THE 1978 ECONOMIC REPORT OF THE PRESIDENT

883

HEARINGS

BEFORE THE

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CONGRESS OF THE UNITED STATES

NINETY-FIFTH CONGRESS

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THE 1978 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 22, 1978

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Reuss, and Long; and Senators Bentsen and Javits.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director; Jack Albertine, Thomas F. Dernburg, Kent H. Hughes, and L. Douglas Lee, professional staff members; Mark Borchelt, administrative assistant; and Charles H. Bradford, George D. Krumbhaar, Jr., M. Catherine Miller, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, CHAIRMAN

Representative BOLLING. The committee will be in order.

For many years the external sector attracted only the sporadic attention of American policymakers. That period is behind us.

Exports have become such a substantial portion of GNP that in 1977 they exceeded the total value of private residential construction by almost 50 percent. The flow of repatriated profits and other services provides an important counterweight to mounting trade deficits. For many banks and industrial firms foreign operations have become a major source of profits.

In 1977 strong gains in domestic production and employment were not matched by the external sector. Net exports of goods and services fell from a surplus of $7.8 billion in 1976 to a deficit of $9.1 billion in 1977. A significant increase in surplus on services was more than offset by a $21.1 billion increase in the merchandise trade deficit.

In my own view, the sharp increase in the trade deficit reflects domestic strength more than external weakness. The rise in the deficit appears to be largely the result of slow growths abroad and a growing American appetite for imported oil.

The sheer magnitude of the trade and current account deficits have contributed heavily to the recent depreciation of the American dollar. Although the dollar fell by about 5 percent in the trade-weighted basis, the drop against the Japanese and selected European currencies has been very sharp.

The lack of an urgently needed national energy policy and the expectation that trade and current account deficits will continue for

the foreseeable future have contributed to a continued instability in foreign exchange markets. That instability can disrupt trade and investment savings to the detriment of the United States and our economic allies. The depreciating dollar and deficits have already had an impact on domestic policy.

In mounting its defense of the dollar the Federal Reserve has elected to raise the discount rate as well as the Federal funds rate. I am frankly concerned that the resulting increase in short-term interest rates could dampen the recovery and slow-needed capital investment.

The administration has proposed a budget deficit that, in part, is designed to offset the drag created by the deficit in the U.S. current account. As future current account deficits are matched by tighter monetary policy, more and more reliance will have to be placed on fiscal policy to achieve a high employment level of balanced growth.

The recent instability in foreign exchange markets has also renewed interest in the overall health of the international financial system. Large private banks have played a major role in redistributing or recycling financial surpluses earned by the OPEC cartel. Many of these banks are based in the United States. A number of my colleagues in the Congress have questioned the future ability of the private banks to shoulder such a large share of the recycling load.

In some cases there has been active concern that certain U.S.-based banks may be overexposed to individual developing countries.

Before I welcome our witnesses, I would like to call on Senator Javits.

Opening Statement of Senator Javits

Senator Javits. Thank you very much, Mr. Chairman.

Mr. Chairman, we have a very interesting panel of witnesses, and I do not wish in any way to delay their testimony except to state that I consider that we are on the threshold of very earth-shaking events in this field; that is, the United States as it relates to and is related to the world economy. I have to go elsewhere, because I have four committees meeting this morning, one of which I am ranking member; I am due there now.

I would like to say, Mr. Chairman, that I sought to do something which we don't often have an opportunity to do as members of the legislature. I have given a thoughtful in-depth presentation of my own views on the economy on the problems which we are facing. This speech, unfortunately a rather long presentation, is in the Congressional Record of February 8. I wish I were gifted enough to make it shorter.

I notice that Mr. Malmgren has done me the great honor of having reviewed it and commented upon it in his prepared statement. I hope very much that I could invite the other witnesses, if they have not already had a look at it, to review it. If they don't find it worth their time, forget it. If they do find it worth their time, I would greatly appreciate whatever comment they might be willing to

make—hostile or friendly or whatever—it doesn't matter at all. We are all seeking information.

Then I would ask unanimous consent that the comments, if any, of any of the witnesses, including Walter Wriston, may be made a part of the record.

Representative BOLLING. Without objection, so ordered.

