax credit with a single-year per capita tax credit of $240.

The question is: Don't you think it would be appropriate to make the credit fully refundable—and you have indicated your view of refundable taxes earlier in reply to Congressman Moorhead's question on refundability of the investment credit—but what I am really after is whether you have made any revenue estimates that would give us some idea of the cost of such a proposal.

Secretary BLUMENTHAL. We can get you those.

Representative BOLLING. I would like to have that. It would be helpful.

Secretary BLUMENTHAL. We will submit it for the record, if you like.

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

REVENUE LOSS FROM MAKING THE $240 PER CAPITA CREDIT REFUNDABLE

The revenue loss from a refundable $240 per capita credit would be about $15 billion at 1976 levels of income.

Representative BOLLING. In addition to that, the members of the committee, I understand, have questions they would like to submit to you in writing and I would like you to reply to them.

I will submit them on their behalf.

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. W. MICHAEL BLUMENTHAL TO ADDITIONAL WRITTEN QUESTIONS POSED BY MEMBERS OF THE COMMITTEE, SUBMITTED ON THEIR BEHALF BY REPRESENTATIVE BOLLING

Question 1. In 1977, the U.S. dollar slipped about 5 percent in value relation to the currencies of its major trading partners. As a result of the slippage in dollar value, the cost of imports will rise. How much impact will that increase have on the consumer price index? On the GNP deflator?

Answer. There is no single, unique measure of "the" impact of the dollar depreciation on the U.S. price level. Estimates vary widely depending upon specific assumptions made and the degree to which indirect effects are taken into account, for example:

The degree to which foreign sellers "pass-through" the effects of dollar depreciation in the form of higher dollar prices.

The degree to which prices of domestically produced substitutes, and other products may rise in sympathy with dollar import prices.

Possible indirect effects of increase in consumer prices, e.g., on wage demands.

The extent to which exchange rate changes are passed through (both directly and indirectly) to U.S. prices depends on utilization rates both here and abroad. The higher the degree of resource utilization, the greater the likelihood of pass-through. It is estimated that when all these effects have worked through, a 1 percent depreciation of the dollar might increase the CPI by .25 percent, with about .15 percent being felt in the first year.

We would expect the effect of dollar depreciation on the GNP deflator to be of similar orders of magnitude.

Question 2. The lower relative value of the dollar should act to increase U.S. exports and reduce U.S. imports. By how much and in what time period will the depreciated dollar affect U.S. imports and exports?

Answer. Empirical studies suggest that a 1 percent improvement in our price competitiveness, as measured by the price-adjusted exchange rate—whether due to exchange rate change or to differences in inflation rates—is likely to produce an increase of $½ to 1 billion in our exports when fully effective. The time lag involved is on the order of 1½ years.

Question 3. For several developing countries, the export of manufactured goods has become a very big business. On a recent trip to Brazil, Assistant Secretary of the Treasury Bergsten suggested that Brazil and other "middle income" developing countries reduce their barriers to imports from the developed world. Has the new policy toward the "middle income" developing countries been reflected in our stance at the Tokyo round of trade negotiations?

Answer. Yes, the new policy toward the "middle income" developing countries has been reflected in our stance at the Tokyo round of trade negotiations. We have emphasized to developing countries that we expect them to make some contribution to trade liberalization in response to our offer in the MTN to cut tariffs and other barriers and trade. We will soon indicate our specific market and supply access interests to each country. We recognize that the poorer developing countries cannot grant us full reciprocity and do not expect them to do so. However, we believe that developing countries should make contributions consistent with their trade, financial, and development needs. We believe trade liberalization aids development and is therefore in the interest of developing as well as industrialized countries.

We have also offered to consider special and differential treatment for developing countries in certain trade areas to the extent it is practical and feasible. While we have not presented a proposal in detail, we have agreed to consider some form of special treatment on the condition that it be tied to developing country graduation. That is, as developing countries develop, they must accept more responsibilities in the open world trading system and make more contributions toward its maintenance. Our basic policy is to favor generalized liberalization and not to grant permanent preferential treatment.

Question 4. How would the volume of U.S. exports be affected by the full application of developed country GATT standards to the "middle income" developing countries?

Answer. There are too many variables and unknowns to permit any reasonably accurate quantitative estimate of the potential increase in U.S. export volume. Trade liberalization by the "middle income" countries probably would have some positive impact on U.S. exports. However, the ability of those countries to purchase goods from us could be limited by the amount of foreign exchange they have available.

Response of Hon. W. Michael Blumenthal to Additional Written Questions Posed by Senator Proxmire

Question 1. There is a feeling in some government circles that Robert Strauss was heavy-handed and unnecessarily harsh in his handling of the trade negotiations with Japan. Some people believe he may have publicly humiliated the Japanese government and that this could have been avoided. Have such concerns been expressed to you, and what are your own views?

Answer. I am aware of the criticism of Mr. Strauss in some press articles, but no one has expressed such views to me personally. I strongly disagree with such criticism. Robert Strauss negotiated firmly and fairly with the Japanese. I applaud the diligence and tact of both Mr. Strauss and his counterpart, Mr. Ushiba.

Question 2. It is also being said that the agreement worked out with Japan will not significantly increase U.S. exports to Japan. What will be the impact on our exports from the agreement?

Answer. In considering the impact of the Strauss/Ushiba announcement on U.S. exports, one must take into account the entire sweep of its several parts. Major features include a reiteration of Japan's decision to strive for higher economic growth, commitments by Japan to play a leading role in MTN negotiations, to reduce tariffs on a wide range of manufactured goods, to liberalize quotas on several agricultural products, to increase the share of manufactured goods imports relative to total imports, and a pledge to seek a large reduction in the current account surplus in 1978 and 1979 and to accept a deficit if one should occur.

All of these undertakings will directly contribute to an increase in our exports to Japan. More importantly, each part of the agreement multiplies the impact of others so that the total effect is more than the summation of the particular sections. For example, while the advance tariff reductions will have some impact upon exports of a specified list of U.S. goods, the higher rate of Japanese domestic growth, if achieved, will multiply the impact of the tariff cuts.

This is why it is essential that the Joint Statement by Ambassadors Strauss and Ushiba must be viewed in its entirety. I think those who fully comprehend it will recognize that it represents a fundamental change by Japan from a policy of discouraging imports to a policy of actively working with the U.S. and other countries to increase imports of manufactured goods and agricultural products. The consequent impact of the agreement will be a substantially higher level of U.S. exports to Japan than would have occurred without it. In the first four months of 1978, for example, the dollar value of Japan's meat imports was 12.4 percent above the 1977 average and the value of consumer durable goods imported was 20.6 percent above last year's average. We think these are quite promising signals of real progress.

Question 3. Perhaps the most significant outcome of the talks was Japan's adoption of a 7 percent GNP growth target. But in view of their failure to reach their 6 percent target last year, how realistic is this new target? Do you expect Japan to grow by anything close to 7 percent at the same time that they may be constraining their exports?

Answer. The Japanese Cabinet adopted 7 percent real growth as a target for fiscal year 1978 (April 1978–March 1979) at the time of its adoption of the budget for that year on December 29, 1977. This real growth target was subsequently reiterated by Ushiba in the Joint Statement of January 13, 1978 as an indication of that government's determination to achieve it. In view of the measures proposed in the fiscal 1978 budget, as well as subsequent actions by the government of Japan, we are confident that Japan is prepared to take all reasonable and appropriate measures to achieve the growth objective it has chosen.

Prime Minister Fukuda again expressed his determination at the Bonn Summit to achieve the 7 percent growth target. In August or September he will determine whether appropriate additional measures are necessary.

Question 4. There are a similar set of problems with West Germany. Last year we ran a significant deficit with her, although not so large as the one with Japan, and Germany too had a disappointing year economically. She grew by only 2.4 percent despite assurances given at last year's summit that she would adopt more stimulative policies. Are we engaged in the same kind of discussions with Germany as we have had with Japan? If not, why not?

Answer. The Administration has consistently urged industrial countries to strive for sustained non-inflationary economic growth and for reduction of imbalances in international payments. The decisions adopted by Germany and Japan with respect to domestic growth targets are decisions made by those countries themselves. We have avoided making any judgments as to their sufficiency or the appropriateness of actions taken by these countries to achieve targets they have adopted.

In early February, I visited Chancellor Schmidt for a general review of economic relations between us. At that time, the Chancellor and his advisors indicated to me that in view of recent trends in their economy, they were optimistic about their target of a 3.5 percent real growth rate in 1978. In particular, it was noted that the projected average of 3.5 percent for the year implied that if achieved, they would be growing actually at close to 4.6 or 5 percent toward the end of 1978. I indicated to the Chancellor that if they did achieve that growth rate, it would make a very good contribution to the overall economic situation.

In subsequent meetings with both the Finance Minister and the Economic Minister, we recognized that growth rates in some countries were still lower than desirable and agreed that our policies would remain firmly oriented toward self-sustaining recovery, steady non-inflationary growth, and stability in foreign exchange markets. Their views were reaffirmed during President Carter's state visit to the Federal Republic of Germany and in discussions with many German counterparts at the Bonn Economic Summit.

Question 5. In your prepared statement you listed a series of "hazards" which you say might pull us down from our "safe growth path and result in either slower growth or excessive inflation." You mention the increase in social security taxes, which have everyone concerned, the cost of imported fuels, etc. But nowhere do you list or mention the hazard of the tremendous increase in energy costs which passage of the President's energy bill would bring about.

The price of gas and oil will rise to the world level.

Even under your proposal the cost of natural gas will go to $1.75. In 1964, it was at the 14 cents–17 cents level. It rose to 42 cents by 1974, and to $1.42 in 1976.

$1.75 is a ten-fold increase, but during this same period of time discoveries have fallen. In fact, they have dropped almost in half while prices have gone up ten-fold. I calculate that deregulation of natural gas alone would cost each Wisconsin family about $300 each.

What effect do you believe the passage of the energy bill—even in the form of the Administration's bill—will have on inflation, and what makes you believe that these vastly new higher prices for oil and natural gas will either increase production or reduce consumption in a world where the automobile is still a necessity?

Have you taken this increase into account in your estimates?

Answer. Because most natural gas is sold under long-term contracts, the Administration's proposed natural gas pricing policy should have little effect on the current rate of inflation. The inflationary effects from the energy program result primarily from the tax on crude oil. This tax, if enacted, is projected to raise the inflation rate by 0.3 to 0.4 percent in 1978 and 1979.

It is estimated that the higher prices of oil will have a small, but noticeable impact on consumption of petroleum. The evidence suggests that consumers do indeed respond to higher prices of petroleum. Between 1973 and 1976 the real price of gasoline increased by 18.5 percent. We have estimated that had it not increased, gasoline consumption would have been 150 thousand barrels a day higher than the levels which actually occurred. While this is a small share (2 percent) of total asoline consumption, it is noticeable. In the long run, consumers will respond to higher prices by buying more efficient cars and by using their autos more efficiently.

The Administration's plan is designed to reduce consumption of oil and gas, not only via a higher market price, but also through granting tax credits for insulation and other conservation measures. Another important element of the Administration's plan places important emphasis on the use of coal (as a replacement for oil and gas) as a boiler fuel.

With respect to supply, the Administration tried to construct a program which provided the maximum incentive to new production of oil and gas with the minimal inflationary and disruptive effects on the economy. For instance, new production of oil would receive the world price level. This incentive was projected to increase 1985 oil production by 1.9 perecnt while increasing gas production by 7.3 perecnt over levels which would have occurred without the program. Most of the increase in supply would come after 1980.

The supply, inflation, and consumption effects were taken into account when we made our estimates.

Representative BOLLING. Congressman Brown of Ohio.

Representative BROWN of Ohio. I have one bit of business I would like to state for the record, with particular reference to the previous exchange between you, Mr. Chairman, and Mr. Blumenthal, wherein Mr. McCracken is quoted in the Wall Street Journal and Arthur Okun in the Post.

I guess perhaps those selections are appropriate to the effect that the energy deficit—I mean, the energy impact on our balance-of-payments deficit—is not really the real problem; it is the fact that we haven't had growth in our exports to balance that and that growth is the thing that has leveled off and not continued.

It relates to the question.

Representative BOLLING. Would it be all right if I closed the hearing by using a small piece of Latin?

De gustibus non disputandem est.

The hearing stands recessed.

[Whereupon, at 12:23 p.m., the committee recessed, to reconvene at 10 a.m., Friday, February 10, 1978.]

THE 1978 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 10, 1978

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

The committee met, pursuant to recess, at 10:15 a.m., in room 345, Cannon House Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

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

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director; Richard F. Kaufman, general counsel; G. Thomas Cator, Thomas F. Dernburg, Kent H. Hughes, L. Douglas Lee, George R. Tyler, and Katie MacArthur, professional staff members; Mark Borchelt, 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. This morning the Joint Economic Committee continues its annual hearings on the Economic Report of the President. Today we are meeting to discuss the labor market outlook and policies and programs to improve the operation. The labor market seeks to review the unemployment rate at which inflationary pressures arise. We are pleased to welcome the Secretary of Commerce Kreps and Secretary of Labor Marshall to discuss these critical issues.

I would like to take the opportunity to commend the administration for its analysis of the structural unemployment problem in the President's Economic Report and in many respects 1977 was a very good year. Employment grew by 4.1 million jobs and the unemployment rate declined 1.4 percentage points to 6.4 percent. It is obvious that the fiscal and monetary policies can do much to reduce unemployment.

But it is equally obvious that these policies will not be sufficient to reduce unemployment to their fictional level. Special measures are needed to aid those who will be left jobless when the economy reaches full production, the maximum rate of output consistent with nonaccelerated demands of inflation.

Now in this time we must begin to think about these pressures that are in place and work effectively before we reach this full production level. Although we are not sure what full capacity is, we do know about the problems of output at high levels of production. That

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employment will largely be composed of minorities and women. We need policies to deal with the demographic structure of unemployment.

I should add that as our society's attitude toward the elderly changes we are going to have a problem at that level, too. But we also need to look at the geographic issue of structural unemployment. Many of our cities, particularly our old cities, are experiencing a decreasing number of employment opportunities and unemployment is increasing. It is becoming apparent that there is a significant relationship between our urban problems and structural unemployment, specifically among minorities. These relationships exist not only in old cities but in urban areas throughout the country.

Similarly, rural regions have unique employment and unemployment problems, which need to be directly addressed. These are essential issues I have raised and we welcome your comments on them.

We will hear both of you before we question. Secretary Kreps, will you proceed as you wish?

STATEMENT OF HON. JUANITA M. KREPS, SECRETARY OF COMMERCE

Secretary Kreps. Thank you, Mr. Chairman.

My comments will overlap some of your own. I think they underscore the points you have made.

Other members of the administration have testified that the country can expect economic growth to continue at a rate of between 4½ and 5 percent over the next 2 years, a rate of growth sufficient to bring continued reductions in the rate of unemployment. Significant progress has been made over the past year in reducing the level of unused resources, but much remains to be done. The President's program provides the appropriate response to current economic circumstances by establishing a stable framework in which the economy can continue to expand.

But I would like to spend my time here by directing attention to a different perspective on the state of the economy. Even if we fully meet or surpass our national economic growth targets, we will have solved only part of our economic dilemma. For behind the national totals of GNP, prices, and employment, there is a very diverse picture of the health of the American economy. The economic recovery, now entering its fourth year, must be shared more broadly by different groups and across different sectors of the economy.

As you know, the unevenness in our economic growth was the focus of the recent White House Conference on Balanced National Growth and Economic Development. Some of the major issues discussed at the conference and the ones to which I should like to devote attention today reflect structural imbalances and unused resources among demographic groups, industries, regions, and urban areas.

UNEMPLOYMENT

Nowhere are these problems more clearly seen than in the differences in unemployment rates by various demographic categories.

Over the period of economic recovery, the unemployment rate for blacks has declined by only half as much as for whites. The unemployment rate for black teenagers, now nearly 40 percent, actually has risen further during the recovery period. The human and social costs of such unemployment are immense. Not only is the country losing the potential current output from this economic resource, but by the lack of job training and experience, the country is losing some of the economic potential of a generation.

To meet this challenge of concentrated high unemployment among young blacks and certain other groups, the administration's 1977–78 economic program included an increase in the public service jobs and a more precise targeting of the program to the low income and longer-term unemployed segments of society.

In 1977, Congress passed the Youth Employment and Demonstration Projects Act and the administration has requested that 166,000 jobs be funded in fiscal year 1979. In addition, the Department of Labor and the Department of Commerce are developing a program by which the structually unemployed can find permanent jobs and training in the private sector. About $400 million is provided in the fiscal year 1979 budget for this private sector jobs initiative.

RESOURCE UTILIZATION

The existence of unused resources is apparent not only when expressed in terms of unemployment rates, but also in terms of the utilization of our physical investment capacity. Capacity utilization in manufacturing is now about 83 percent.

The rate is slightly higher in primary processing industries, and slightly lower in advanced processing industries and materials industries, but by and large manufacturing capacity is now roughly in balance among broad industrial sectors. Barring any unforeseen explosions of demand in foreign economies, it should remain that way for the immediate future.

This is a much different situation from that which occurred in 1973 when not only were utilization rates extremely high but there were sharp imbalances between primary and advanced processing sectors of a sort that had not occurred in previous periods of high resource utilization.

For the near term, present capacity utilization rates leave ample room for continued gains in production. However, the experience of 1973 has taught us the importance of a sector-by-sector monitoring and analysis of the economy.

We need to pay attention to questions of production growth, growth in investment and capacity, and pressures on costs and prices in order to flag potential problems that could impede overall economic performance.

The President's program is farsighted in addressing the potential future problem of an economy operating at high levels of labor resource utilization and the implications that that might have for capacity utilization.

The business sector will receive a net tax reduction of $6 billion under the program, part of which represents an extension of the investment tax credit to structures, a direct incentive to the expansion of productive capacity. Such an emphasis will directly and specifically aid those industries whose markets have been weak recently but which could be expected to improve dramatically as the President's goals are realized. Such a measure also promotes investment expenditures generally so that the full utilization of labor resources will be compatible with a full utilization of capital resources in a balanced economy.

HELPING INDUSTRIES ADJUST

The administration has also addressed the economic problems of certain specific industries. The Department's footwear industry program is an example of the Government acting as facilitator of local initiative and private sector response toward a national problem—namely to help an industry adjust to and/or meet foreign competition.

One of our projects the Department has undertaken is in Massachusetts. Working with State and local agencies has provided a range of assistance aimed at turning part of the decaying center city into a focal point for production of footwear.

The Economic Development Administration and State and local agencies are planning to rehabilitate several buildings located in the central cities for footwear and other manufacturing purposes.

The administration and the Department have also embarked on a program to assist the domestic steel industry in modernizing its plant. Import competition and the high cost of pollution abatement equipment have severely restricted cash flow to the industry and made modernization extremely difficult. Substantial loan guarantees from the Economic Development Administration will facilitate this process of modernization.

REGIONAL DIFFERENCES

In addition to monitoring the problems of particular sectors of business, we need to be aware of the differences among various regions of the country. It is quite apparent that not all areas of the country have shared equally in the economic recovery to date.

Economic growth in a particular region can vary from the national average for any number of reasons. For example, in any cyclical recovery there are certain industries whose fortunes are closely tied to changes in the national economy, and certain regions whose fortunes are closely tied to those industries.

. Investment expenditures have been rising more slowly in this economic recovery than in previous recovery periods and export demand for capital equipment has been somewhat weak, reflecting the moderate to sluggish rate of growth in major foreign countries. Thus, regions of the country dependent on capital equipment production have not been growing at a rate that would utilize their potential.

In addition, cyclical changes in the national economy often impact more severely on older cities because of their aged, sometimes technologically obsolete capital equipment and the resulting high costs of production. Plants in these areas are shut down first in an economic downturn and revived last, if at all, in the ensuing recovery.

Continued strong growth of the national economy will help lagging areas of the country by promoting capital investment. But this will only partly correct the imbalances.

Some of the growth differences between regions is the result of fundamental structural change. This is nowhere more evident than in the regional changes in manufacturing employment and in capital expansion.

Over the past 20 years, there has been a significant regional shift in the distribution of manufacturing employment. While I am sure that this is a widely perceived phenomena, it is nevertheless instructive to consider some rather striking examples.

In 1956, New York State had nearly 12 percent of total U.S. manufacturing employment; by 1976, its share had fallen to about 7½ percent, representing a loss of 600,000 jobs. In Massachusetts, the employment share was slightly over 4 percent in 1965 and slightly over 3 percent in 1976. Pennsylvania also suffered a decline from 8.8 percent to 7 percent during this period. States such as California, Texas, Florida, and North Carolina were significant gainers.

Regional differences in expenditures for total private nonresidential building construction are striking. Between 1973 and 1976, nonresidential building declined by 5 percent nationwide, but declined by 23 percent in the Northeast, 6 percent in the North Central States, and only 2 percent in the South; it rose 9 percent in the West.

These estimates indicate the seriousness of the economic problems facing certain regions of the country.

ADMINISTRATION'S RESPONSE

The administration's employment and tax policies begin to address these problems by improving the utilization of human and investment resources in lagging areas of the country. The employment programs are targeted toward areas of highest unemployment.

Recognizing the need to help revitalize central cities with an older capital stock, the administration has proposed that the investment tax credit be extended to structures and be allowed for rehabilitation as well as new facilities. While the President is proposing to eliminate the tax-exempt status of industrial revenue bonds, a tax exemption will be continued for economically depressed areas.

In addition, economic development policies can play a major role in addressing problems of unused resources in certain areas of the country. The significant increase in the budget request for the Economic Development Administration—from $382.5 million in fiscal year 1977 to $627.4 million in fiscal year 1979—represents one important thrust to this administration's attack on urban and rural economic distress.

This infusion of additional resources will enable EDA to take its flexible mix of program tools and apply them to many economic development problems. These include chronic structural unemploymen, incipient or long-term economic decline, pockets of poverty in our inner cities, or sudden, severe economic dislocations caused by defense base closings, major plant closings, or the impact of trade policies.

An illustration of these policies has been the targeting of Federal funds for the $4 billion round II of the local public works program initiated by President Carter. Approximately 8,500 projects were authorized by EDA in the fiscal year ending September 30, 1977. About 4.000 State and local governments are taking part in the program. The average unemployment rate for those areas receiving funds was 9.4 percent, well above the national average, and higher than the average for areas receiving funds under round I. This, I think, is clear evidence of growing success in directing funds where they are most needed.

Regardless of the type of problem being experienced, or the type of area experiencing it—cities, suburban communities, or rural areas—EDA's objective remains the same: the attraction of private investment in order to strengthen local economies and create permanent private sector jobs.

Additional efforts will be needed. It is important that the Federal Government adjust its programs and policies to account for regional differences and to persist in the economic development of distressed areas.

URBAN POLICY

The economic problems of our urban areas are a special aspect of growth problems which require additional attention. In conjunction with other members of the administration, the Department of Commerce has made a broad range of proposals to the White House to strengthen Federal urban policies. In broad terms, our proposals would improve policy coordination with State and local governments; increase the effectiveness of economic development grant and loan programs; provide for substantial additional resources for economic development in urban areas; increase incentives to the private sector to participate in urban economic development; improve the linkage between manpower training and economic development; and directly increase the employment of urban minority youth. Approval of all or some of our urban policy proposals will significantly increase our capability to deal with regional and urban imbalances.

In summary, creation of a well-balanced and prosperous economy in which diversity does not mean distress and inequity requires us to look behind the national growth and employment totals. In this statement, I have tried to review different ways in which we are examining growth patterns: By demographic group, by industrial sector, by region, and by urban and rural areas. These are the demanding and complicated aspects of economic policy today.

Thank you, Mr. Chairman. I would be pleased to respond to any questions you may have.

Representative BOLLING. Thank you, Madam Secretary, the tables attached to your statement will also be included as a part of the hearing record.

[The tables follow:]

TABLE I.—UNEMPLOYMENT RATES

[In percent]

	1973	1975	1977	Percentage point change 1973–75	Percentage point change 1975–77
Total	4.9	8.5	7.0	3.6	−1.5
White	4.3	7.8	6.2	3.5	−1.6
Adult men	2.9	6.2	4.6	3.3	−1.6
Adult women	4.3	7.5	6.2	3.2	−1.3
Teenagers	12.6	17.9	15.4	5.3	−2.5
Black	8.9	13.9	13.1	5.0	−.8
Adult men	5.7	11.7	10.0	6.0	−1.7
Adult women	8.2	11.5	11.7	3.3	.2
Teenagers	30.3	36.9	38.3	6.5	1.5

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

TABLE II.—LABOR FORCE,[1] EMPLOYMENT[1] AND PARTICIPATION RATES[2]

	1973	1975	1977	Percent change[3] 1973–75	Percent change[3] 1975–77
Total:					
Labor force	88,714	92,613	97,401	4.4	5.2
Employment	84,409	84,783	90,546	.4	6.8
Participation rate	60.8	61.2	62.3	.4	1.1
White adult men:					
Labor force	44,490	45,617	46,960	2.5	2.9
Employment	43,183	42,801	44,784	−.9	4.6
Participation rate	81.6	80.7	80.3	−.9	−.4
White adult women:					
Labor force	26,648	28,609	30,853	7.4	7.8
Employment	25,494	26,459	28,930	3.8	9.3
Participation rate	43.5	45.3	47.4	1.8	2.1
White teenagers:					
Labor force	7,553	7,858	8,295	4.0	5.6
Employment	6,602	6,453	7,020	−2.3	8.8
Participation rate	56.0	56.7	59.4	.7	1.7
Black adult men:					
Labor force	5,050	5,238	5,504	3.7	5.1
Employment	4,763	4,626	4,953	−2.9	7.1
Participation rate	78.4	76.4	75.6	−2.0	−.8
Black adult women:					
Labor force	4,066	4,350	4,833	7.0	11.1
Employment	3,734	3,850	4,269	3.1	10.9
Participation rate	51.3	51.2	53.4	−.1	2.2
Black teenagers:					
Labor force	909	940	958	3.4	1.9
Employment	634	594	591	−6.3	−.5
Participation rate	40.2	39.1	38.4	−1.1	−.7

[1] Thousands.
[2] Percent.
[3] Participation rate changes are percentage points.

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

TABLE III.—CAPACITY UTILIZATION

[In percent]

	1966 peak	1973 peak	1975 low	December 1977
Manufacturing	91.6	88.0	69.6	83.0
Primary processing	92.5	93.6	68.1	84.7
Advanced processing	91.8	85.4	70.4	82.0
Materials	(1)	93.1	69.7	82.1

[1] Not available.

Source: Board of Governors of the Federal Reserve System.

TABLE IV.—MANUFACTURING EMPLOYMENT

[In thousands]

	1956	1966	1972	1976
Total United States [1]	17,243.0	19,214.0	19,090.0	18,956.0
New England	1,522.2	1,549.4	1,355.5	1,348.1
Connecticut	439.4	471.5	400.1	395.6
Maine	111.1	115.0	102.4	101.9
Massachusetts	719.1	696.0	602.5	592.7
New Hampshire	84.0	96.0	91.1	94.3
Rhode Island	129.3	127.5	120.9	122.5
Vermont	39.3	43.4	38.5	41.1
Mid Atlantic	4,411.5	4,332.5	3,870.0	3,525.6
New Jersey	834.5	878.2	823.3	753.2
New York	2,042.2	1,894.6	1,602.2	1,440.1
Pennsylvania	1,534.9	1,559.7	1,444.5	1,332.3
East North Central	4,882.3	5,195.1	4,925.7	4,742.7
Illinois	1,315.4	1,393.4	1,279.8	1,198.5
Indiana	623.1	719.7	709.4	681.7
Ohio	1,391.4	1,404.4	1,346.8	1,293.5
Michigan	1,081.0	1,169.0	1,094.3	1,056.7
Wisconsin	471.4	508.6	495.4	512.3
West North Central	1,002.3	1,182.8	1,232.5	1,256.2
Iowa	173.3	211.5	223.4	231.3
Kansas	127.0	139.5	145.7	164.8
Minnesota	226.3	288.0	310.8	317.5
Missouri	395.4	445.4	438.2	416.4
Nebraska	61.2	75.1	85.1	87.9
North Dakota	6.7	8.9	10.9	16.1
South Dakota	12.4	14.4	18.4	22.2
South Atlantic	1,955.8	2,508.0	2,786.5	2,775.7
Delaware	60.9	70.7	69.4	69.2
District of Columbia	18.9	20.9	17.8	15.4
Florida	159.7	275.2	351.3	343.1
Georgia	338.9	430.5	476.7	477.2
Maryland	276.7	279.8	248.8	231.6
North Carolina	470.6	644.0	756.9	757.6
South Carolina	234.0	313.9	354.3	370.5
Virginia	263.2	340.0	388.0	387.1
West Virginia	132.9	133.0	123.3	124.0
East South Central	1,118.6	1,393.3	1,512.4	1,514.6
Alabama	243.7	296.8	333.4	340.0
Kentucky	174.6	226.0	251.6	271.0
Missouri	295.4	445.4	438.2	416.4
Tennessee	304.9	425.1	489.2	487.2
West South Central	825.1	1,050.4	1,246.3	1,401.1
Arkansas	90.2	147.9	185.2	194.9
Louisiana	155.4	164.9	180.4	191.6
Oklahoma	92.6	113.3	142.0	156.1
Texas	486.9	624.3	738.7	858.5
Mountain	223.6	318.2	402.1	444.5
Arizona	37.4	77.7	98.7	105.6
Colorado	72.5	99.5	131.0	141.1
Idaho	27.7	35.5	43.6	52.0
Montana	21.2	23.0	24.5	23.7
Nevada	6.1	7.0	9.8	12.9
New Mexico	14.2	18.4	26.1	30.1
Utah	37.5	50.4	60.5	70.7
Wyoming	7.0	6.7	7.9	8.4
Pacific	1,579.2	1,994.5	1,976.3	2,119.6
Alaska	(2)	6.6	8.1	10.5
California	1,218.0	1,531.3	1,535.2	1,646.7
Hawaii	(2)	24.2	24.9	23.3
Oregon	148.0	167.2	184.0	192.9
Washington	213.2	265.2	224.1	246.2

[1] Total U.S. figures differ from sum of the States numbers which are 17,520.7, 19,524.2, 19,307.3, and 19,128.1 in 1956, 1966, 1972, and 1976 respectively.

[2] Indicates not available.

Note.—Details may not add to total due to rounding.

Source: U.S. Bureau of Labor Statistics.

TABLE V.—MANUFACTURING EMPLOYMENT, PERCENT DISTRIBUTION

	1956	1966	1972	1976
Total United States	100.0	100.0	100.0	100.0
New England	8.7	7.9	7.0	7.0
Connecticut	2.5	2.4	2.1	2.1
Maine	.6	.6	.5	.5
Massachusetts	4.1	3.6	3.1	3.1
New Hampshire	.5	.5	.5	.5
Rhode Island	.7	.7	.6	.6
Vermont	.2	.2	.2	.2
Mid Atlantic	25.2	22.2	20.0	18.4
New Jersey	4.8	4.5	4.3	3.9
New York	11.7	9.7	8.3	7.5
Pennsylvania	8.8	8.0	7.5	7.0
East North Central	27.9	26.6	25.5	24.8
Illinois	7.5	7.1	6.6	6.3
Indiana	3.6	3.7	3.7	3.6
Ohio	7.9	7.2	7.0	6.8
Michigan	6.2	6.0	5.7	5.5
Wisconsin	2.7	2.6	2.6	2.7
West North Central	5.7	6.1	6.4	6.6
Iowa	1.0	1.1	1.2	1.2
Kansas	.7	.7	.8	.9
Minnesota	1.3	1.5	1.6	1.7
Missouri	2.3	2.3	2.3	2.2
Nebraska	.3	.4	.4	.5
North Dakota	(1)	(1)	.1	.1
South Dakota	.1	.1	.1	.1
South Atlantic	11.2	12.8	14.4	14.5
Delaware	.3	.4	.4	.4
District of Columbia	.1	.1	.1	.1
Florida	.9	1.4	1.8	1.8
Georgia	1.9	2.2	2.5	2.5
Maryland	1.6	1.4	1.3	1.2
North Carolina	2.7	3.3	3.9	4.0
South Carolina	1.3	1.6	1.8	1.9
Virginia	1.5	1.7	2.0	2.0
West Virginia	.8	.7	.6	.6
East South Central	6.4	7.1	7.8	7.9
Alabama	1.4	1.5	1.7	1.8
Kentucky	1.0	1.2	1.3	1.4
Missouri	2.3	2.3	2.3	2.2
Tennessee	1.7	2.2	2.5	2.5
West South Central	4.7	5.4	6.5	7.3
Arkansas	.5	.8	1.0	1.0
Louisiana	.9	.8	.9	1.0
Oklahoma	.5	.6	.7	.8
Texas	2.8	3.2	3.8	4.5
Mountain	1.3	1.6	2.1	2.3
Arizona	.2	.4	.5	.6
Colorado	.4	.5	.7	.7
Idaho	.2	.2	.2	.3
Montana	.1	.1	.1	.1
Nevada	(1)	(1)	.1	.1
New Mexico	.1	.1	.1	.2
Utah	.2	.3	.3	.4
Wyoming	(1)	(1)	(1)	(1)
Pacific	9.0	10.2	10.2	11.1
Alaska	(2)	(1)	(1)	.1
California	7.0	7.8	8.0	8.6
Hawaii	(2)	.1	.1	.1
Oregon	.8	.9	1.0	1.0
Washington	1.2	1.4	1.2	1.3

1 Indicates figure is less than .0005 pct.
2 Indicates not available.

Note.—Details may not add to total due to rounding. Based on table IV figures using sum of States numbers for total United States.

TABLE VI.—VALUE OF NEW CONSTRUCTION PUT IN PLACE FOR PRIVATE NONRESIDENTIAL BUILDINGS BY GEOGRAPHIC REGION AND TYPE OF CONSTRUCTION

[Millions of dollars]

	1973	1974	1975	1976	1973 to 1976 percent change
All Regions:					
Private nonresidential	27,584	29,664	26,406	26,091	−5
Industrial	6,243	7,902	8,017	7,184	15
Northeast:					
Private nonresidential	5,500	5,100	4,312	4,230	−23
Industrial	924	986	907	833	−10
North Central:					
Private nonresidential	7,677	8,066	7,614	7,192	−6
Industrial	1,948	2,146	2,151	1,822	−6
South:					
Private nonresidential	9,073	10,551	9,025	8,871	−2
Industrial	2,128	3,330	3,483	3,039	43
West:					
Private nonresidential	5,334	5,927	5,456	5,799	9
Industrial	1,243	1,440	1,478	1,490	20

Source: U.S. Department of Commerce, Bureau of the Census Construction Reports C30, July 1977.