Before we proceed, I might say I have read my colleague's presentation, which is an indepth objective effort to arrive at the truth. As Senator Javits says, I think, in his speech, he is in a unique position to render that kind of service to the country because he has had a long career for a long time here and he now seems to think he is not above the battle, but in a position more than ever to be in the battle.

To discuss all these particular issues as well as the broad implications of the external sector of the U.S. economy we have assembled an exceptionally able panel. I am pleased to welcome Mr. Robert Solomon of the Brookings Institution, Mr. Harald Malmgren of Malmgren, Inc., and Professor Franco Modigliani of the Massachusetts Institute of Technology. At 11 o'clock Mr. Walter Wriston, chairman of the Citicorp, will join us.

If you prefer to give us a brief summary of your testimony, the entire text of your prepared statements will be included in the record.

Mr. Solomon, will you lead off for us?

STATEMENT OF ROBERT SOLOMON,[1] SENIOR FELLOW, THE BROOKINGS INSTITUTION, WASHINGTON, D.C.

Mr. SOLOMON. Thank you, Mr. Chairman. It is a pleasure to be here. I should say that as I listened to your opening statement, I think you have scooped me. I am not sure I have terribly much to say that you have not already covered in your statement and covered very well.

My statement is quite brief and I will just go through it quickly. I will address myself to the external position of the United States and to the policy questions that that position raises.

The marked increase in the U.S. trade deficit to which you have called attention—from $9.3 billion in 1976 to $31.4 billion in 1977—has been a subject of considerable concern, controversy and confusion. Actually the current account provides a better measure of the U.S. balance on current transactions. This balance moved from a small deficit of just over $1 billion in 1976 to an estimated $18 billion in 1977.

In appraising the U.S. external position it has to be remembered that at present oil prices the normal position for an oil-importing country is a deficit on current account. As long as the OPEC group of nations has a surplus on current transactions, it is inevitable that the rest of the world will have a deficit of equal size.

Representative BOLLING. Let's pause for a moment and see if we can't stop this noise interference.

[1] The views expressed in this statement are the sole responsibility of the author and do not purport to represent those of the Brookings Institution, its officers, trustees, or other staff members.

[A brief recess was taken.]

Representative BOLLING. Well, let's try it. The noise outside is part of the new construction.

Mr. SOLOMON. I was saying, Mr. Chairman, that the normal position for an oil-importing country under current conditions is a deficit on current account. It is worth noting that, in the first 3 years after the large rise in oil prices OPEC put through, the U.S. current account was in surplus even though the OPEC nations had a surplus averaging almost $50 billion per year. Thus for the first 3 years following the OPEC price rise the United States did not carry any of the deficit that corresponds to the OPEC surplus.

All that changed in 1977. One of the reasons it changed is that our oil imports increased by about $10 billion. The other major reason is that our nonoil imports increased much faster than our exports. This happened because the United States enjoyed a healthy rate of expansion in 1977—about 5 percent in real terms—while other industrial countries, our major trade partners, were either stagnant or contracting.

It is not widely realized just how stagnant the economies of Europe and Japan were in 1977. The newspapers mainly report the change in real GNP from 1976 to 1977 and they tell us that instead of 5 percent, Germany grew by 2.5 percent. These year-over-year statistics are more a measure of what happened in 1976 than of what happened in 1977.

If an adolescent boy grows 6 inches, from 6 foot to 6 foot 6 inches, during his 15th year and then grows no further, it may be said that his average height was 3 inches more in his 16th year than in his 15th year, even though he did not grow at all in his 16th year.

Similarly, Germany's real gross national product rose in 1976 and then leveled off. From the fourth quarter of 1976 through the third quarter of 1977, from the latest data available, the real gross national product in Germany increased at an annual rate of less than 1 percent. Other European economies were also sluggish in the course of 1977. For the OECD countries of Europe, taken together, industrial production in the third quarter of 1977 was lower, on a seasonally adjusted basis, than in the fourth quarter of 1976. Production actually fell in the spring and summer of last year.

In the case of Japan, the statistics are confusing. Real gross national product shows an increase of 5.7 percent, annual rate, in the first three quarters of 1977, but industrial production rose less than 1 percent.

I cite all this detail because these facts are so little known. The rest of the industrial world was in a near recession in 1977. It is not surprising, therefore, that U.S. exports increased so little.