TABLE VII.—UNEMPLOYMENT RATES, BY STATES

[In percent]

	1973	1975	1976	November 1976 [1]	November 1977 [1]
New England	6.0	10.2	9.1	7.6	5.4
Maine	5.7	10.3	8.9	8.1	7.5
New Hampshire	3.3	9.1	6.4	5.2	4.4
Massachusetts	6.7	11.2	9.5	7.5	5.1
Rhode Island	4.6	10.9	8.1	6.7	5.0
Connecticut	6.3	9.1	9.5	8.3	5.3
Vermont	5.3	9.4	8.7	8.0	6.9
Middle Atlantic	5.3	9.3	9.5	8.9	6.9
New York	5.4	9.5	10.3	9.6	7.4
New Jersey	5.6	10.2	10.4	9.4	7.8
Pennsylvania	4.8	8.3	7.9	7.4	5.7
East North Central	4.5	8.9	7.3	6.6	5.0
Ohio	4.3	9.1	7.8	7.1	6.0
Indiana	4.3	8.6	6.1	4.9	4.4
Illinois	4.1	7.1	6.5	6.1	4.4
Michigan	5.9	12.5	9.4	8.2	5.6
Wisconsin	4.0	6.9	5.6	5.3	4.1
West North Central	3.9	5.2	5.0	3.2	2.7
Minnesota	4.5	5.9	5.9	5.2	4.2
Iowa	2.1	4.2	4.0	3.3	2.5
Missouri	3.9	6.9	6.2	5.5	4.8
North Dakota	3.6	3.7	3.6	3.8	3.6
South Dakota	2.6	3.7	3.4	3.2	2.1
Nebraska	2.0	3.9	3.3	2.7	2.6
Kansas	3.0	4.6	4.2	4.0	3.7
South Atlantic	4.0	8.5	7.4	7.1	5.5
Delaware	5.1	9.8	8.9	8.8	6.7
Maryland	4.1	6.9	6.8	6.3	5.1
District of Columbia	6.3	7.6	9.1	8.3	7.1
Virginia	3.6	6.4	5.9	5.3	4.8
West Virginia	6.8	8.6	7.5	6.9	5.8
North Carolina	3.5	8.6	6.2	5.8	4.8
South Carolina	4.1	8.7	6.9	6.2	5.1
Georgia	3.9	8.6	8.1	7.2	5.9
Florida	4.3	10.7	9.0	7.9	6.3
East South Central	4.2	7.9	6.2	5.6	5.0
Kentucky	3.7	7.3	5.6	4.9	4.5
Tennessee	3.9	8.3	6.0	5.3	4.4
Alabama	4.5	7.7	6.8	6.4	4.6
Mississippi	3.9	8.2	6.6	6.3	5.7
West South Central	4.3	6.4	6.0	5.7	5.0
Arkansas	4.3	9.5	7.1	6.7	5.5
Louisiana	6.8	7.4	6.8	6.8	6.3
Oklahoma	3.0	7.2	5.6	5.0	3.7
Texas	3.9	5.6	5.7	5.5	4.8

TABLE VII.—UNEMPLOYMENT RATES, BY STATES—Continued

[In percent]

	1973	1975	1976	November 1976[1]	November 1977[1]
Mountain	5.2	7.5	7.2	6.6	(2)
Montana	4.9	6.3	6.1	5.5	(2)
Idaho	4.8	6.2	5.7	5.0	4.1
Wyoming	3.3	4.2	4.1	4.1	3.9
Colorado	4.1	6.9	5.9	5.9	5.3
New Mexico	7.4	10.0	9.1	9.0	7.0
Arizona	5.0	12.1	9.8	8.2	6.3
Utah	5.2	6.8	5.7	4.9	4.3
Nevada	6.0	9.7	9.0	8.2	6.6
Pacific	7.0	9.8	9.1	8.1	6.8
Washington	2.9	9.5	8.7	7.7	5.7
Oregon	6.2	10.6	9.5	8.6	7.6
California	7.0	9.9	9.2	8.5	6.8
Alaska	8.3	6.7	8.0	9.0	13.2
Hawaii	7.3	8.2	9.8	9.7	7.7

[1] Unadjusted.
[2] Not available.

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

Representative BOLLING. Secretary Marshall.

STATEMENT OF HON. RAY MARSHALL, SECRETARY OF LABOR, ACCOMPANIED BY ARNIE PACKER, ASSISTANT SECRETARY FOR POLICY, EVALUATION, AND RESEARCH

Secretary MARSHALL. Mr. Chairman and members of the committee: It is a pleasure to appear before you today to review the state of the American economy.

I have accompanying me today Arnie Packer, who is Assistant Secretary for Policy, Evaluation, and Research.

In the coming year the Congress will be asked to make several major decisions that will strongly influence the future path of the American economy. This morning I would like to discuss with you how those decisions can set the economy on a full-employment path.

The administration's goal is to reach an unemployment rate of 4 percent in 1983. The present unemployment rate is 6.3 percent. This means the unemployment rate must fall by about 0.5 percentage points each year between now and 1983. While this would represent an extraordinary performance—based on historical standards—I think it is both a reasonable and desirable goal.

At present, the economy is still recovering from the deep recession of 1975. In May of that year, unemployment reached a postwar high. Over 8.4 million workers were unemployed, and the unemployment rate registered 9.1 percent. Since then, the unemployment rate has fallen by almost 3 percentage points and employment has grown by over 8 million.

It is a remarkable figure. As you know, 4 million of that growth took place last year, which is also a truly remarkable accomplishment. It is remarkable because in many of the industrialized countries of the world employment is not growing at all. The reason for their high level of unemployment is a relatively stagnant economy.

Most of the reasons for our relatively high rate of unemployment relate more to demographic developments than to the fact that we have a stagnant economy, because clearly the economy is not stagnant.

During 1977 the most dramatic growth in employment was realized. From December of 1976 to December of 1977, the unemployment rate fell by a full percentage point, and over 4.1 million new jobs were created. That was the largest growth in employment in any year since the end of World War II. It was twice as large as the growth experienced in the second or third year of any other postwar recovery.

The recovery is now almost 3 years old. We are almost 60 percent of the way from an unemployment rate of 9.1 percent in 1975 to our goal of an unemployment rate of 4 percent in 1983.

While progress can be expected to be more difficult as we approach that goal, I am confident we can succeed.

To reduce the unemployment rate by one-half percentage point a year will require real economic growth in the range of 4.5 to 5 percent per year. During this past year, the economy grew 5.75 percent in real terms. This exceeded by a full percentage point the performance in 1976. Since the trough of the recession, real GNP has grown strongly at an average rate of 5.7 percent per year and employment has grown at a rate of 3.2 percent per year.

The recent growth has been stimulated in part by several fiscal measures, but primarily its growth has been due to private sector outlays for housing, autos and inventories. For 1978 the growth is less likely to come from these sectors and more likely to come from consumer spending, private investment, and State and local government.

The policies adopted this year will be a key to whether future economic growth continues at a high rate. The administration is requesting a major increase in fiscal stimulus for the next year. Outlays are requested to be $7.8 billion above the levels implied by existing law, while proposed revenues are to be reduced by $24.8 billion below the level provided by existing law. This stimulus is needed to keep the economy growing at a rate of 4.5 to 5 percent over the next few years.

It is extremely important that inflation begin to decelerate. An acceleration in the rate of inflation would pose a major threat to the recovery. It would bring calls for excessive monetary restraint and wage and price controls.

The administration is proposing to work with private sector representatives to achieve a deceleration of private wages and prices. It also proposes to examine its own behavior to find additional ways to reduce any inflation caused by governmental actions.

We believe the inevitability of a conflict between low rates of inflation and low levels of unemployment has been exaggerated. Indeed, there are reasons to believe that high levels of employment in certain instances can reduce pressure on prices. These arguments have received far too little attention in the past.

First, high rates of unemployment cause a drain on the unemployment insurance and social security trust funds. Unemployment causes outlays to go up and revenues to fall. The usual response to this drain is to raise subsequently payroll taxes, and thereby increase unit labor costs.

For example, unemployment benefit payments under State programs rose from 0.74 percent of total private wages and salaries in 1973 to 2.59 percent in 1975 as the total unemployment rate increased from 4.9 percent to 8.5 percent. In 1976 the payments declined to 2.01 percent of private wages and salaries as the unemployment rate fell to 7.7 percent. We estimate the drain on the trust funds increases by more than one-half percent of total wages and salaries for each percentage point increase in the unemployment rate.

Second, State and local tax receipts fall as unemployment rises. Since these governments must balance their budgets over the long term, a natural response to this decline is to raise tax rates, particularly sales taxes. But sales taxes are part of the cost of living, and when these rates rise, they cause the price level to rise.

Third, high rates of unemployment cause productivity to decline since production workers are laid off at greater rates than nonproduction workers thereby lowering production while labor costs remain high. In addition, the layoff of workers often changes the attitude of the remaining workers, with a resultant demand for productivity lowering work-rule protections. With lower productivity, unit labor costs are higher.

And, fourth, overhead costs from idle capital facilities must eventually be recovered. In prolonged economic slumps, many firms with market power will raise prices in order to reach a targeted rate of return on capital if a low level of production moves them away from that target.

Because many of these factors affect prices only after a long and irregular period of time, they are frequently not given proper recognition in the simple statistical relations that purport to establish a link between low rates of unemployment and high rates of inflation.

There are good reasons, of course, to expect inflation to accelerate as full employment is approached. Shortages of particular kinds of labor or productive facilities can arise with a resultant rise in prices. It is here that the structural programs will become a critical factor in achieving full employment without igniting inflation.

Our projections indicate the unemployment rate can fall to about 4.75 percent by 1983 without an acceleration in the price level. Beyond that point, shortages for skilled workers could develop unless the structure of the labor force can be altered by improving the availability and utilization of currently underutilized segments of the labor force. If the unemployment rate is to fall to the 4-percent goal, structural employment policies, such as the following, will have to improve the performance of the secondary labor force.

These structural policies include:

Training—to lift workers from unskilled low-wage markets where employment opportunities are limited, into the more skilled markets to alleviate shortages that might otherwise arise.

Improved coordination with private firms—to encourage them to accomplish their own goals by hiring hard-to-employ workers and providing them with on-the-job training.

Public service employment—to provide job experience for those who are not able to obtain an unsubsidized job.

Youth programs—to help youth, especially those with limited schooling, to overcome handicaps and find useful employment.

Labor market information—to better enable workers to find the best possible jobs and to reduce the time workers spend between jobs. I might also add, better labor market information helps employers with job location decisions and also with their longrun immediate training programs.

Antidiscrimination enforcement—to break down artificial barriers that can create artificial excesses and shortages.

The challenge for these structural approaches can be seen from the existing pattern of unemployment. In January, when the overall unemployment rate was 6.3 percent, the rate for adult white males was 4 percent. The female unemployment rate was 30 percent larger than the male rate; the black unemployment rate was 130 percent larger than the white rate; and the teenage unemployment rate was 200 percent larger than the adult rate.

In Table 1 I present the underlying unemployment data for January 1978. These differences will persist unless structural policies are adopted. They will create bottlenecks in the attempt to reach 4 percent unemployment.

Table 2 shows what the pattern of unemployment would be in 1983 at the overall rate of 4.75 percent without any structural changes in the labor force. The black unemployment rate would still be 120 percent larger than the white rate; the female unemployment rate would be 40 percent larger than the male rate, and the teenage unemployment rate would still be 190 percent larger than the adult rate.

These wide differences in employment experience are unacceptable. Reducing these differentials can reduce the overall unemployment rate without adding to inflationary pressures. This is because structural policies can increase the supply of skilled workers so as to avoid bottlenecks that would otherwise arise.

A few examples can indicate the possible size of the gains to be had from reducing unemployment through targeted programs:

If, by structural programs, we are able to reduce the 1983 differential between the black and white rates of unemployment from a ratio of 2.2 to 1 to a ratio of 1.5 to 1, the overall unemployment rate would fall by 0.4 of a percentage point.

If we develop programs that cut in half the differential between the unemployment rate for those aged 16–24 and that for adult men, the unemployment rate would fall by 0.6 of a percentage point.

If the adult female unemployment rate could be reduced from 30 percent higher than the male rate to 15 percent higher, the overall unemployment rate would fall by 0.25 of a percentage point.

These illustrations in no sense limit what can be done. The unemployment rate for adult white males is projected to be 3.1 percent in 1983 in the absence of any structural programs. While this number is low in comparison to the rates we have seen recently, even this number hides large pockets of disadvantaged, hard-to-employ workers as well as some easily employable workers who have had a string of bad luck. In particular, this number includes many who are handicapped, who have a limited education, who live in isolated locations or have medical or emotional problems.

The unemployment rate for white adult males, 20 and over, with less than a high school education was 1.9 times that for those with

12 or more years of schooling. This group includes 11.2 million workers, 1 million of whom were unemployed in March of 1977. This suggests that even the white adult male rate can be reduced substantially by targeted programs.

By directing our programs at these groups, we feel the overall unemployment rate can be reduced substantially without generating any upward pressure on wages and hence prices.

The President's budget for fiscal year 1979 provides important resources for strengthening existing structural employment policies and for establishing some new ones.

The administration's fiscal year 1979 budget recommended that public service employment be continued at 725,000 jobs throughout 1979, rather than being phased down. The budget also contained an expansion to $1.2 billion in the Youth Employment and Demonstration Projects Act to provide work opportunities and skill training for unemployed youth who most need help.

The welfare reform proposal, which was sent to Congress in mid-1977, would create up to 1.4 million jobs, supplemented by cash allowances, for primary earners in low-income families who are able to work. An initial demonstration project included in the 1979 budget would create 50,000 jobs, and more jobs would be phased in once the welfare reform program is enacted.

The resources devoted to new initiatives in structural employment indicate the President's strong commitment to achieving full employment and to using structural programs to aid in reaching that goal. However, while Government programs can provide valuable assistance to disadvantaged workers, in the end we must turn to the private sector for the bulk of our permanent job opportunities. It is in private industry that most productive jobs with opportunity for advancement are found. For this reason, the administration's fiscal year 1979 budget request also includes $400 million to begin a new major initiative for private sector hiring of the disadvantaged.

The President's fiscal year 1979 economic strategy is carefully designed to put us on the road to achieving our long-term employment and price stability goals. It is important that the proposed actions be viewed as a whole rather than piecemeal since each element contributes to the achievement of our objectives.

Specifically, the macroeconomic stimulus portion of the President's tax package is intended to continue real growth at a 4.5- to 5-percent rate. This rate of real increase in economic production is required to achieve further reductions in cyclical unemployment and to contribute to the productivity growth that will assist in combating inflation. The President's tax package is also calculated to offset necessary increases in social security and energy taxes which would otherwise constitute a growing drag on consumer spending, and to stimulate investment so capacity shortages do not arise several years in the future.

The real growth insured by the stimulus provided in the budget should improve private sector job opportunities where five out of six new jobs in the economy are created. In fact, in 1977, 89 percent of the increase in employment took place in the private sector.

Finally, the President's anti-inflation program of deceleration is critical in that an acceleration in inflation would cut into the real growth required to provide increased job opportunities in the private sector. Any erosion of real growth resulting in unutilized productive facilities and higher unemployment would only contribute to inflationary pressures as employers try to cover costs and governments raise taxes to replenish funds needed to combat the hardships of unemployment.

Thus, the employment and anti-inflation programs contained in the President's economic program must be viewed as complementary. Unemployment will be attacked first through monetary and fiscal policies aimed at achieving a growing economy, and, second, through carefully targeted structural programs. Inflation will be attacked by looking for ways to limit cost increases and improved productivity in the public and private sectors.

Each of these efforts is important if we are simultaneously to move toward full employment, reduce the rate of inflation and insure a prosperity that is equitably shared.

Representative BOLLING. Thank you, Mr. Secretary.

[The tables referred to in Secretary Marshall's statement follow:]

TABLE 1.—UNEMPLOYMENT RATES FOR VARIOUS DEMOGRAPHIC GROUPS

	January 1978	
	Rate (percent)	Number (thousands)
Total, 16 years and over	6.3	6,226
White	5.5	4,775
Men, 20 yr and over	4.0	1,894
Women, 20 yr and over	5.5	1,737
Both sexes, 16–19 yr	13.7	1,144
Black and other	12.7	1,487
Men, 20 yr and over	9.8	554
Women, 20 yr and over	10.8	548
Both sexes, 16–19 yr	38.7	385

Source: Table I is taken from the Bureau of Labor Statistics January 1978 release on the unemployment situation.

TABLE 2.—HYPOTHETICAL UNEMPLOYMENT RATES FOR VARIOUS DEMOGRAPHIC GROUPS IN 1983

[Assuming an overall unemployment rate of 4¾ pct and no change in the historical structure]

	1983	
	Rate (percent)	Number (thousands)
Total, 16 yr and over	4.8	5,044
White	4.2	3,854
Men, 20 yr and over	3.1	1,566
Women, 20 yr and over	4.2	1,459
Both sexes, 16–19 yr	11.0	829
Black and other	9.2	1,190
Men, 20 yr and over	7.2	463
Women, 20 yr and over	9.4	523
Both sexes, 16–19 yr	22.1	204

Note.—Table 2 gives the simulated distribution of unemployment rates by demographic group if macroeconomic policy succeeds in reducing the overall unemployment rates to 4¾ pct. The simulation procedure uses the average relation over the business cycle from 1954 to 1977 between the unemployment rates for various demographic groups and (1) the unemployment rate for males between 25 and 55 and (2) the fraction of the population 16 and over which is between 16 and 19. This is the same procedure followed by Michael Wachter in "The Changing Cyclical Responsiveness of Wage Inflation," "Brookings Papers on Economic Activity," 1976:1, p. 115–167.

Representative BOLLING. Senator Proxmire.

Senator PROXMIRE. I want to thank both of you for excellent statements. Secretary Marshall, we have before us a bill which is highly controversial and is going to be debated at some length in the Senate. The House already passed the Labor Reform Act, and as you know, it is about to come before the Senate. I would like to ask you if you could briefly give me your reaction to the charges that have been made that if this bill passes it will have an adverse economic effect on the country.

The statistics that I have seen are that this would increase union membership by 6 or 7 million over a period of 3 to 5 years, wage increases would be sharply higher than otherwise, on the order of maybe a 25-percent higher increase than would be otherwise, wage costs would go up, because it would have no favorable effect on productivity, it would have a serious effect on inflation, unemployment would be increased, and strikes would be substantially increased, and that would have an adverse effect on the economy.

I support this bill. I think it is a necessary bill. I think it is a relatively modest bill. I want your reaction, if you have made any study on the statistical effect this bill would have on the economy over the 4 or 5 years.

Secretary MARSHALL. My view is that these charges are grossly exaggerated. It is a modest bill. What it really does is reaffirm the basic purpose of the National Labor Relations Act of 1935. We have demonstrated in most cases that the basic purpose of that act is an effective policy for handling labor management relations. Workers ought to have the right to organize and bargain through representatives of their own choice, or to refrain from organizing and bargaining collectively.

We included in the National Labor Relations Act initially some mechanisms to protect workers in their exercise of the right to make the choice about collective bargaining. One of these was a representation election conducted by the National Labor Relations Board. Another was the unfair labor practices, to establish the rules of the game, to make it possible for workers to exercise the right to select a union or to refrain from doing it without intimidation or unfair labor practices of employers.

Senator PROXMIRE. Could I interrupt? I am familiar with the terms of the bill. I think other members are, too. What I want to know is if you have made any kind of estimate or if you could give us any estimate of what effect this bill is likely to have on inflation, unemployment, or employment.

Secretary MARSHALL. The reason I was going into that background is to say that the only way you can make such an estimate is if you assume that strengthening the protection of workers against unfair labor practices and strengthening their right to make the choice, would somehow lead to a greater increase in union membership, which I do not think will happen. My estimate is that it will not lead—by itself—to a great increase.

It is very difficult to determine that because we do not know the extent to which violations of the law are now deterring workers in the exercise of their rights. My judgment is that the lawbreakers are not numerous and, therefore, we are not talking about a significant number of employers who habitually violate the law.

I believe that there are some, though, and the evidence indicates that there are some, so there would be an increase.

The other thing you are unable to determine is the extent to which workers are afraid even to initiate the process of joining unions because of the fear of discharge.

Senator PROXMIRE. Would you conclude that in the event of somewhat more membership it would not necessarily be a big increase and wage payments in the country?

Secretary MARSHALL. I think in the industries likely to be affected, the increases are likely to be very modest indeed. We are talking about relatively low wage industries where the workers will not have——

Senator PROXMIRE. You think it would not have a significant effect on inflation or unemployment?

Secretary MARSHALL. That is right; yes.

Senator PROXMIRE. Secretary Kreps, I would like to ask you, both you and Secretary Marshall, but you first, about this very puzzling and difficult problem of black unemployment. You both have indicated a very welcome sensitivity to that situation. But it is so puzzling because the statistics that I have seen indicate that back 30 years ago, before we had any real progress in civil rights, and before we had any legislation prohibiting employment discrimination when I used to go to plants in Milwaukee, plants that hire many thousands of people, I would not see one single black face, although we had a substantial black population.

That has been remedied greatly. We put into effect in the sixties a whole series of programs to provide better training as well as for other people who were disadvantaged. In spite of all that, we have a far worse situation now of black unemployment than we had at that time.

At the time there was not any difference in black and white employment and now there is a sharp difference, like 2 to 1. It is hard for me to believe, although you indicate a sensitivity and concern—I really want to know if there are any new initiatives that are different and are likely to get into this? The best analysis I have seen suggests the reason for this change is because the actions by the Federal Government have been so overwhelmed by what has happened in the work force.

We have had a tremendous increase in women, in white teenagers. They have tended to displace and compete effectively, and perhaps too effectively, with the black teenagers. At the same time, because of the birth rate, demographic figures indicate that there was twice as high a birth rate of blacks as whites during the baby boom period. They are coming on the job scene now. Have you taken that kind of analysis into consideration and do you think there are initiatives we can adopt that will bite into this and provide for an improvement for blacks?

Secretary KREPS. You will recall, Senator, in the letter that I sent to you, I did discuss the very point that you raise; namely, that there was a differential birth rate which now leads to larger numbers of black youths entering the work force, which creates some of the problem. The additional factor is that to the extent that programs are successful in reducing unemployment and in providing some opportunities and the image of opportunity to black youth, those programs cause more youths to come into the work force than would otherwise be there.

So I think what you are seeing, to some extent, is an increase in the participation of black youth that you would——

Senator PROXMIRE. Some of the statistics we have show that that may not be the case, that black participation did not increase last year when there was an enormous increase in the overall participation in the labor force. Black participation did not parallel white participation.

Secretary KREPS. I would have to check the figures. It certainly is true in the case of other groups that come and go from the labor force. Youth, I assume, was included. Certainly it is true of women that as the job availability increases the numbers that came in increased.

In any case, there is obviously an increase in the number of youths who are seeking jobs. On the demand side, it is clear that there are great disparities between the perceived job capacities of youth, whether or not those are really needed, and employers' job demands. That is to say, there is a reluctance on the part of many employers to reach that particular group of potential employees. That calls for programs to improve the training and the placement operations for these people. Secretary Marshall could deal in more detail with that.

Senator PROXMIRE. Let me get to Secretary Marshall on that, because I think that leads right into the problem. Your analysis indicates that the most effective programs are on the jobs programs rather than programs where there is training not directly related to an immediate job.

How about such suggestions as the one projected by a professor from Yale who proposed that you have a voucher system in which the employers are given an incentive for hiring people and, I think, it could be used to provide somewhat of a strong incentive for hiring black teenagers. Do you think that is reasonable?

Secretary MARSHALL. Could I back up and talk a little bit on Secretary Kreps' comment, and then answer, because I think your analysis of the problem determines what you do about it. If you look at the black employment problem, I think the first point I would make is, it is very difficult to compare the situation today with the situation many years ago when the black population of the United States was mainly southern and rural and predominantly in agriculture. Agricultural unemployment is not ordinarily counted as much as industrial unemployment is. So you get industry shifts that tend to cause a problem.

A major problem that we have had, as Secretary Kreps indicated, is that the black population of working age increases much faster than the white population of working age. Between 1966 and 1976 the working age black population increased at more than twice the rate of the working age white population.

But the employment experience was about the same. The increase was 20.2 percent for blacks and 20 percent for whites. You had a large increase in the working age population for blacks, but they did not get into the work force.

One reason they were not in the work force and were not counted as employed is, of course, the high unemployment rate. Another is the differential in the labor force participation rates. For young people that is very serious. Last April the labor force participation of young blacks, 16 to 24, was 38 percent, and it was 60 percent for whites. By the summer when you get an increase in the labor force participation rates of young people generally, the relative numbers were 60 and 75. So they narrowed some, but still there was a considerable differential.

A major problem is that blacks do not live where the jobs are growing. This is a geographic dispersion. In the North the problem is mainly an urban problem. Jobs are growing outside the central cities and blacks live in the central cities. In the South it is mainly a rural problem. Blacks do not live in those places in the rural South experiencing rapid growth and employment.

Part of what has to happen is that we have to have a rural strategy and an urban strategy if we are to deal with that, and I do not really think that a voucher system addresses itself to that fundamental problem. You have to do some things to promote economic development in those places where people live or you have to do things to get them out of those places and into the areas where growth is taking place.

We believe that a number of things need to be done. The Youth and Employment Demonstration Projects Act addressed itself to a number of these. One program that we think is desirable is a program to make it possible for young people to stay in school through a jobs program. Other young people need the residential-type training that you get in the Job Corps. They need to be removed from the environmental situation that they find themselves in. Others need to get into an apprenticeship program, and that is mainly a private system where the voucher system probably would not be very useful. We do think, however, that the voucher system ought to be carefully examined as a possible way to deal with one range of the problem.

In the targeting of programs what we believe is that you have to have programs that meet the particular needs of people where they are. There will be no one thing that will accomplish that objective.

Senator Proxmire. Thank you very much.

Senator Javits.

Senator Javits. Thank you, Mr. Chairman.

I have the pleasure of questioning my two favorite Cabinet members, both very able, dedicated, and wonderful people.

I want to ask you some questions about three things on commerce and one on labor. If I do not complete what I have in mind, may I ask permission, Mr. Chairman, to have the questions answered in writing?

Representative Bolling. Without objection, so ordered.

Senator Javits. Mrs. Kreps, one is productivity; two, urban policy; three, export promotion. I would like to ask Secretary Marshall questions about inducements to targeted employment somewhat along the lines that Senator Proxmire has opened up but with a different emphasis.

What I have in mind, Mr. Secretary, is the private sector hiring in two ways: one, by a tax benefit for excess hiring that is over and above what the business has been doing, and second, by a straight subsidy. I would like just to state as a prelude that I was your most ardent supporter in not making the minimum wage divided by a youth differential. However, we have to pay a price for that. There is still youth that cannot be employed by those rates. I believe it is certainly more desirable, therefore, to give the subsidy or give the tax break rather than to break the minimum wage.

We have to do that. We cannot have it both ways. What I would like to ask you is this. Is the Department working anything out along those lines? Does it agree that those are the lines along which we have to move? What does it think of the idea that I, for example, have proposed to target unemployment and tax breaks for the 16- through 19-year olds who have not been employed at all or unemployed for 15 weeks or for whatever period you would think wise.

And second, I would like to propose a test for the subsidy concept by giving the 45 community development corporations, which are quasi-public corporations, the ability to subsidize wages of youth breaking into the labor markets. That is, to actually pay for the wages of the youths whom the CDC's have used in their own businesses, such as supermarkets.

Secretary MARSHALL. We are giving favorable thought to both tax benefits and subsidies as a way to induce the private sector to do things. We have not come to a firm conclusion about the effectiveness. We believe that what we need to do in order to develop the most effective way to get the private sector involved is to, first, start working with the private sector to see what they will be most responsive to. We have had some experience with both approaches in other areas, not necessarily in the youth employment.

As you know, there are certain advantages and disadvantages of using tax subsidies as a way to induce people to employ workers. The disadvantage of the tax approach is that, first, you run the risk of complicating the tax system. And second, that you can never be sure that you have the net effect that you expected to have, that is to say, unless you carefully target and design the program, which I think can be done, the risk of that is to give a tax advantage to people for what they would have done, and that means you dissipate the effectiveness of the tax expenditure that you make for that purpose.

With respect to the subsidies, we think that a lot depends on the way that is handled. We already used that, and I think we have used it effectively. That is, you compensate private employers for the extra cost of employing the group that you are asking them to employ or train. That seems to be perfectly legitimate. The danger, of course, is that you give competitive advantages and compensate—pay part of the payroll cost of the employers giving them a competitive advantage above that adding the cost of putting the people on.

Senator JAVITS. Are you prepared to present any plans to us in both of those areas? I realize there are dangers, but that is why we have you there.

Secretary MARSHALL. We can present to you our thinking. We have done a good bit of that.

Senator JAVITS. I ask unanimous consent that the answers of the Labor Department in its specific plans on these two points, when made available to us—which I hope will be shortly—be made a part of the record.

Representative BOLLING. Without objection, so ordered.

Senator JAVITS. Secretary Kreps, why do we not go strongly for an urban policy, which is an economic development strategy, instead of a welfare strategy? What are you recommending? I see from your prepared statement that you have presented a program.

In other words, you are saying that the cities are dead and gone, so that all we have to do is try to save the people the best way we can? Or are the cities—with over 70 percent of the people living in them—capable of an enormous economic renaissance in our country?

Secretary KREPS. As you know, Senator Javits, different cities are at different stages in their recovery, or in some instances, I suppose, deterioration. But it is not our view that the cities should be ignored in the model construction programs that we are working on. In the urban policy package that we have been working on with the administration, our Department's portion of those recommendations go to the purpose of creating jobs in the inner cities, by providing loans and grants to private industry that will help to induce them to come in and build or retain facilities in the central cities where, as Secretary Marshall indicated, the minorities, and youth in particular, need to find jobs.

Thus we are recommending a soft public works program, which we hope the urban policy will contain, designed and targeted toward the disadvantaged, doing work in rehabilitation of buildings, public buildings, refurbishing, winterizing buildings, that sort of thing. We are further recommending expansion in our effort to provide private sector jobs for those people who have been on PSE jobs, working with the business community to enable that transfer to occur.

Throughout our own endeavors in the urban area, we have had only one objective, and that was job creation. All of our loans, all of our grants, all of our efforts are designed to that end. These efforts will, by themselves, obviously not turn the tide for the cities and, more recently, we have been working with the mayors in the cities across the country to make sure that all of the resources of our Department, which are many, are available to them.

We have found, for example, that the mayors spend a large portion of their budget for fire prevention. We have, in the Commerce Department, the National Fire Prevention and Control Administration, the Fire Prevention Academy, and a whole program. We have put those together and are making available to the mayors technologies and techniques which they formerly did not have. So it goes with many other things that we in the Department have that the cities have not used.

So, in combination with the economic development programs, our other efforts to help the cities go well with the programs which the other Departments are supporting.

Senator JAVITS. Is the Small Business Administration housed within the Department of Commerce?

Secretary KREPS. No.

Senator JAVITS. How do you relate to it?

Secretary KREPS. The Small Business Administration concentrates a lot of its attention, most of its attention perhaps, on lending, on making loans to small businesses to help them in their financial endeavors. We work with them, most recently, for example, in arranging the 10-percent minority set-aside for the whole public works program. They helped us to identify small business firms in construction.

But we in the Commerce Department work with small- and medium-sized businesses across the board, not in the lending arena, per se.

Senator JAVITS. The reason I asked you about small business is because of the opportunities for export promotion for small businesses, and this will take a very active role by the U.S. Government. Only large companies like American Express and others have tried to do any exporting because the small businessman is frustrated by the regulatory paperwork, which includes the way a business packs a shipping case, how it sends a piece of machinery, how it offers services, and so on.

You also may have some recommendations on amending the antitrust laws with respect to the prohibition against overseas collaboration which may materially inhibit small businesses collectively from taking advantage of the export market. I strongly urge you to present a very vigorous and advanced program on it. It is good for America because the program could educate us as to what exports mean to our economy and prevent the United States from becoming protectionist and isolationist, as we threaten to become. This could be very important to the small businessman; I know IBM and First National City did this in respect to export earnings.

Could you comment on that?

Secretary KREPS. Yes; I would be pleased to. We have new initiatives at the Department aimed at persuading the medium-sized business firms to engage themselves in export trade. You are quite right, that this has not been their pattern. Our total export trade is a much smaller percentage of the trade than in the case of European countries, and we have never concentrated on that potential. Our Assistant Secretary for Industry and Trade is now beginning a nationwide program of contacting medium-sized firms with this endeavor.

Senator JAVITS. Could you let us have your plans on urban policy, which you refer to in your prepared statement; and could you let us have your plans and recommendations on export expansion, especially for small- and medium-sized businesses?

Secretary KREPS. Yes. You mean in writing?

Senator JAVITS. Yes. I ask unanimous consent that those be included in the record.

Representative BOLLING. Without objection, so ordered.

Senator JAVITS. My last question is on productivity; but you may not be able to finish answering it, because my time is almost up. I am deeply dismayed that we are in what is called in baseball, the cellar. We are the greatest country on Earth in technology—220 million people compared to 4 billion—and yet we consume one-third of the Earth's goods and make one-third, and productivitywise, we are dead. Can we not, Madame Secretary, fix the excitement, the attention, the patriotism of our country on that subject and undertake a major productivity drive?

I think it is not popular with trade unions who are even against labor management committees—which I cannot understand—but, nonetheless, a productivity drive is in the interest of our Nation. Do you agree with that?

Secretary KREPS. Absolutely, sir. We have been working very hard to get the office of our Assistant Secretary for Science and Technology to work directly with industry on some newer plans and long-range schemes for improving the transmission of technology. It is in part a problem of transmission. In many instances we have far better technology than we are using. We have been giving a good deal of attention to this.

Moreover, we are very much interested in actions such as the Lundine bill which go to the heart of some of this.

Senator JAVITS. Could we ask you for a paper on that? These 10-minute questioning sessions are inadequate. I thoroughly agree that they are necessary, but the only way to get something meaty is to ask you to submit a paper. Could you do that?

Secretary KREPS. Yes.

Senator JAVITS. I ask unanimous consent that that be included in the record.

Representative BOLLING. Without objection, so ordered.

Representative MOORHEAD. I think it is symbolic that we have the Secretary of Labor and the Secretary of Commerce here at the same time, because I believe what is good for labor in reducing unemployment is good for business and commerce, because healthy business means jobs. The symbolism of both of you appearing today is quite interesting. I would like to ask both of you if you could give me your opinion as to which programs are the most cost effective, the public works programs or the public service jobs programs?

Secretary KREPS. I think there is no doubt that the price per job created is lower if you are talking about public service jobs. If your evaluation is on the basis of how many jobs you can generate per $1 million of expenditure, it would always go to public service jobs.

When you begin to write in other criteria, however, the criteria of whether it is a permanent job, the question of whether it will become a private sector job, and therefore not requiring any further public funding, the question of what it constructs or builds of lasting value, when you begin to write in those additional variables, the answer becomes more complex.