It is also not surprising that sizable movements of exchange rates occurred in 1977. The growing current account deficit of the United States had its reflection in a growing surplus in Japan, Britain, and Italy, and a substantial continuing surplus in Germany and Switzerland. The increasing external deficit in the United States generated expectations that the dollar exchange rate would decline, particularly against the currencies of the countries with sizable surpluses. These expectations became self-fulfilling.

While the U.S. current account deficit increased during 1977, interest rates in the United States were rising relative to those in Europe and Japan. At the present time the rate on day-to-day money is about 3 percent higher here in this country than in Germany. On 3-month financial instruments the interest rate differential is even larger.

Ordinarily one would have expected that the higher interest rates here would have attracted capital from abroad, thereby financing the current account deficit without much movement of exchange rates. That this did not happen can only be explained on the grounds that expectations of further exchange rate movements outweighed the pull of higher interest rates in influencing the flow of private capital.

As a result, the trade-weighted value of the dollar has fallen about 5 percent, or perhaps a little more by now, during the past year against the currencies of other industrial countries. Although the yen has moved up more than 20 percent and the deutschemark more than 10 percent against the dollar, the Canadian dollar and other currencies have depreciated.

Thus a major part of the explanation for the so-called decline of the dollar lies in the poor economic performance of other industrial countries, most notably Japan and Germany. Domestic demand in those countries failed to expand adequately. When the question is asked, how much further will the dollar depreciate, it is not possible to give an unconditional answer. It depends on what happens to the economies of Japan, Germany, and the other industrial countries.

As is well known, Japan has announced a program of domestic stimulation designed to bring about a 7 percent growth rate in the year ahead. There are faint signs that economic activity in Germany may have picked up in the fourth quarter of last year. Time will tell.

Meanwhile, what can the United States be expected to do? It is hard to believe that anyone would suggest that we slow our economic expansion in order to stabilize exchange rates. That would aggravate the stagnation in Europe and Japan and make everyone worse off.

Intervention in foreign exchange markets by the Federal Reserve and the Treasury is at best a limited approach. We should have learned in the 1960's and early 1970's that when fundamental forces are at work, attempts by monetary authorities to hold exchange rates are bound to be unsuccessful. In any event, massive intervention in deutschemarks by the United States affects monetary conditions in Germany and would probably be objected to by the German authorities themselves.

The fact is that the only concrete action the United States can take is to enact an effective energy program. While even this would not have an early impact on the balance of payments, it would improve the long-run outlook and thereby affect short-run expectations.

But the main point, Mr. Chairman, is that despite the charges of benign or malign neglect from across the Atlantic Ocean, it is only the United States among the industrial countries that has maintained a healthy rate of economic expansion in my view. The neglect is to

be found in the misdirected economic policies of the other industrial countries. There is some reason to hope that the economic performance of these countries will improve this year.

Thank you.

Representative BOLLING. Thank you very much.

Mr. Malmgren, would you proceed.

STATEMENT OF HARALD B. MALMGREN, PRESIDENT, MALMGREN, INC., AND COEDITOR, THE WORLD ECONOMY

Mr. MALMGREN. Thank you, Mr. Chairman.

As Senator Javits remarked, I referred to his statement on the floor of the Senate of February 8. Over the years, and through four administrations, I have learned to read what Senator Javits had to say, regardless of who was in power, because he is one of the most insightful and far-seeing Americans who comment on the international economic scene.

In this particular regard, Senator Javits made a number of statements in recent months about the dangers of the international economy. He has been said to be too pessimistic by some people. His most recent statement I read with great care, and I find myself in near full agreement with what he has said about the forces of economic change, and in particular that we are now facing a potential crisis in the international economic area.

The President presented his Economic Report to you recently. I have made a number of comments on that report in my prepared statement, especially about the need to coordinate policies internationally, emphasizing the danger that without that coordination there would be great difficulty in the months ahead. Prime Minister Callaghan only a few days ago made a similar statement, to those of Senator Javits and the President, giving some more particulars about what should be done at the forthcoming summit. Prime Minister Fukuda has also been talking about the need for greater coordination.

I think Chancellor Schmidt in this connection has been doing two things: Calling for greater harmony of policy; and, second, less criticism from the United States. But it is Senator Javits' statement that really gives some meat to the bones, as opposed to most of these other rather general and political statements.

Senator Javits does call for a significant amount of summitry and coordination, with which I agree. But why is it important?