If you take the extreme contrast between an LPW job and a PSE job, the former is much more expensive at first glance. On the other hand, it is a private sector job. It is a construction job. A lot of that money goes for capital equipment. You end up with the public getting a road or a highway. I think the so-called science of measurement is not sufficiently advanced to give us a precise answer as to which is more cost effective.

Secretary MARSHALL. I have very little to add to that. The only thing I would say is by way of elaboration. In targeting you need different kinds of programs for different kinds of people. If you have heavy unemployment in the construction industry, then it is clear that public service employment is not the way to get at it. Public works would be.

If you have low income persons unemployed, public works is not the way to get at it. You are more likely to put different groups to work in each of these programs, and therefore they are both necessary in an overall program mix.

Representative MOORHEAD. Public service job programs, what is the effect of substitution, the people that would have been hired anyway so to that extent we are not creating new jobs? In some cities we are really in effect giving fiscal relief.

Secretary MARSHALL. This has been a very serious problem with public service jobs, one we worked very hard to reduce. I think the evidence indicates we have. Under the stimulus built up from last year, the movement from roughly 300,000 jobs to 725,000 jobs, there has been virtually no substitution. The evidence indicates that we have been able to keep substitution to a very low level in terms of analysis.

We made a statistical analysis of that which we would be happy to share with you. But the effect of it, if you do get any, obviously depends on what kind of substitution you are talking about. Some kind of substitution is preventive. That is to say, a local unit of government does not have the revenue to continue to provide services. They use our funds to hold those people who would have been unemployed. Obviously you reduce unemployment in that, even though you get substitution, unemployment does not go up. The kind of substitution that we are more worried about, even though we are worried about all of it, but the kind we are more worried about is where the local unit of government uses money designed to reduce unemployment, to continue employment they would have otherwise. That is the kind that we think we very effectively can deal with in our new procedures.

There are various ways to deal with that. One is to go to a project approach. Another is to limit the extent to which local units of government can supplement wages. because if you have a program designed for low income people and you limit the extent to which it can be used for higher income people, then you avoid substitution. We believe by encouraging the community development corporations as a delivery mechanism and through better enforcement of the regulations, that all those things can minimize substitution.

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

State and local government employment aggregates indicate that substitution in connection with Public Service Employment programs have been minimal.

Total employment at State and local governments increased by less than 14,000 per month in 1976, while PSE enrollment declined slightly. Since April of 1977 total employment at State and local governments has increased at an average rate of 46,000 per month; over the same period, Public Service Employment has grown at an average rate of 39,000 per month, approximately 31,000 of which was government employment (the remainder being with community-based organizations). Thus the increase in State and local government employment other than that accounted for by Public Service Employment was about 15,000 per month last year, somewhat more than it was in 1976 when Public Service Employment was declining.

This indication is supported by the preliminary findings of a study based on interviews in depth with a sample of program participants and their supervisors.

The study indicates that 51 percent of the positions represented expansion of existing programs, new programs, or special projects and that 31 percent of the positions came from maintenance of programs that would otherwise have been curtailed. Only 18 percent of the positions were classified as displacements because the interviews revealed that the function would have been performed in the absence of Public Service Employment programs.

Representative MOORHEAD. Turning now to the manpower training programs, how successful have we been in placing trainees in permanent jobs? I mean longer than 30 days. I have been told of instances, I hope they are exceptions rather than the rule, of people going through one training program after another, almost making a career out of it. I think Secretary Kreps mentioned trying to link the training programs and the job programs together.

Secretary MARSHALL. This varies a good bit by program. We did have an analysis of that. I would be happy to make that available for the record, also, depending on which program you are talking about. In general, obviously, it depends on first, the characteristics of the people who are in the program. Some of the public service employment programs are used during periods of very high unemployment for people who are already well-trained and have skills. For them the success rate is very high. Others have not been—they require work experience in these programs. But they have not really acquired many skills in the public service employment training programs.

Some of the programs have been extremely successful, like the apprenticeship training program where people flow through the program and then they are in the private sector.

One determinant is the nature of the program, the nature of the people, the stage of business cycle you happen to be in when you are doing it. Another determinant is the length of time that you take. The longer period of time after people have been in the program, the more likely they are to have been absorbed into the regular economy.

Let me also say that this is another area that has been of considerable concern to us with respect to our employment and training programs, and is one of the reasons that the President has made the recommendation for the private sector initiative. We think that they do a lot to facilitate the movement of people out of the public programs into private programs.

We have done a fair job at the national level working with the private sector. We have not done a very good job working in the local labor markets. The recommendation that we made is that private industry councils be established at the local levels to be intermediaries between the private sector and our training programs. Also, in the welfare reform—public service employment recommendations, we built in strong incentives for people themselves to move first into jobs, but then out of public service jobs into private sector jobs.

You always earn more under the proposal in private jobs than in public sector jobs. The main point of that is that while that has been a very serious problem in the past, we do not think that the evidence from the past is a very good judge of what is likely to happen in the future.

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

During fiscal 1977, of the 1,470,700 persons leaving CETA programs, 35 percent entered unsubsidized employment, 36 percent returned to school, entered the military or were placed in other training programs, and 29 percent dropped out of the program.

The overall success of training programs must be measured in terms of the employment and earnings records of participants well after they have finished their training, however. The Continuous Longitudinal Manpower Survey, being conducted by the Bureau of the Census and funded and directed by the Employment and Training Administration, should yield valuable insight into this question. The Survey is tracking the employment and earnings records of a sample of CETA participants on an ongoing basis subsequent to their periods of participation in the programs. Initial results will be available in April.

"The Impact of Employment and Training Programs," a policy statement by the National Council on Employment Policy, presents an excellent summary long term findings by various researchers with regard to earlier training programs. Annual income gains ranging from $1,300 to $1,600 were representative of the findings. By most estimates hourly wage gains accounted for between a fifth and a fourth of the earnings gain with greater regularity of employment accounting for the rest.

Representative MOORHEAD. Mr. Secretary, as I recall your testimony, you said that without the structural programs that if unemployment went below 4.75 percent, you begin to have an inflationary push. Is there enough money in the programs? Will they be carried out long enough to reduce that figure, and what is your target for that?

Secretary MARSHALL. We think so. The figure 4.8—the assumption that we are making is that by 1983 the program that we have now will not be the only program in existence. We have the welfare reform component, which is 1.4 million jobs, and that is a sizable component of that. We have an urban policy that is not yet in place.

To answer your question, a lot depends on what we do between now and 1983. The distance that we think we have to close with structural programs is eight-tenths of 1 percent in unemployment. We believe that the things that are already in existence or planned can accomplish that.

Whether they accomplish it or not depends upon what we do with the number of other policies we also have. A very serious consideration is what we do about illegal immigrants. That is a leakage into the system that could completely swamp our effort to reduce unemployment by the structural programs we have now.

The reason for that is that the illegal immigrants, or the undocumented workers, tend to compete directly in most of the labor markets that we have targeted. I think another determinant is what we do on the energy policy. If we do not do something about the energy policy we will export a lot of jobs, and therefore our ability to make this target will be limited.

But if you assume we have all these general policies in place and we have the immigration policy in place, then we believe that what we have already planned between now and 1983 could easily make it possible for us to close that gap of 0.8.

Representative MOORHEAD. You mention the energy program. I was visited yesterday by businessmen from western Pennsylvania, particularly the large electric utility firms that have industrial customers, expressing the concern over the apparent opposition to the settlement of the coal strike. A number of them mentioned the Taft-Hartley Act, but they did not mention anything about presidential power to allocate, let us say, electricity, allocate coal supplies, including some union-mined coal that is on the barges on the river.

I think that the administration has been very helpful. But are you considering any action of an emergency nature to avoid the layoffs that are projected if the coal strike is not settled?

Secretary MARSHALL. Yes. We are considering emergency measures to deal with this problem. We have not come to a firm decision about exactly what they ought to be. But we have been developing information on areas of critical shortages, the location of supplies that could meet those shortages, and possible ways to bring the two together. We hope to get the settlement. But if we do not, we have to be prepared to use these emergency measures.

Representative MOORHEAD. Secretary Kreps mentioned as a part of structural unemployment, regional unemployment. In your testimony you did not stress that, except after a question from Senator Proxmire. Are there programs to be administered by the Department of Labor? Do they take into account the regional unemployment, because you might have nationwide, let us say, the white adults, head of family figure, one figure, but in a given region it may be considerably higher. That is just one example.

Secretary MARSHALL. The reason I did not emphasize that in the testimony was that I read Secretary Kreps' testimony and I knew that she was going to emphasize that. We work very closely together with the Economic Development Administration to coordinate the job activities with regional activities. We think that is extremely important.

We believe you have to do more than just train people. You have to coordinate the training with the jobs and with economic development. This is true whether you are talking about urban or regional or rural policies. Each of these labor markets is different and the regions differ.

Rural markets are not like urban markets, and if you try to apply an urban program to a rural place, you probably will not be very successful.

Representative MOORHEAD. Thank you. May I have permission to submit further questions?

Representative BOLLING. Without objection, so ordered.

Before I call on Mr. Brown, I would like to comment on the fact that the two Departments do work together and coordinate their activities. That is very pleasant to observe, because I have been in town, and so have others, when the Secretaries of Commerce and Labor did not speak to each other.

Representative BROWN of Ohio. Let me speak to the Secretary of Commerce, perhaps appropriately. I want you to know that I have worn my blue devil necktie.

Secretary KREPS. That is great. Would you explain what that means?

Representative BROWN of Ohio. I went to Duke University and I graduated in economics from there. For that reason, perhaps, I am less panic striken about the administration of your Department than I am about the circumstances that surround problems in the Labor Department, Mr. Marshall. So I would like to turn to you first, if I may.

I notice in your oral testimony you did not mention the coal strike. Let me tell you what the situation is in my neck of the woods, and then get some comments. I have been advised that we have a voluntary cutback program where industry was asked, as of the end of last week, to cut back by 5 percent, and that voluntary program has resulted in one-half of 1 percent of industrial electricity being conserved.

Now, the utilities serving the major city in my area as of yesterday said that they have 36.5 days of coal remaining, 35.5, I suppose, today. Below 20 days there is a mandatory cutback program. Even if that is successful, it adds only 5 days to the coal supply that they have available. News reports say that it would take 10 days for the miners to vote on the issue, another 25 days for Ohio utilities to receive the coal once it begins to move.

That means that somewhere out there they will turn off the lights in a good part of Ohio. They have already turned of street lights in most of the major cities. Is there not something more that the Department of Labor could do about this problem in terms of bringing in negotiators, sitting them down and saying, let us get an agreement that is really going to help, so that we do not have a major emergency.

When I say major emergency, I mean closing down industries in Ohio which will, I think, and Ms. Kreps might agree, have the impact of closing down industry in other parts of the country. Last year, when we did not have natural gas, we had to close down industries in Ohio, and that resulted in a closing down of industries in southern California.

I was out there. They closed down because they get parts from Ohio plants. That does have part of a nationwide impact.

Secretary MARSHALL. I would say if there is anything else that the Labor Department could do that they are not doing now——

Representative BROWN of Ohio. Let me suggest bringing the parties together. I suggested this to the President. I said, bring them into a room and lock the door and give the key to Amy. Say to them, "When you get finished, call me, and I'll send Amy down to unlock you."

Secretary MARSHALL. The problem is not a lack of an agreement. One was negotiated last Friday. The real problem that we face now is getting an agreement that the workers will ratify. We believe that the best way for those people to settle, unless we really get into a national emergency, is for the parties to settle their problems themselves.

We think one of the difficulties of constant Presidential intervention would be that collective bargaining would tend to break down. If any party ever thought they could get more from the President than they could get from the other side, then they would not bargain.

Representative BROWN of Ohio. We have had congressional intervention in things like the rail strike and the steel strike. We had in previous administrations Mr. Usery, who went in and took personal charge of the situation in the dock strike. Who have you involved from the Labor Department?

Secretary MARSHALL. Our approach and our policy is that we start from the assumption that we ought to encourage collective bargaining, and that the Government ought to stay out.

Representative BROWN of Ohio. I could not agree with you more, and I also think the industry ought to stockpile. But how long has the strike gone on now?

Secretary MARSHALL. Sixty-five days. Let me also say that that does not mean the Labor Department is ignoring it. We work very closely with the Federal Mediation and Conciliation Service.

Representative BROWN of Ohio. That is the usual procedure. Is there anything unusual that you have done?

Secretary MARSHALL. The unusual thing that we have done is, if I follow your testimony over what has happened previously, that I have stayed out of it. I think that——

Representative BROWN of Ohio. Has it worked?

Secretary MARSHALL. I think that it worked in the longshoremen's strike. The relative impact of that strike was much less than it had been in previous cases. It worked in the strikes we have had so far, and I believe it has worked better in this particular case than would have been the case if either I or the President had intervened.

Representative BROWN of Ohio. Let me interrupt you. We are now at 35 days, and even if the strike is settled tomorrow, we still have a problem. What do you intend to do?

Secretary MARSHALL. The evidence we have from the Department of Energy is that we do not now in the country have a total coal supply problem.

Representative BROWN of Ohio. Can I call you when the lights go out?

Secretary MARSHALL. What you can do is call Secretary Schlesinger. There are some supplies, as you know, in Ohio, and the question is moving those supplies from the places where they are to places where they are needed.

Representative BROWN of Ohio. But you are talking about moving coal. How will you move it?

Secretary MARSHALL. One reason, according to information I got, is that some of those companies are afraid to move the coal, because they are afraid of violence if they do try to move it. That is a local law enforcement problem. Once the strike gets resolved you should have much less fear, even if there is a reality of moving that coal because of opposition from the miners themselves.

At that point, once the contract gets settled, it will be much easier to move the supply of coal around for that particular reason.

Representative BROWN of Ohio. But you do not have any real program for getting——

Secretary MARSHALL. We do have a program. We have also had a contingency plan for intervention. We have contingency plans for invoking the Taft-Hartley injunction if it gets to that situation. But you cannot invoke the Taft-Hartley unless you demonstrate national emergency.

Representative BROWN of Ohio. Turning out the lights in Ohio——

Secretary MARSHALL. Is not a national emergency. Historically, the main way to justify using the Taft-Hartley is in connection with defense. That does not mean that that will be the case in the future.

Representative BROWN of Ohio. I have 27,000 employees at Wright Paterson Air Force Base in my district. I suppose——

Secretary MARSHALL. It cannot be purely localized.

Representative BROWN of Ohio. I wish I could explain to you how totally frustrated the people in my area are because of the inability of Government to deal with this; maybe not the inability, but just the Scarlet O'Hara attitude that says "We will worry about it tomorrow."

We had a situation last winter where we had 1 million people out of work for a period of time. We had schools close, public facilities close, and now we face it again this winter for another reason.

Secretary MARSHALL. I think we have an ability to deal with it. I think what we say is that we believe that the procedures we have used so far to deal with the strike are the ones that should have been used, and we believe that the things we would have to do if we really got to what would be considered a national emergency would be productive. I think the important point to recognize, besides what I have already said about getting either the Secretary of Labor or the President involved, is that this is a matter of timing and a matter of judgment about what the extent would be at that particular time.

Representative BROWN of Ohio. I will call you when we settle the strike, and then you tell me what the timing is. I do not think we are getting much——

Secretary MARSHALL. If you have a suggestion that makes sense——

Representative BROWN of Ohio. I have, and so have all of the members of the Ohio delegation. We have all written to the White House, all of us, a bipartisan letter.

Madam Secretary, yesterday Secretary of the Treasury Blumenthal told me that in 1979 people with an income of $17,000 would have to pay more in taxes than they do now. In other words, inflation-induced tax increases, on top of the social security tax increase, would more than wipe out the effect of the President's proposed tax cut.

Upon review, I have to say that the statement leads to startling conclusions. At the time, the median income of taxpayers is about $15,000 to $16,000 a year. By 1979 median income of taxpayers will be about $17,000 to $18,000, assuming a 6 percent inflation in 1978 and 1979. This means that by 1979, over half the taxpayers will be paying higher taxes than they are now. Can you explain to me how the tax cut that the President has proposed is going to have any long-run positive impact upon our society in terms of the expansion that Secretary Marshall wants and I am sure that you want?

Secretary KREPS. The tax cut proposed for this year is, as you know, on balance a net plus to business and to individuals. As the social security tax rate rises, it is true, just as you say, that people will have to pay more, and the net gain from this particular tax cut will be eroded.

Representative BROWN of Ohio. Could we quantify those figures, because we have a figure that in 1980 the social security tax impact will be $9.4 billion. In 1981, however, it goes up to $18.4 billion. That is $400 a family. In 1985 it will hit $37 billion. That is $740 per family. Is that about right?

Secretary KREPS. I am sure you have the correct figures, sir. The increase is very sharp. We all know that. I think the policy suggested here is what we are concerned with. It seems to me that the implication would be that if you wanted to offset that you would, obviously, have to have subsequent tax decreases to do so.

Representative BROWN of Ohio. Subsequent tax cuts?

Secretary KREPS. Subsequent tax cuts if you are going to offset the rise in social security taxes.

Representative BROWN of Ohio. But the question is, if we merely have the modest tax reduction that the President has proposed this year, and we have the impact of the tax increases and social security, and not counting energy, where he has proposed a significant increase, would we not be better off to stimulate with a stronger tax cut this year, to stimulate the kind of investment and production that we need, the kind of job creation that society currently needs?

Secretary KREPS. Our best judgment, sir, was that this package was approximately what we need for this year.