We have, over the years, become accustomed to political rhetoric, from as far back as we can all remember, that the world is interdependent and we should somehow get together, work together, and not to fight. It sounds good to the public, and it makes one feel comfortable.

In the 1970's that rhetoric has become reality. That is to say, the U.S. economy and the economies of other countries have become much more intertwined for a variety of reasons. It is very easy to give a lot of statistics on the interaction, but for example when people talk about the trade of the United States, there is a tendency to look at trade in relation to GNP and say, for example, that U.S.

exports ranged from 3 to 4 percent of GNP for 100 years and then in the 1970's suddenly that ratio doubled or more than doubled. So, it is said we have a bigger impact.

That figure to me is not so revealing. There are much more fundamental figures which I have put in my prepared statement, relating exports to our American production of goods. That is, if we take out services from the economy, and talk about farm and industrial production, then our exports amount to nearly one-quarter of our total production and our imports are one-fifth to one-quarter.

So you are talking really about one out of four jobs. That is a larger ratio than most people use. This is not fully understood in the public. The domestic impact does come out when there is a shift in world market for grain, for example. In the chairman's state a shift in the world market, with development of world surplus we find grain farmers are up in arms, asking what did they do in Washington? Half of the U.S. grain production goes into world markets. Thus if the grain market of the world falls, the U.S. market suffers.

There is no separation of domestic and foreign any longer. There is one market. This is increasingly true in the industrial market as well. It is just not in the farm area of trade. Companies throughout the United States, if their equity is undervalued, are finding they are ripe for takeovers not only by other American companies, but by foreign companies. The depressed equity market is in good part due to hesitancy on the part of the international market to invest in the U.S.—to underpin the stock position at this time.

In my view the way the typical policymaker has tended to respond to the growing interdependence is resort to old themes and old theories and a lot of simplistic economics. In particular, there is a tendency to do something which fits political reality quite nicely, and that is to practice what I call the "politics of blame." It is not "my" fault, it is "their" fault. It is very good to do this, especially when it comes to foreigners, who don't vote.

If we can say the Germans or Japanese are failing, we can be less critical of ourselves. The "politics of blame" tended to generate the so-called "locomotive theory." Here I disagree with Mr. Solomon's analysis in some part, because I think we have gotten so preoccupied with blaming someone else that we have forgotten to look at the problem.

This reminds me of Mr. Monnet's frequent advice in the last couple of decades, that, what we ought to do is get everybody on the same side of the table and put the problem on the other side.

Now what is happening is there is a tendency in the United States at this time not only to practice this politics of blame, but to perceive the world economy as near an economic turnaround. Every month you hear something good said officially about the next month, quarter or half-year. In reality, we have been in a weak recovery ever since the recovery started, both domestically and internationally.

The evidence is quite clear that this recovery is much weaker than it should have been compared to previous recoveries, and particularly that investment has been very, very weak. This means no one is taking the long-term view. Everybody is looking short term, with

no willingness to commit to long-term change. That unwillingness to commit is a political matter, that is not just economics. We have a state of no confidence. It is a widespread mood of the public, to think short term.

Now, the U.S. official analysis tends to be that there is a lot of idle capacity around; if we only stimulate demand somehow, everything will come out fine. Capacity will be used up, businessmen will invest, and everything will take off in a nifty way.

It is my view that the capacity figures are completely misleading, not only in the United States, but in all industrialized economies. There are a lot of reasons for that I won't go into. I am sure you have heard arguments before this dealing with the capacity figures. But in any event, I don't think any of the businessmen I talk to are much concerned about near-term capacity figures. They are much more preoccupied with the stability of the long-term picture and whether or not they should invest long term, in light of future uncertainties.

The locomotive theory only works if you believe that stimulation of effective demand, particularly consumption, will fill up the capacity situation, and then that will lead to investment. If you are concerned more directly about the investment picture, you have to go more deeply into the problem than just proposing stimulating demand, because that is a structural question at this time.

There is also a tendency to rely on exchange rate policy, basically, in almost an emotional way. There are some people I talk to who say, "Well, the Germans and Japanese and a few others don't do what they ought to do, so they can suffer the consequncs in form of appreciation of their currencies." But the consequences of that are not what we really want in some cases.

What we are finding is that very rapid rise of a currency slows down the growth of that nation's economy, which is the opposite of what our objective is. And in the near-term it also tends to enhance the trade surplus, which of course is also not our objective.

But I am not so much worried about the so-called trade surplus problem, as I am about the fact that too rapid currency appreciation is slowing the rate of growth in Germany and Japan, which is not what we want at this time.

Now this overrapid appreciation of the yen and D-mark is what we offer as an alternative to the failure on their part to be good locomotives. As I have said, this is basically a way of saying it is not my problem, it is their problem.

Now, the Germans don't agree with the analysis. They don't say, "I am sorry, I can't do it politically." They are saying, "I don't agree with your analysis at all." They are saying basically that they have to stabilize wages and cut production costs in order to position themselves for rapid growth a year or two from now. To me that is an inefficient approach to restructuring, but it is one way.

A better way should be to stimulate capital formation very vigorously, but that is politically difficult in any country, because it is very hard to find anybody in favor of improving profits through tax action at a time of unemployment and worker hardships.

Now there is a real question in my mind as to who is right, as

between the United States and the Germans, but it doesn't really matter. What we find ourselves doing is arguing about behavior instead of arguing about the problem.

In my prepared statement I have walked through some aspects of the problem. In particular I comment on the role of oil, and in turn on the recycling problem. I point out that very little attention has been paid to the fundamental issue of how borrowed money is being used, and the impact of that borrowed money on exports of the United States and other industrialized nations.

I am saying that it is not a very well-known fact that U.S. exports to the nonoil LDC's have grown to the point that they account for one-fifth to one-quarter of our total exports. In other words, our exports to the nonoil LDC's are bigger than our exports to Canada or any other single country.

These nonoil LDC's are the heavy borrowers, and they borrow to buy. We forget about that aspect of the borrowing problem. If we advise these countries to belt-tighten without thinking about the consequences to us, what we are saying is "Borrow less, import less and sell more," which sounds pretty good to a banker. But what that really means is buy less of our goods, and sell more to us of labor-intensive products, of a type that are already creating some problems in our economy.

So in a sense there is a very tight interrelationship between our international financial advice, and the trade problem in our domestic economic adjustment. Very few people think about that interaction.

I am not saying there should be no belt-tightening. I am saying you can't give that advice to other nations and then wave off the consequences, because the consequences are basic to the industrial production of the United States.

The U.S. trade deficit, I tend to think, is not such a big problem, and I explain why in my prepared statement. I don't think it is necessarily a long-term problem. It depends on the agricultural outlook, and on investment. I think the investment picture is the key to everything and I repeatedly say this because in our exports of manufactured goods half of those are in capital goods. If there is no investment demand in the world economy, there can be no export strength for our capital goods. If there is, then there will be export strength.

We are not really being tested in any competitive way now. So I am not concerned about fundamental competitiveness. I am more concerned with the fact that we have a structural change going on after the worst world recession in 40 years. People hesitate to describe the recession that way, but it is very clear from any of the figures you want to look at that it was much worse than the public pronouncements about it.

Now, this structural adjustment problem we face is basically related to a number of changes that are now historically inevitable. The energy price adjustment caused us to face a problem of adjusting to changes in relative prices between sectors, creating a need to rearrange our industry and agricultural sectors, and sort out within industries, as for example, in the steel industry, the high-cost energy using plants from the low-cost energy users.

We now also have to deal with continuous adjustments of exchange rates. More important even than that is the fact that we have now a dynamic change in comparative advantage taking place around the world, which I tend to call "rolling adjustment." Not so long ago, as you know, Congress was very concerned about imports of textiles from Japan. The Japanese were very much fretting over the U.S. policy toward them. Today Japan is very much worried about imports of textiles into Japan from Taiwan, Korea and other developing countries. I think tomorrow you will find Taiwan, Korea, Hong Kong and other groups of countries fretting about imports to them from the lesser developed countries. In fact, I have heard bankers in some of those places criticize the low-cost labor of other countries and poor labor conditions.

This process is not something you can change. Moreover, the pressure to service debt in the LDC's will enhance that difficulty, because these countries that are in debt will have to export more to service their debt, which means we are going to have more, not less, international competition, and more, not less, import adjustment problems.