Representative BROWN of Ohio. To keep us even.

Secretary KREPS. There is a net gain this year. The question is, of course, whether you would want them to propose, as I said, subsequent tax cuts as the burden of social security tax becomes heavier, or whether the Congress would prefer to reconsider the way it refinances social security, which I think you did discuss with Secretary Blumenthal.

But in any event, if you push it into the future and assume no further tax relief, then you get a very depressing picture.

Representative BROWN of Ohio. Could I ask which position the administration is likely to take? Are they for reevaluating the social security tax increase and reducing that, or are you telling me that the President will in fact propose additional tax cuts in subsequent years to just offset the social security tax increase that we anticipate?

Secretary KREPS. The President has not ever promised that he would never cut taxes again. I think you simply have to make that decision when it comes about. I would think that the question of future financing of social security is both a congressional decision to make and an administrative one. Obviously, from the beginning there were differences of views as to how that should be carried on. I assume those differences of views persist.

Representative BROWN of Ohio. I would hope that we would get a clear signal from the administration as to whether he intends to support a different position than that which he took just a couple of months ago.

Secretary KREPS. Could we also, sir, have a similar indication from the Congress?

Representative BROWN of Ohio. You can from me, and I will vote to increase the tax reduction. You get the other 434 members to do likewise, or even just the two-thirds on the other side of the aisle. I think we can get it to work out.

Representative BOLLING. I have some questions. One has to do with the similarity which I think exists between some of the programs to deal with structural unemployment, and trade adjustment assistance first mandated under the Trade Expansion Act in 1962. I had a little bit to do with the enactment of that a long time ago. I knew exactly why I was doing it. We are now back in the situation where the pressures for that kind of economic isolationism that existed in that period is even greater. Is it true that the administration of trade adjustment assistance has been a disaster, and if so, why?

Secretary KREPS. I think most people agree, sir, that the trade adjustment assistance program in the early years was not very effective. It was not funded sufficiently. But also its procedures were such as to offer help to industries pretty much after the industries had collapsed. It was designed really primarily to provide assistance to workers.

Representative BOLLING. Almost a welfare bill.

Secretary KREPS. I was referring to a burial insurance. We have been trying very hard, for reasons that you suggest, that is, to try to find ways to abort the protectionist trend. We have been trying to find ways to improve the workability of the Trade Adjustment Assistance Act. We think in the Department that it is an important tool if used properly and if funded adequately.

We have made some recommendations to the Vanik bill and have been working for improved funding under that, and are prepared to discuss that in some detail, our own ideas for ways which that could be made to work. If you want to deal with it just a minute longer, I may ask Assistant Secretary Jasinowski to spend a moment on that, since he has been working on it.

Representative BOLLING. I would appreciate it.

Mr. JASINOWSKI. Without taking a lot of the committee's time, I would just say that we have been working with Labor and it again is one of the choice collaborative efforts we have made administratively in the Labor and Commerce programs which are significantly reducing the bureaucratic morass, which has characterized that program for years.

Second, the President has approved some new proposals this year in the budget with respect to trade adjustment assistance, particularly focused on reducing the loan rates and providing other incentives for private firms. But, also going to some Labor and Commerce programs. We will be discussing those with Members of the Congress over the next couple of weeks.

I think that that does not go to the full solution of the problem as you raised it because there is still the question of how these programs can be better related to other structural problems, and that remains part of the unfinished agenda that we have to deal with.

But it is something that the Departments of Commerce and Labor are sensitive to and will be working on in the future.

Representative BOLLING. You are actively attempting to deal with the program.

The other question I have is even a worse one. We have, No. 1, this conversation going on, more than conversation, but conversation going on in Congress about proposals being made by Congress that instead of having a modest tax cut with modest reforms, about a $25 billion cut, that the whole emphasis be shifted suddenly from the President's approach to an approach that would substantially reduce social security taxes by just trading off the funds, moving funds around. There is a proposal in the House, and I do not know whether there is one in the Senate, to just shift completely.

So you have an enormous—substantial reduction in the payroll taxes and no tax cut. I do not want a lengthy comment on that, because I will add something to it. I gather that there are those who feel that unemployment insurance system is in a very bad condition, if not in a disastrous condition, and that the proposal to improve it includes often very substantial increases in the payroll taxes.

The whole problem represents—I think it has to be looked at together rather than separately, although I recognize the difficulty of doing that with this kind of legislation. I know where they go in the committee structure and so on. But I would like your comments on the general approach and then a little on the specifics of what the administration is doing about meeting the criticism that is very clearly implied in those proposals.

I do not know whether it is fair to put them together. But I cannot look at them without putting them together.

Secretary KREPS. Mr. Chairman, it is of course, an immensely complicated question, and of course, the proposals that have appeared in Congress, we have not had a chance to analyze. So, we have no Administration position on that. As you know, the administration's tax proposals are intended to provide some stimulus to the economy, but also to offset what it thought would be the increase in taxes that occurred as a result of the social security programs, needs, and the different upward shifts that were mentioned earlier connected with rising incomes.

I think it is very important for us to go ahead with the tax cut in this year and to provide the stimulus to the individuals that we have outlined. If, however, the Congress and the administration would like to take another look at the funding of the social security and have possible changes in the way it will be financed, and if the administration also has a year to consider where the growth rates are, what kind of stimulus or incentives we need to encourage growth, then I think we all might very well come out with a different package.

I think for this year we have a reasonable set of proposals and we have now adequate time to consider how we would like to go into 1979 and 1980. But I do think it would be difficult for the administration to shift its position on the tax program, which it has labored long and hard to get consensus on to bring before the Congress.

So we would hope that whatever proposals you have for financing social security, particularly in a different manner, could be treated in such a way as not to interfere with the program that we are pursuing. We would be happy, of course, to look at it and to work with you next year.

Representative BOLLING. Secretary Marshall, would you comment?

Secretary MARSHALL. The unemployment insurance system has encountered some difficulty, primarily because the unemployment compensation system was never designed to deal with long-term unemployment. The underlying assumption was that the system would deal with short term unemployment; that you could handle that with an insurance principle. The difficulty arose when we first started the extended program, and then the Federal supplemental program, and started incurring sizable debts in order to provide unemployment compensation to people. We have come part of the way in trying to deal with that problem by our taxes to deal with the Federal part, the Federal Supplemental Benefits part, and to make recommendations in handling that debt.

We have not yet dealt with EB, extended benefits, which is a combination of State and Federal, because there is a problem of equity. Some States made a more vigorous effort, and therefore, if we did anything to forgive that debt across the board you would have serious equity problems.

We have, therefore, recommended that the National Unemployment Compensation Commission, which will be chaired by former Secretary of HEW, Wilbur Moore, take a look at that as a financing question and make some recommendations to us. Our general belief also was that recommendations to reduce the tax rate from seven-tenths to five-tenths was a good move, that is to say, that will contribute to moderating the rise of inflationary pressure because of the increase in labor unit costs that comes about because of higher unemployment insurance tax rates.

Our preference is, first, to try to get the system back on the insurance principle; to try not to use it to deal with long-term unemployment but to try to get job creation to do that. We are not sure about the remaining debt, that is, the heavy debt and the extended benefit debt of the system.

Representative BOLLING. I want to make a comment. The question—neither question indicated my attitude. I am not sympathetic towards the tactic of developing larger and larger programs as a reason for opposing a short-range program; nor am I much given to the position that we should also advocate the better in lieu of the best which might be possible. The reason I ask these questions is basically to establish the fact that the administration is trying to deal with the whole complex of problems which it confronted when it came into being which require solution over time and not in one fell swoop, and that the program hangs together in a very fundamental way.

When I first looked at the administration's program, I did not like any of the details. I had a different view on the taxes. I had a different view on structural unemployment. I had a different view on every piece. Then I fully realized that when you put together the whole thing, including the energy bill, that then I thought it was a reasonable program which might actually be enacted.

Senator PROXMIRE. I want to congratulate you on your superlative judgment in economists, the fact that you took the gentleman to your right, Mr. Jasinowski, who was a valuable member of the staff of this committee, and Courtenay Slater, who is a brilliant, imaginative, extraordinarily helpful former staff member of our committee. You have Lucy Falcone, I understand, and you are about to steal Bill Cox from us. You almost have a Joint Economic Committee downtown. I guess you are taking us over.

Secretary KREPS. I am surprised you can operate without all these people.

Senator PROXMIRE. Secretary Marshall, I am very indebted to you for your statement on inflation. It is a good, solid statement, and particularly what you show is not just a theory but specific instances in which as unemployment drops inflationary pressures tend to diminish. You put your finger on a series of things that would suggest that one way of coping with inflation, at least at one stage of the cycle, is to reduce unemployment.

Your first point is that the unemployment compensation fund, you say, "we estimate the drain on the trust funds increases by more than one-half percent of total wages and salaries for each percentage point increase in the unemployment rate."

Then you point out the State and local tax receipts decrease because as unemployment increases the industries suffer and then revenues drop. They have to make up for that. In Wisconsin they have to balance their budget. They increase taxes and often the sales tax is the first thing to go.

Then you point out the productivity decline. Part of improving productivity is not only providing technological advances but providing for a growing economy. There is no mystery as to why Japan and Germany have had this marvelous increase. The economies were tremendously explosive. As you use more and more of your work force, more and more intensely and more and more of the plant intensely, productivity goes up without any technological changes.

Then you talk about slack economies. The reason I engage in this long summary of what you have said is because I am concerned about the Humphrey-Hawkins bill's lack of balance. It seems to me if we are going to have a specific goal for unemployment, we ought to have a specific goal for inflation. You have indicated that there is nothing inconsistent with that. I am very anxious to try to support that bill because I think we should have a goal for unemployment, numerical goal, not just rhetoric. But why not balance that with a numerical goal for inflation so that we can move together and they can have equal status?

Secretary MARSHALL. In my mind the major difficulty is that I do not think we can have numerical goals unless we can see how to reach them. I had to work that out in my mind with the 4-percent unemployment target. I do not know how we could get such a target with inflation partly because we do not have complete control over everything that——

Senator PROXMIRE. We don't have everything that controls unemployment.

Secretary MARSHALL. But, we come closer to it and employment is more measurable than that is.

Senator PROXMIRE. Let me interrupt. Mr. Shiskin, your man, testified before this committee just a week ago that the inflation statistics are thoroughly reliable.

Secretary MARSHALL. I think they are reliable. That is not the problem.

Senator PROXMIRE. You mentioned measurable. They are both measurable.

Secretary MARSHALL. We don't have complete control over the things that influence inflation as we do over the things that influence employment. I don't see how, short of wage and price controls, and I don't know if you could do it there, we could get a specific target and move towards it.

Senator PROXMIRE. I would agree we couldn't expect to move with regularity. But, neither could we with unemployment or inflation. I would agree that there is no assurance that we will get unemployment down to 4 percent. There is no assurance that we will reduce it one-half percent every year. We would like to do it. But, that is a hope. Again, it is a goal. Heaven knows, there was no assurance that we could reach the housing goal. My amendment in 1968 provided for 26 million housing starts in 10 years, ending this year. We didn't come close to achieving that. I think it was a helpful goal. But, we did put that in knowing it wasn't a prediction or assurance but it would be helpful to measure the way we were making progress.

Secretary MARSHALL. I think that was right and it was a good goal and it was one that could be met.

I can see physically how we can meet the employment goal. I believe we could do it. But, I have to confess that I don't see how either—precisely how you would meet any particular goal with respect to inflation other than one that is fairly nebulous. That is to say, you might say we will decelerate.

Senator PROXMIRE. The Humphrey-Hawkins bill requires the President to set targets each year for productivity, for growth, but, not for prices.

Secretary MARSHALL. I think it is mainly because it is hard to do.

Senator PROXMIRE. Hard for growth. After all, one element of growth is prices.

Secretary MARSHALL. But, in talking about physical, tangible things—I am not saying they are easy. I don't see how you could get an inflation target and then move toward it as well as I can with the unemployment target.

Senator PROXMIRE. Your testimony gives, I think, much too rosy a view, and, in general, the administration has given a rosier view than the other side:

For 1978 the growth is less likely to come from these sectors—housing, autos and inventories—and more likely to come from consumer spending, private investment, and State and local government.

If we have less demand for automobiles, less demand for housing, how can consumer spending go up? Consumer spending was good last year. If we have less rapid increase, I don't understand how we are likely to get more consumer spending.

Secretary MARSHALL. They will spend on other things.

Senator PROXMIRE. Such as? Autos and housing are so important, so massive in the total amount of transactions. How will you get an overall increase in consumer spending?

Secretary MARSHALL. All these are likely to continue. But, I think the relative composition is likely to drift away from those. One of the reasons is inventories have been depleted because consumer demand was higher than was anticipated. Inventories were, therefore, depleted and, therefore, you get more demand for those things.

Senator PROXMIRE. A lot of people argue that they lowered their inventories because of the capacity of management. Then, you have investment in plant and equipment. As I understand, the Commerce Department has projected an increase of that investment of around 4½ percent. Last year it was what, 8 percent? That would be a drop in the increase in plant and equipment investment. So, the official statistics from the agency show the response going the other way.

How can we have an increase in private investment if investment in plant and equipment is likely to increase at a lower rate?

Secretary MARSHALL. All of investment is not just in plant and equipment.

Senator PROXMIRE. Plants and equipment and housing are the big ones.

Secretary MARSHALL. I expect investment in inventories to build up. I also expect the fact that as you get greater utilization of existing capacity, when the capacity to produce has been lagging, sales increase.

Senator PROXMIRE. The capacity would be in plant and equipment.

Secretary MARSHALL. Some increase in that but some increase in other kinds of investment.

Senator PROXMIRE. Perhaps I am wrong. May be Mrs. Kreps could correct me. Is it wrong or right that the expectations is that plant and equipment expenditures will not increase as rapidly?

Secretary KREPS. I was just asking Courtenay Slater and I will let her respond.

Ms. SLATER. You are quite correct that the Department's plant and equipment survey suggests a 4½-percent increase. However, other statistical indicators that we got were very, very strong. Our judgment is that that survey is underpredicting a little bit and that business plant and equipment investment will probably be in the range of 6 to 7 percent.

You might be interested to know that we had a meeting of the Economic Advisory Board yesterday, people outside Government, well-known forecasters, and there was a good deal of consensus on that forecast, which is not quite as strong as we would like to see it. But, it is significantly stronger than the survey suggests.

Senator PROXMIRE. The point I am making is that I do feel that you may be looking at the economic world through somewhat rose-colored glasses.

Representative Brown of Ohio. Let me get back to an earlier point. Even though the average income taxes collected have not risen—the averages have not risen more than a couple of points as a percentage of income—nonetheless, everyone finds himself in a substantially higher marginal bracket because the cuts we have had came through credits and deductions, rather than through widening of the income levels in the tax brackets, or lowering the tax rates in each tax bracket. The higher marginal rates push more and more people into tax shelters. The higher marginal rates produce the after-tax reward for more work—more work, more pay—or more investment where the reward is more profit. So, the result is that we have disincentives built into the system with this increased marginal tax rate.

Do the models used by the Department of Commerce, the Department of Treasury, or the Department of Labor, or the administration in general take this disincentive impact into account?

Your answers have indicated to me, and perhaps this isn't fair, that the macro impact is the thing that one who sits as the Secretary of Commerce or Labor or Treasury looks at. But, I am concerned, Mr. Marshall, not with the macro impact, but the micro impact on the individual. Look at the parochial individual who gets the money taken out of his pocket even though it is put into the pocket of another. It has a depressing effect on that individual.

Secretary Kreps. I wonder what you should do about it.

Representative Brown of Ohio. The model question is the one I am concerned about.

Secretary Kreps. I think you may be imputing to the models a finer set of variables than we have been able to utilize or conceptualize. I don't know how you would feed into a model a factor for disincentive in ways that we are not now doing in some broader way. I would be glad to turn to the experts on predicting. But, it is without regard to whether you can define a mathematical model in such a way to take into account some hypothetical change in incentive. It, nevertheless, is apparent to the administration, as it is to you, that as people get pushed into higher tax brackets that there is a disincentive and one is aware of that in making broad policy judgments. I would not want us to believe that we could be quite as refined in model building as is implied.

Representative Brown of Ohio. I think there are models being built along these lines at this time. We had a few days ago Mr. Shapiro from the University of Michigan who is working in this area of incentives as they are translated by the public into individuals' perceptions of their future and whether they will be better off or worse off. It might help to look at some of those. I would commend it to the administration to see what the impacts are.

Let me ask another more precise question and that is, whether or not the models take into account the effect of inflation on the depreciation allowance. Do they predict a weakening in business investment as inflation causes the cost of replacement of old equipment to rise above the amount of depreciation a firm is allowed to write off? I have this problem in my business that I attempt to operate in real life when I am not here in Washington because we just don't collect the money under the depreciation schedule that it takes to keep the equipment modernized. We have to take that into account.

Secretary KREPS. I apologize. Could you repeat the question?

Representative BROWN of Ohio. Do the models take into account the depreciation allowance?

Secretary KREPS. Yes. The difficulty is not with the models. That is predictable within some range. But, the difficulty might come from the fact that policy is not always made on the basis of precise results of models.

Representative BROWN of Ohio. I gathered that from what Mr. Blumenthal said about looking at the social security tax after the Members of Congress had gone home and heard from their constituents, without having had the impact of the new taxes but only from what they heard.

Does the model the administration uses work with real economic profit? For instance, once again using my company as an example, if it makes $100,000 this year and $100,000 next year, it is a lot worse off because that $100,000 doesn't mean as much as it used to. It is a similar story, if our volume of sales stays the same. We are really not keeping up if we don't apply the GNP deflator to it.