I give a number of reasons why this leads to a need for very rapid investment in our economy. I think that is the heart of the problem. You can't adjust if you don't invest. There is no job creation if there is no job creation. The public investment alternative is not such a great possibility, given our budget limitations.

I go through some of the problems of capital investment and conclude that even the pending tax proposals of the administration are not going to do very much in this area. In my view the economic outlook is not good in the other OECD countries. It is not bad here, but it is not good here either.

If you take the United States and put it in the international context, then it is doubtful that the U.S. economic outlook will be as good as it is said to be by the administration.

I think the forecasts of the Government, for 4.5 to 5 percent GNP growth, are much more optimistic than private forecasts. I, myself, tend to think even more pessimisticly than many private forecasts, because of the depressing international effects on the U.S. economy. But especially, I am pessimistic about the outlook for investment.

The tax proposals of the President are supposed to ease this stress somewhat. I am very doubtful whether those tax proposals are beneficial to business in a significant way.

Now, when you look at all of this together, basically what I would say is if you don't have significant investment, you can't maintain the old type of trade policy, which is fairly liberal, because if you can't restructure the economy, then the only restructuring that will be done is on the job front. And we either have job creation or job displacement. Without rapid investment, the industries that are less efficient will not be compensated for by growth in the more efficient industries.

So in a basic sense, taking the long-term view, if you are a free trader, you have to be for strong investment, especially now in light of the major adjustment problems the United States faces. Moreover, if you are really interested in having a significant rate of growth in

the United States, it seems to me you have to sort out the western economic system as a whole, and get it stabilized.

In my view investors are not going to become very optimistic about the long term unless the outlook is more stable, or more serene, let's say. That would take quite a bit of concerting of policies among the major countries; in other words, they have to be seen to be cooperating instead of fighting. I think that is the key to international investment at this time. That is where I come out with Senator Javits' remarks.

Basically, without a concerting of policies and an end to the arguments between capitals, the uncertainty in exchange and capital markets will remain, and investors, when they invest, will invest short-term to cut costs, and not long-term, and without that long-term investment there can be no free trade.

[The prepared statement of Mr. Malmgren follows:]

PREPARED STATEMENT OF HARALD B. MALMGREN

"The economic difficulties that we face in the United States also confront most nations around the world. Our mutual problems are the legacy of the trauma suffered by the world economy during the early 1970s.

"Abroad, as well as at home, concerns about the future have deterred business investment in new plants and equipment. As a consequence, economic growth has stagnated in many countries, and the rise in the capital stocks needed to increase productivity, raise standards of living, and avoid future inflationary bottlenecks is not occurring.

"The problems we face today are more complex and difficult than those of an earlier era. We cannot concentrate just on inflation, or just on deficits in the Federal budget or our international payments. Nor can we act in isolation from other countries. We must deal with all of these problems simultaneously and on a worldwide basis.

"The condition of the world economy requires above all that nations work together to develop mutually beneficial solutions to global problems. If we fail to work together, we will lose the gains in living standards arising from the expansion of world commerce over the past three decades. If the world economy becomes a collection of isolated and weak nations, we will all lose. (The President of the United States in his Economic Report, January 30, 1978.)"

This is the international framework of the President's assessment of our economic condition.

In earlier years, such rhetoric was often used to fire the imagination of the American people about the world outside. In the past, however, the underlying interaction of the U.S. situation with the world's ups and downs was not so fundamental as the rhetoric implied.

In the 1970's, the rhetoric and the reality have converged. The problems of the U.S. economy and the problems of the world economy are now mutual. Unilateral action can no longer work very well, and international market developments have major domestic implications.

To the public, this became painfully apparent in the early 1970's with the worldwide boom and its effects on food prices and commodity prices—and in the form of dramatic or painful events like the Russian grain deals, imposition of price controls, and sporadic export controls. Then came the oil embargo, long gasoline lines, and the subsequent run-up in the price of all energy. The farmers learned that foreign demand was a primary determinant of domestic prices. Gradually, industries that had lived in comfort and isolation learned that foreign competition, and even foreign takeovers, were part of the new reality.

In dealing with the new interdependence, our public rhetoric did not have to change all that much. Our actual policies should have changed, but the reality was that we tended to stay with the old ideas, institutions, and procedures that we knew so well. The one-time release of the exchange rate system from the fixed rates of the past was a shock, but corporations and banks soon adapted. Indeed the commercial and financial world learned to cope and innovate far

more readily than governments. Recycling became the province of banks and multinational enterprises, and the scope of influence of financial managers grew by leaps and bounds.