Secretary KREPS. We do that, of course.

Representative BROWN of Ohio. How about inventories?

Secretary KREPS. Yes.

Representative BROWN of Ohio. So, you could tell me what the real profit of the oil industry was without the inventories problem? You could squeeze that out, couldn't you?

Secretary KREPS. That could be squeezed out.

Representative BROWN of Ohio. Would it be squeezed out in terms of anticipating the taxes that accompany this?

Secretary KREPS. I think you would have to ask the tax experts. I suppose it would depend on precisely what they were trying to accomplish.

Representative BROWN of Ohio. Let me put it this way; the real economic profits of American industry are scarcely higher than they were in 1962. Doesn't that slow down in some way the country's growth?

Secretary KREPS. Well, the industry is not acting on that fact alone. If it were, it would be disincentive to growth, if nothing else were happening.

Representative BROWN of Ohio. The fact that you don't change the tax structure very much to adjust for inflation means, it seems to me, that you do have a depressing effect on the economy on that basis.

Let me switch to another train of thought, if I could.

It seems to me what is happening to our tax code is that the base of it is shrinking while the rates on what is left are rising, even though the average tax, as a percentage of GNP, might not rise. Nonetheless, the marginal rates do rise, this chokes off efforts at saving, incentives for work, and so on. In other words, you are getting a smaller and smaller proportion of the people who are getting taxed more and more, although the average works out fine.

In other words, I could put it on a calendar basis. You get taxed 10 percent of your earnings on Monday, 20 percent on Tuesday, 30 percent on Wednesday, through 70 percent on Sunday, if you work

7 days. Your average tax is somewhere around 40 percent. But, what we seem to be doing is having no tax on Monday, none on Tuesday, then on Wednesday having 30 percent, 45 on Thursday, 55 on Friday, and may be 70 or greater on later days of the week. You may be able to hold the same percentage, but it seems to me that if you did it on that calendar basis, the average man quits around Wednesday.

Maybe if you translate that back to whether the average man's tax rate get up there when he starts making over $20,000 or $25,000, and he doesn't qualify any more to send his kid to school on a loan and he has to pay all of it himself, you find that he says to hell with it. The incentive is gone.

Frankly, Mr. Marshall, it is happening to those union members out there who want the system to help them, if you believe what the union leaders say. But, somehow when I talk to them individually, they always say they want the Government to get off their backs rather than to do more for them. Where are we headed?

Secretary MARSHALL. Let me also say that I think the union leaders and the members through time have had a strong interest in Government getting off their backs. But, Mr. Packer has a more precise answer.

Mr. PACKER. That is an interesting analysis about the increase in the marginal tax rate while the average tax rate remains the same. Of course, there is some needed increase in marginal rates to make the Federal tax system somewhat more progressive on the income tax side to offset regressive increases in other taxes. The tax rates are rather proportional across income groups, if you include all taxes.

If the outcome was as you suggested, what evidence would one be likely to find—most people accept a job and accept the terms of the job. 40 hours a week and so on, and they can't say, I won't work on Fridays or Thursdays because I want a lower tax rate.

Representative BROWN of Ohio. Don't take the calendar approach too literally. This is an example of what is happening to people. The Friday people are the ones I am worried about giving up.

Mr. PACKER. One would expect that a family could make that choice very easily. One would expect that the number of workers in a family would diminish if they were concerned about high tax rates, secondary workers, whether they be the male or female worker in the family. They would decide that the tax rates are so high they would rather stay home and not incur that tax rate.

However, the evidence on labor force growth suggests that that is not the case. One sees, if anything, more and more members of each family working, pushing, taking the chances, and pushing themselves into higher tax rates.

The evidence on the micro side too, the evidence of the highly paid executive who has that choice on Saturday and not Friday as to whether to work, finds very little evidence that the high tax rates that we have experienced have worked out that way.

Representative BROWN of Ohio. Let's reverse it, if we could. Let me give you the example of the so-called Kennedy tax cut in the 1960's. At that time it was said, if we cut taxes the Federal Government would have the money to take care of all the social programs we would like to have. He cut the tax rates, or the Congress at the

President's recommendation cut the tax rate from 92 percent to 70 percent at the maximum.

The result was that at the lower tax rate the Federal Government had more tax revenue because the incentive was there to work. I guess what you are telling me is that people just work more no matter what, no matter if they are punished or rewarded for it. I find that a little hard to accept in view of the numbers of people, as in Mr. Marshall's example in his oral statement, in our society who are not working at all.

Mr. PACKER. Let me first correct the misimpression that tax rates do not matter. I am sure that as tax rates get well above 50 percent——

Representative BROWN of Ohio. I think your example of participation in the work force is designed to say to me, maybe I am wrong, that if the tax load is higher, that if the people have a tougher time making it, they will work harder. What I am saying is if the rewards are higher they will work harder. We both can't be right.

Mr. PACKER. Empirically, if rates were too high one would see a reduction in participation. The increase in the participation rate suggests that the phenomenon that you speak of has not yet affected the labor force participation on an aggregate basis——

Representative BROWN of Ohio. I am not talking about an average. I am talking about where the impact hits hardest.

My time is up. If you could give me statistics, I would love to have them from the Department of Labor on the participation rate. Where are those increases in the participation rate coming from? Are they coming at the middle-income level, people who—I don't want to use an unpopular word, but—are disadvantaged in our system the way it is set up? Or are they coming at the lower end of the scale? Or are they coming at the top end of the scale where the $98,000 a year folks who are bored want something else to do?

Mr. PACKER. Yes; we can provide them for the reward.

I would answer, generally, the incentive for most people is the availability of jobs. Black participation rates, where there are no jobs, fall off. As job opportunities become available people participate more. The incentive to work is very infrequently a part of our problem. It is the opportunity to work that has more often been the problem. Generally speaking, when the Government provides the opportunity to work there seems to be no shortage of——

Representative BROWN of Ohio. How about when the private system provides the opportunity to work?

Mr. PACKER. Of course, the private sector is the basis for most opportunities and the tax cuts are designed to provide tax cuts for that.

Representative BROWN of Ohio. And increased savings, and increased opportunity for jobs, and increased profit that makes the investment that holds the inflation rate down, because if you don't do both—my time is up. Send up the participation rates. I would like to have them quantified now and historically.

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

Participation rates of married women, husband present, tend to be highest when the husband's income alone would result in a family income below the median income of husband-wife families. For a substantial portion of the

population; then, the addition of the wife's income puts the family into middle-income tax brackets.

The following table shows that in March of 1976 and in March of 1977 participation rates of wives were greatest in the category for which the husband's income in the previous year was between $10,000 and $14,000.

PARTICIPATION RATES OF MARRIED WOMEN, HUSBAND PRESENT, BY INCOME OF HUSBAND IN THE PREVIOUS YEAR

[In precent]

Income of husband in previous year	Labor force participation rates	
	March 1976	March 1977
Under $10,000	43.9	44.0
$10,000 to $14,999	50.9	53.7
$15,000 to $24,999	44.4	47.5
$25,000 and over	32.5	36.6

(The fact that the average participation rates are lower in the category where the husband's income is below $10,000 than in the $10,000 to $14,999 category reflects differences in the representation there of other factors affecting participation rates. If rates by presence and age of children and educational attainment of wife are weighted by their portions in the next income category, the weighted average rates for this group are approximately the same as they are for the $10,000 to $14,000 category.)

Lower participation rates at levels of husband's income above $15,000 may reflect the impact of the progressive income tax structure, as Representative Brown suggests. They may also reflect the family unit's increasing demand for leisure as income rises, however, with nonparticipation of a secondary worker being the means to achieve this goal.

It is noteworthy that inflation caused tax rates on real incomes to increase between 1976 and 1977 and yet participation rates of married women in all categories, particularly the higher income categories, continued to rise.

Representative BOLLING. I want to be sure Congressman Brown has the last word, which has been happening recently.

I want to thank you both very much for a very interesting session.

I will be submitting some questions in writing to each of you. I hope there won't be too many. But, I hope you will be able to answer them relatively quickly because we need to start writing the report soon.

This has been a most useful discussion. We thank you both.

[Whereupon, at 12:30 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, February 22, 1978.]

[The following questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. JUANITA M. KREPS TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE BOLLING

DEPARTMENT OF COMMERCE,
Washington, D.C., March 22, 1978.

Hon. RICHARD BOLLING,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: Thank you for your letter of February 15 concerning questions the Committee did not have time to ask me during my Feb. 10, 1978, testimony on the Economic Report of the President.

We are pleased to be able to provide you with this additional information. The answers to your questions as listed are as follows:

1. We anticipate that the Economic Development Administration (EDA) will be able to spend the $205 million currently designated for urban areas in

the 1979 Commerce budget within the first six months of fiscal year 1979. The demand for such assistance is far greater than EDA's current urban funding levels. Our local economic development constituency has grown concurrent with the deepening need for revitalization of urban infrastructure as distressed areas have attempted to retain and rebuild their private economic base.

Given the opportunity, EDA could expend more than $205 million for urban assistance in fiscal year 1979. EDA has already requested additional funding as part of its Urban Regional Policy Group (URPG) submission to better enable it to meet existing demands. The additional funds would be expended to reduce the existing backlog of urban project applications for the regular EDA programs and to meet the rapidly increasing number of project applications for EDA's new program based on locally developed Comprehensive Investment Strategies.

2. The Administration has not yet proposed a National Development Bank. Therefore, these comments apply to the bank as proposed by the Department of Commerce.

We have proposed a National Development Bank serving both rural and urban distressed places which would provide long-term and low-cost financing to credit-worthy firms willing to locate, expand, or remain in distressed locations. Financing would be provided in conjunction with grants made by the Economic Development Administration. The Department of Commerce's proposed Development Bank would differ from current EDA functions in the following ways:

1. Eligible areas would be more stringently targeted.
2. The subsidy offered by the Bank would tend to be deeper than current EDA subsidies.
   a. The Bank might subsidize interest rates below Treasury's cost of borrowing.
   b. The EDA would provide grants for up to 15 percent of capital costs with a maximum of $3 million.
3. Eligible firms would not need to demonstrate that they were unable to get other private funding. In fact, the Bank would assist credit-worthy firms. As proposed, the National Development Bank might operate either with off-budget authority, borrowing from the private sector through the Federal Finance Bank, and/or it would operate directly between firms and their private banks using Federal guarantees.

The latter option would require an on-budget authorization for a contingency fund, and because it operates in the non-subsidized market, could not provide interest rates as low as the Treasury borrowing rate, unless there were additional interest subsidies authorized.

3. With regard to extending the investment tax credit to cover structures, the Administration proposes a 10-percent credit for investments in rehabilitations of existing buildings as well as for new structures. Such coverage should help to stem rather than aggravate the problem of out-migration from the cities.

There are many problems involved in targeting tax instruments on specific areas, particularly in defining and certifying qualifying areas, and I therefore urge that the proposal to provide a supplemental credit for investments in places of high unemployment be thoroughly scrutinized.

I appreciate your interest in the programs administered by the Department of Commerce and your continued support. If we can be of further assistance, please let me know.

Sincerely,

JUANITA M. KREPS.

RESPONSE OF HON. JUANITA M. KREPS TO ADDITIONAL WRITTEN QUESTIONS POSED BY SENATOR JAVITS

DEPARTMENT OF COMMERCE,
Washington, D.C., March 29, 1978.

HON. RICHARD BOLLING,
Chairman, Joint Economic Committee,
Washington, D.C.

DEAR MR. CHAIRMAN: When Secretary Kreps testified before the Joint Economic Committee on February 10, Senator Javits asked that she submit for the hearing record answers to several questions. In response, I am enclosing brief papers on our recommendations for export expansion and technology and economic development and our urban policy plans.

If we may be of any further assistance, please let me know.

Sincerely,

CHARLES HASLAM,
Acting Secretary.

Enclosures.

EXPORT EXPANSION RECOMMENDATIONS

The Department of Commerce is redirecting its export promotion activities to focus on smaller and medium-size firms in an attempt to get more of these companies to expand their export efforts and improve their export performance. To the extent resources allow, we intend to work one-on-one with individual companies to help them develop customized export marketing strategies.

The programs being explored to assist exporters include:

The formation of city export task forces, university symposia, in-plant speakers and film programs and industry forum seminars. We propose to assist training facilities whose principle objective would be to train a continuing supply of export executive staff for placement through U.S. industry.

A joint venture program with states, cities and trade associations under which these bodies could submit proposals for the Federal Government to help support export expansion projects.

A small business export expansion task force to include representatives of all interested government agencies, the appropriate small business committees of the Congress, and associations and private organizations that represent the small business point of view.

We ultimately hope to establish a modern, efficient communication and information system which would be comprised of the following elements:

(1) A comprehensive file of American exporters to enable more efficient dissemination of trade opportunities and to provide the basis for further counseling and assistance.

(2) A comprehensive file of foreign trading partners available to assist the marketing needs of specific companies.

(3) A statistical data file from which we could provide market analysis and projection services to small, minority, and impact-distressed companies to replace cumbersome statistical publications which are not readily accessible throughout the country.

(4) Non-statistical marketing data, which will enable us to provide as a service to small firms, abstracts and citations on market research and Foreign Service economic reports.

The program is an ambitious one, yet our $27 billion trade deficit spotlights the need for vigorous programs designed to stimulate exports from a broader base of the American private sector.

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TECHNOLOGY AND ECONOMIC DEVELOPMENT

An analysis of the current innovation process indicates a significant underinvestment by individual firms and, consequently, by industry as a whole, in certain kinds of research and developmental activities. R&D investment by firms tends to be product-oriented and market constrained and for the most part neglects the longer-range, more expensive, higher-risk, basic, process-oriented, integrated conceptual research that yields information fundamental for future innovation but not always of immediate proprietary value. This is sometimes referred to as infratechnology development. One reason for this under-investment is that the cost and risks of R. & D. activity needed to advance infratechnology are often high while the rate of cost recovery may be slow. Also, the benefits of such R. & D. may accrue to many firms and not solely to the investor. Many industries lack the intellectual resources and facilities to develop such infratechnologies. Moreover, the basic organization of an industry and the characteristics of its market may be significantly altered if new technologies are developed, and the organization that has grown up around existing technologies may be threatened.

Given the benefits to society and the disincentives to private investment in infratechnology development, we believe a Federal program to help advance industrial infratechnology is appropriate. The program will operate in those instances where the private sector, acting alone, cannot or will not engage in the requisite R. & D. activities to achieve these ends. It will provide a forum for cooperation among Government and industrial groups. Its purpose will be the development of new knowledge and technology. Initially, we are proposing that the program focus on:

Trade impacted industries, such as the shoe, apparel, and steel industries.

Lead industries, particularly those threatened by high R. & D. investments on the part of competitive foreign countries, such as the electronics industry.

Regulation-impacted industries, including those in which a significant share of investment funds normally available for R. & D. have been allocated for compliance with environmental and/or health and safety regulations.

Industries severely impacted by marked and rapid changes in resource prices (e.g., changes in the prices of energy and materials).

Industries containing many small firms in which productivity advance has been less than the national average.

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STATEMENT ON URBAN POLICY

The forty-year history of Federal urban policy this week turned a significant corner. President Carter has advanced the nation a long and sure step toward solving the problems of our economically troubled cities. For the first time the nation has a consistent and comprehensive urban policy.

The task of policy formulation demanded and received the best efforts of several Federal Departments working under the leadership of Housing and Urban Development Secretary Patricia Harris.

I am especially pleased that the President's urban policy recognized the central role of private sector economic development and jobs for minorities, disadvantaged youth, and the long-term unemployed.

The President's urban policy is grounded on the clear perception that Federal resources are limited, and that effective action requires the cooperative efforts of all levels of government and the active participation of the private sector.

This urban policy confirms my view that significantly expanded private sector participation is essential to urban revitalization. Many elements of the President's program call for targeted public aid to induce multiples of private investment that will increase permanent jobs and strengthen the tax base in troubled cities. Significant new tax incentives will encourage business to locate in our urban areas.

Tying such business development to increased employment opportunities for minorities and the disadvantaged is also an important improvement in our urban policies. Both the $3 billion labor-intensive public works program and the government-wide minority business set-aside will substantially contribute to this objective.

The Commerce Department has been a vigorous advocate of this approach throughout the long urban policy development process. As the Federal Department chiefly responsible for economic development efforts, Commerce will play a central role in implementing the President's program.

President Carter's proposal includes a major expansion of the Commerce Department's budget for urban assistance including:

A $3 billion, three-year "Labor Intensive Public Works" program to rehabilitate and revitalize existing public facilities. This is the first major public works program that earmarks employment opportunities for the long-term unemployed and disadvantaged youth.

$275 million for EDA's flexible Title IX program to provide grants, loans and loan guarantees with the objectives of reversing long-term economic deterioration by strengthening local economic development, creating industrial infrastructure, and promoting business investment. This program will provide grants to support the National Development Bank.

A two-year, $200 million tax incentive program to provide a 5 percent tax credit to selected firms in economically distressed communities. The Department of Commerce will issue "certificates of necessity", within 30 days of application from a firm, based on an evaluation of the firm's likely contribution to the economic and unemployment development of the city.

Commerce will co-chair a new National Development Bank that will lower the costs of doing business in distressed areas through loans and grants. The Bank will provide important new incentives to induce healthy, growing businesses to locate in areas where jobs are needed most.