Government, for its part, has barely kept up. Whenever an international problem occurs, there is a tendency to treat it as an aberration. If the problem involves other governments, a typical response is to blame other governments for failing to do something, and not shouldering their fair share. The *politics of blame* is of course the easiest way to deal with domestic as well as international difficulties. Few high officials or politicians would ever say that they were themselves at fault. It is much easier to say the fault is the creation of someone else, preferably a foreigner who doesn't vote locally. The so-called "locomotive theory" of what is needed to get the world economy going is closely linked to the politics of blame. "West Germany and Japan are the problems: they should do more."

Since politicians and bureaucrats are increasingly expected to do something, official intervention is another typical response to economic trouble. The widespread and growing resort to trade restrictions and official subsidies and other aids to industries and farmers are a major manifestation of this response. But since this creates international conflict, governments simultaneously call for greater international cooperation. That rounds out the politics nicely.

From the U.S. perspective, this tendency to practice the politics of blame, and to resort to short-term remedial actions can best be assessed in light of a view that our economy and the world economy, are fundamentally sound and that around the corner we shall find better times. Given a little time, and the tax package, the U.S. economy will respond favorably. Given further exchange rate pressures, and a little arm-twisting, the external markets will be strong once again.

TOO MUCH OPTIMISM AND OVERSIMPLIFIED ECONOMICS

In my view, there has been a tendency throughout the industrialized nations, in recent years, to overestimate the forces of recovery, and underestimate the structural difficulties in which we find ourselves.

There is a widespread view among economists and economic advisers that although confidence has been shaken in recent years, all will be well if effective demand is increased. It is said, in this school of thought, that present low levels of capacity utilization throughout the OECD countries are deterring investment and consequent job creation. Raise demand and capacity utilization will go up, and investment will take place. This, of course, leads to the "locomotive" concept: stimulate demand in the stronger economies and they can pull the weaker to higher levels of capacity usage, after which the engine of worldwide investment growth will take over.

These economic advisers also believe that exchange rate adjustment helps propel the world in the right direction. On the one hand, a falling dollar puts great pressure on some nations to reflate, and on the other hand it eases the pressures of adjustment resulting from poor U.S. trade performance.

The reality, in my view, is so much more complex, involving both politics and economics, that this oversimplified policy design is becoming dangerously misleading. It certainly leaves financial markets confused.

There is a modest economic recovery in the U.S. The rest of the industrialized world is in much worse shape. As the OECD Economic Outlook (of December, 1977) pointed out, industrial production in the OECD group has been stagnant, or even declining in some cases, since April of last year. Unemployment is actually rising in a number of countries, especially in Europe. Consumer demand is everywhere very weak. Wages are rising faster than productivity in the Western economies, to the point where little or no rebuilding of profit margins is expected in 1978. Investment is generally in trouble.

Investment as a percentage of GNP has been moving *down* since 1973 for most of the OECD countries. Larry Veit of Brown Brothers, Harriman recently noted that between 1970 and 1975 profits as a share of GNP fell 4 to 5 percentage points or more in most OECD countries, while unit labor costs rose faster than selling prices in all major industrialized countries except Canada. The real profit picture is of course much worse, because of inflation and other drag effects.

The push theoretically generated by exchange rate movements is failing to achieve its task. Economists wave this off as a short-term phenomenon, in the

form of the so-called J-curve reaction. The reality is that overrapid appreciation of the yen and the D-mark have resulted in dampening profit margins and investment, so that economic growth has been *retarded*. In other words, as export revenues increase, from rising export prices, fast appreciation has put the brakes on domestic growth. This is the opposite of the proclaimed objective of spurring growth.

If exchange rates always reflected current comparative advntage in the trade account, the floating and volatile rates we see in world exchange markets would be based on fundamental economic forces. But exchange rates also reflect, and are often dominated by, both long-term and short-term capital or financial flows, and by cross-market interaction, from commodities to gold to national currencies, and from one currency to another. Speculation is combined with the search for safe havens in a stormy sea, with the result that the exchange markets have become highly disorderly. Particular national currencies are vulnerable, as we have recently seen with the Swiss franc and the French franc, and as we can expect in others, depending on any political or economic worry that might arise. A hammering on otherwise sound national currencies, such as the Canadian dollar, would not be surprising.