As Chairperson of the President's Statistical Policy Committee, the President has asked me to explore the opportunities for developing a government-wide urban information base. The data base would include social, economic and fiscal data on our nation's cities that could be used to improve Federal policies for cities themselves to better plan their local development strategies.

In addition, the Commerce Department contributed significant new program and policy initiatives that extend beyond our immediate responsibility:

Based on the success of the minority business set-aside provisions of our Local Public Works program, an amendment which Representative Mitchell sponsored, the Department of Commerce proposed that the Inter-agency Council on Minority Business coordinate an Administration-wide effort to enable minority firms to share in the contracts flowing from DOT, HUD, EPA and other federal construction grant-in-aid programs. This recommendation has become part of the Administration's urban policy.

The Department of Commerce also developed the policy proposal for including state governments as partners in federal urban policy. Because federal-local policies will fall short of success if state governments are not supportive, the President has approved an experimental incentive program to increase state responsibility for declining urban and rural communities.

The President has also properly emphasized the need to use existing Federal resources more effectively. During the last year, the Department of Commerce has begun implementing program and policy changes designed to improve our delivery of assistance to urban areas:

Even before the Urban Package was approved, the Administration increased fiscal year 1978 and 1979 resources for EDA's urban grant and loan programs.

Round II of the local Public Works program targeted almost half of the $4 billion made available to cities over 50,000.

Commerce vigorously enforced a 10 percent minority business set-aside in the Local Public Works program. This will generate over $500 million in construction-related business for minority firms, of which over $200 million will go to firms in large cities.

Commerce's EDA has worked closely with HUD to develop consistent regulations and application procedures for their economic and community development programs.

At the suggestion of many Governors and mayors, Commerce set up an Office of State and Local Government Assistance to coordinate the delivery of Commerce programs to communities and states.

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Fact Sheet

LABOR INTENSIVE PUBLIC WORKS PROGRAM

The Labor Intensive Public Works Program provides for a three year, $3 billion program of financial assistance to communities for labor intensive public works. The public works projects will provide for specific job opportunities for the long-term unemployed.

Objectives.—The main objective of the program is to provide private sector employment opportunities to the long-term unemployed, including the long-term minority and youth unemployed.

The program will also:

Repair and rehabilitate deteriorating facilities with public service, historic, cultural or other value.

Provide for labor intensive public works, such as sidewalks, curbs and recreational facilities.

Assist in energy conservation efforts through the insulation of public buildings.

Demolition of unused and unrestorable structures.

Promote minority business enterprise.

Stimulate the construction industry by providing funding for projects that would not normally be undertaken.

Types of Projects.—The projects that will be funded under the Labor Intensive Public Works Program will be determined by local priorities within set guidelines. A ten percent match in funding will be required. All projects must be labor intensive, i.e., have a labor/cost ratio greater than 50 percent and less than 80 percent.

Allocation of Funds.—The funds will be allocated on the basis of the extent of the long-term unemployment problem in each area.

Employment Opportunities.—At least 50 percent of all jobs created in each area under the Labor Intensive Public Works Program must go to the long-term unemployed. Overall the program is expected to generate about 180,000 person-years of employment and over 300,000 individuals will get jobs through the program.

New legislation will be required.

SPECIAL ECONOMIC DEVELOPMENT ASSISTANCE (TITLE IX)

The Comprehensive Economic Development Assistance Program will provide $275 million a year of economic development grants to support the work of the proposed National Development Bank and to provide flexible assistance to cities to address problems of chronic economic deterioration. The program will target on the Nation's distressed central cities.

Objective.—To reduce the costs for businesses investing in economically distressed central cities and to assist cities in revitalizing their economies, providing jobs for the unemployed and underemployed, and improving the climate for business investment.

Types of Assistance.—100 percent grants which can be used to:

Finance land and fixed assets costs of businesses remaining, expanding or locating in central cities.

Prepare comprehensive economic development plans.

Finance public investments required to implement local economic development plans.

Establish local revolving loan funds for businesses and public works.

Relocate individuals and businesses.

Eligibility.—The program will be targeted to cities suffering serious and chronic economic distress.

Funding.—$275 million for fiscal year 1979.

NATIONAL DEVELOPMENT BANK

The Administration's proposal for a National Development Bank is intended to reduce the comparative cost disadvantage of doing business in economically distressed places, and to increase the availability of investment credit for small and medium-sized firms in such locations.

Over the past year, the Commerce Department has been centrally involved in deliberations on the form and functions of the Bank. It has given strong support to the establishment of a new entity that could provide major incentives to credit-worthy businesses to locate, expand or remain in economically distressed places.

The Bank would provide three kinds of investment incentives:

It would be authorized to guarantee $2 billion in loans by private lenders to cover up to 75 percent of an eligible firm's capital needs (up to $15 million).

It would create a secondary loan market to increase the liquidity of private lending institutions which make capital asset loans for the additional 25 percent share of Bank-assisted projects and to non-assisted small and medium-sized firms in eligible areas.

It could raise the current ceiling on taxable and non-taxable industrial revenue bond issues in eligible localities.

The Bank's financial incentives would be directly linked to grants administered by Commerce (EDA) and HUD (UDAG), which would provide as much as 15 percent of an eligible firm's capital needs (up to $3 million).

The Bank's operations will be further coordinated with EDA's and other Federal development programs through efforts of a three-member Board of Directors which will include the Secretaries of Commerce, Treasury, and HUD.

DIFFERENTIAL INVESTMENT TAX CREDIT

The President has proposed a limited Differential Tax Credit, for which eligible firms would qualify by obtaining "certificates of necessity" from the Department of Commerce.

Certificates of necessity were issued first during World War II and the Korean War to induce businesses to make investments deemed necessary to national defense. The Administration now proposes to issue them to selected firms investing in plant construction or modernization, as well as new machinery and equipment, in economically distressed communities.

All firms, no matter where they are located, can now claim a 10 percent tax credit for such investments. Under the President's proposal, firms receiving certificates could claim an additional 5 percent credit.

The proposal would stimulate new business activity in distressed areas, it would contribute to regional balance in the Federal tax system, and it would allow careful targeting of incentives to labor-intensive firms.

The limited Differential Investment Tax Credit would be administered as follows:

Firms locating in economically distressed communities could apply to the Commerce Department for a certificate. Commerce's Economic Development Administration would evaluate the application and, within 30 days, inform the firm if they were eligible for a 5 percent differential ITC. Commerce's decision would depend on the firm's likely contribution to increased employment and to an improved economic base.

Once a project was certified, the related investment would be automatically eligible for the differential credit.

The program would be undertaken on an experimental basis for two years. Tax expenditure would be limited to $200 million over that period.

MINORITY ENTERPRISE PROCUREMENT PROGRAM

Most minority firms are located in major urban centers with large minority populations and employ a high percent of minority workers. The Department of Commerce is successfully implementing the minority preference element of the Local Public Works Program (the Mitchell Amendment) which is expected to generate over $500 million in business for minority-owned enterprises. Based on the success of this program, the Department recommended and the President approved a program to establish minority enterprise procurement preferences in other relevant Federal grant-in-aid programs.

The Interagency Council on Minority Business Enterprise (IAC) chaired by the Under Secretary of Commerce, will assist Federal agencies in developing effective programs. IAC, which is now successfully implementing goals for direct Federal procurement from minority firms, along with Commerce's Economic Development Administration and Office of Minority Business Enterprise, will provide technical assistance to Federal agencies and state and local grantees in implementing the new program. The program will be flexible enough to account for geographic variations in the availability of qualified minority firms and will be structured to avoid spawning firms that are fronts for nonminority contractors or suppliers.

The objective of the program is to increase the number, size and strength of minority firms in the construction industry. Currently minority businesses participate only marginally in that industry, accounting for less than 1 percent of all public works construction, including Federally financed construction. The market provided by the procurement program will assure minority businesses of substantial construction business experience, clearly the best training for development of competitive enterprise in the mainstream of the construction industry.

EDA'S BASE PROGRAM

Starting with the President's fiscal year 1979 budget, EDA reorganized its budget categories to reflect a greater emphasis on economically stagnating cities and inner-city neighborhoods.

The President's budget proposals for fiscal year 1978 and 1979 will result in a doubling of EDA's city economic development resources, from approximately $100 million to over $200 million. This does not include $138 million in trade and other adjustment assistance, a substantial part of which will go to urban communities and firms.

EDA's recent implementation of Round II of the Local Public Works Program has given cities over 50,000 in population almost $2 billion in funds to construct needed local public facilities. EDA's aggressive enforcement of the minority procurement set aside requirements in the LPW program will generate over $400 million in business for minority firms, about $200 million of which will go to minority firms in cities.

Better targeting of EDA resources will be accomplished through planning revisions which require city and state grantees to identify and address the economic problems of their cities.

Revisions in EDA's urban capacity building programs will produce comprehensive city economic investment strategies through which local, state, Federal and private resources will be integrated.

Program streamlining and efficiency will be achieved through decentralization and expansion of EDA's field structure, shortened and simplified application procedures, the tandem use of management of EDA program tools and strengthened program monitoring and evaluation.

Response of Hon. Ray Marshall to Additional Written Questions Posed by Representative Bolling

Question 1. The President's Economic Report indicates that manpower training programs are a good investment but that their present role is modest in relation to the total unemployment problem. If we should expand our present manpower training programs, by how much and over what time period should we do so?

Answer. Although the ultimate penetration rate would depend on many things, a reasonably scaled manpower training program—principally institutional and on-the-job training (OJT)—would reach a much higher percentage of the persons with structural labor market difficulties than are being served at present. A good estimate of the structural universe—comprised of the working poor plus nonpoor long-term (15+ weeks) unemployed plus discouraged workers—would be about 5–6 million persons. Department of Labor (DOL) programs presently reach at most about 7 percent of this group each year. A more reasonable percentage would be closer to 20, which would allow this entire group to be reached in about 5 years. With no change in the present mix of institutional and OJT, and unit costs rising at 6 percent annually, this implies an annual cost of about $1–$1.4 billion in 1980, rising to $1.5–$2 billion by 1984, over and above the current effort under CETA, which is presumed to continue.

Question 2. Please describe the present financial condition of the Federal and State UI Trust Funds.

Answer. At the end of calendar year 1977 the UI Trust Funds owed approximately $13.5 billion for general revenue advances. From the Extended Unemployment Compensation Account, $3.0 billion was attributed to the Federal share of the permanent extended benefit program and $5.8 billion for the Federal supplemental benefit program. The remaining $4.7 billion represents repayable advances made to the States from the Federal Unemployment Account.

At the end of calendar year 1977 State trust fund balances were approximately $5.5 billion. While the UI system as a whole is in debt, many States are still financially solvent.

Question 3. One recommendation made in the President's Economic Report is that public service employment programs should focus on the structural unemployment problem. What targeting changes should be made to these programs to accomplish this purpose?

Answer. The Department, as it has proposed in the pending CETA reauthorization bill recommends that eligible PSE participants should all be economically disadvantaged, and unemployed at least 5 weeks. Further, "economically disadvantaged" will be determined by family income during the 3 months preceding enrollment in the CETA program. Since persons who are structurally unemployed can be expected to have correspondingly lower incomes than persons with more favorable employment experiences, this recommended change should tend to enroll higher proportions of persons in the structural unemployment universe.

Question 4. How can the large deficits be financed without further payroll tax increases?

Answer. This question must be answered with respect to the two accounts which are currently experiencing large deficits. The first, the Extended Unemployment Compensation Account (EUCA) provides funds for the Federal share of Extended Benefits (EB) and Federal Supplemental Benefits (FSB). The second, the Federal Unemployment Account (FUA) is used to extend repayable loans to States whose trust funds require assistance.

It is estimated by the Department of Labor that the present FUTA tax (rate of 0.7 percent, on a wage base of $6,000) is adequate to fund the EUCA account given current economic projections. With the rate and base remaining constant the entire general revenue advance for EUCA would be repayed by fiscal 1986. If the rate is reduced from 0.7 to 0.5 percent it is anticipated that an additional advance to EUCA of $300 million will be required in fiscal year 1980.

The deficit associated with the FUA account is a function of the loan requests made by individual States. The deficit can be reduced as States begin to repay outstanding loans. This will not take place for the most part, under current law, until calendar year 1981.

Current DOL estimates indicate some additional borrowing will be required in calendar year 1978. The total borrowing is expected to be about 70 percent of the amount required in calendar year 1977, or approximately $900 million. A larger percentage reduction for calendar year 1979 over calendar year 1978 is expected as the full impact of the recent change in the taxable wage base will not be felt until the last half of the current calendar year. In almost every state there is a problem with the timing of outlays and receipts. The first quarter of the calendar year usually has the highest revenues. Therefore, even though it is estimated that only five states will fail to break-even for calendar year 1978, as many as ten states may have to borrow. By calendar year 1980 it is estimated that three states or less will fail to break-even.

Question 5. The Administration's proposal to reduce the Federal tax rate to 0.5 percent merely rolls the rate back to its pre-1977 level. Meanwhile, the wage base has just risen from $4,200 to $6,000 and that strikes me as very unfortunate because it will force many States to raise their payroll taxes. Wouldn't it be best to undo that damage by getting both the rate and the base back down as quickly as possible?

Answer. Congress passed Public Law 94–566 to improve the financing capability of the UI system. The law provided an increase in both the rate and base for the Federal portion of the UI tax. Each State is free to establish its own taxing system but must have a taxable wage base at least as great as the Federal base. In 1977, when the Federal base was set at $4,200, 25 States had a higher base. In 1978, nine States will exceed $6,000.

While it is recognized that payroll taxes do have some adverse effect on employment and inflation the relative share of total payroll taxes attributable to UI was less than 8 percent in calendar year 1977 and is projected to decline to 5 percent in 1980. The analysis of any changes in this tax should take into account that a basic premise of the UI program is to provide insurance in the event of unemployment. This in turn implies that relatively high-cost employers should pay a relatively higher tax than low-cost employers. As a result, a payroll tax as the basic financing mechanism is essential to the insurance principle of the UI system.

A financially sound UI system requires that in the long run the revenue received must equal the benefit paid out. In all states the level of benefits paid to a claimant is a function of wages earned in a base period. Throughout the history of the program, benefits paid have been tied to total wages paid, not taxable wages. At the inception of the program, taxes were paid on total wages (approximately $3,000). Since that time there have been only two increases in the taxable wage base ($4,200 in 1970, $6,000 in 1978) while wages have increased many-fold.

This divergence has caused a serious financing problem with low wage employers paying a relatively higher share of UI costs. As stated before, since in the long run outlays and revenues must be equal, if taxable wages are held constant or reduced there must be a corresponding increase in the rate. If the insurance principle is to remain in effect, there must be some upper limit on tax rates. The only result then, would be to move toward a uniform tax at the state level violating the experience rating principle upon which the program was founded.

Question 6. Has the Federal penalty tax on employers in States that are in debt been imposed on many States recently?

Answer. For calendar year 1978 only the District of Columbia has a penalty tax imposed. In calendar year 1977, Washington and Vermont elected to accept the penalty. Congress has provided for a deferral of this tax if a State meets certain criteria. This deferral could mean that a State would not have to make a repayment until calendar year 1981.

Question 7. Wouldn't it be better to abolish the penalty tax system—which raises taxes in periods of high unemployment—with a system of repayable loans?

Answer. The penalty tax system is simply a means of providing for repayment of outstanding loans.

Congress has chosen to provide for a deferral which delays payment of the penalty tax until 1981 provided certain criteria are met.

The normal process for loan repayment does not begin until the second year following a year for which a loan was first requested. In normal business cycles this lag mechanism is designed to reduce to some extent the imposition of high taxes during high unemployment. If unemployment remains high—as has occurred during the recent recovery period—then this system is less effective in deferring taxes until periods of lower benefit payments. However, in the present recovery, overall business activity as measured by total employment is at record heights and the present high unemployment is less indicative than in the past of lowered economic activity.

Question 8. What criteria would you suggest according to which so-called cost equalization grants might be allocated? We keep hearing about Federal assistance amounting to a "bailout" and I am therefore, looking for a formula that does not penalize those states that have made the hard decisions.

Answer. The DOL is reviewing procedures for this purpose, but at this time does not have a position with respect to the criteria for allocation of cost equalization grants.

Question 9. The United States imports 9.4 million barrels of oil per day at a cost of approximately $45 billion per year. As such, oil imports significantly contribute to our trade deficit. What impact has the large trade deficit had on domestic employment?

Answer. The trade deficit and the oil aspects, in particular, are matters of continuing concern, but their overall impacts are difficult to quantify. The global impact of the higher OPEC oil prices has been to reduce oil-importing nations' real incomes, including our own. To the extent that the OPEC revenues are not being recycled, particularly in the form of increased exports from the United States and other oil-importing countries, short-run impacts are felt on employment as worldwide saving is increased. The United States has felt this effect but has been largely able to offset it in the short run through our economic stimulus measures, and also somewhat because our trading partners, who have pursued less expansive policies, have suffered slower growth as their economies are adjusting differently to the effects of higher oil prices and lowered incomes in their other trading partners. One of the consequences of our higher rate of stimulus and higher growth rate has been our balance of payments deficit, which has been driven up by oil imports but is also due to imbalances with some of our other, slower growing trading partners.

One linking of an objective measure of import impact on jobs is the numbers of persons receiving Trade Adjustment Assistance payments. During 1977, about 120,000 persons received at least one such payment. (Due to the lag between impact and eventual certification and payment, however, most of the impacts actually occurred during 1976.) However, this figure represents only the direct and ascertainable impact of some imports; other direct and indirect impacts are felt also; and no off-setting allowance is made for the jobs created due to exports—which increased about 7 percent between 1976 and 1977.

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