The West Germans have not said "We are sorry, but we have political difficulty meeting the locomotive requirements." On the contrary, they have disputed the locomotive theory as unsound. They do not agree that it is all a matter of inadequate effective demand. On the contrary, they see slow growth as a means of regrouping to fight the perceived number one enemy, inflation. The German prescription is to stabilize wages, growth and cut production costs. It is a somewhat inefficient approach to the need for restructuring to meet today's needs. A better way would be to stimulate capital formation, or private investment, which raises production and capacity and improves productivity—while simultaneously stimulating effective demand. But this is politically difficult in every country. Who is in favor of improved profits, at a time of unemployment and worker hardship? But the most *inefficient* way out of the present situation would be solely to stimulate consumption, or to stimulate public expenditures and personal spending. A rise in public spending creates financing problems which can weaken further the private investment picture, while a rise in consumer spending by itself tends to be inflationary, particularly if business investment is unresponsive.

So there is a real question of who is right. The basic economics is itself not so clear, in a world of continuously changing exchange rates. More fundamentally, the structural change all nations now face may require sectoral policies, and not just sweeping macroeconomic reflation.

It is also not possible to sweep aside the preoccupations of individual groups of workers at a time of high, and in many cases, rising unemployment. National economic policies will necessarily reflect sectoral pressures—and in the absence of vigorous growth, more and more government intervention and guidance is politically likely. It is not a matter of economic logic, or of just riding out job disruption "frictions." Without new capital formation, labor adjustment problems will grow—they will turn out to be structural, not "frictional." Protectionism will follow. The politics of blame will not prevent spreading protectionism. On the contrary, it will be enhanced by the mood of blaming others for weakness at home.

What about the specific problems?

OIL, DEBT, AND TRADE

Enormous attention is paid in the Economic Report to the role of oil in the U.S. current account. The Germans and Japanese have lately also been counterattacking U.S. rhetoric with criticisms of U.S. profligacy in importing oil. The Administration itself continues to stress the role of oil in the deficit. But oil revenues of OPEC countries have resulted in a growth of U.S. exports to OPEC nations from about $3.5 billion in 1973 to almost $15.0 billion in 1977. Military sales and services to this group have also grown. As Professor Benjamin J. Cohen said to the International Economic Subcommittee of this Committee (on October 11, 1977), foreign affiliates of U.S. firms participated in additional sales to OPEC—improving their remittance picture in relation to the U.S. U.S. exports to a number of non-OPEC nations were up because of these nations' exports to OPEC.

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And a major factor has been the financial recycling effect: U.S. bank earnings have been in many cases insulated from domestic economic sluggishness, and have even been boosted, by the combination of access to OPEC surpluses and of lending to non-OPEC developing countries and other heavy borrowers. These countries in turn increased their imports with the use of the borrowed funds—so much so, that U.S. exports to non-oil LDC's provided the only strong sector for U.S. exports in the 1975 economic trough.

The financial side of the recycling and debt situation has been studied and discussed in depth in the last year or two. Various committees of Congress have carried on inquiries about such issues as overexposure of commercial banks and national risk. Very little attention has been paid to the more fundamental issue of how borrowed money is being used, and its impact on exports of the U.S. and other industrialized nations.

It is not a very well known fact that U.S. exports to the non-oil-producing developing countries have grown to the point that they account for one-fifth to one-fourth of total U.S. exports. (For Japan, the figure is closer to one third.) For the U.S., then, this grouping of countries has become larger than Canada or the European nations or Japan. Their demand, moreover, will necessarily grow, as the GNP growth of the developing nations continues to exceed the GNP growth of the OECD nations.

Thus, if we advise these countries to belt-tighten, and borrow less, they must import less and try to export more. The prescribed cutbacks of imports are cutbacks of our exports to them. The prescribed acceleration of their exports are our imports of labor-intensive products—which intensifies our problems of adjustment to a changing world economy. These effects are much too important to leave in the hands of financial specialists who have little or no knowledge of trade, and the politics of trade and domestic growth policies in the industrialized countries.

A rather delicate balance is essential between belt-tightening advice, aid policy, and trade policy of the U.S. and other industrialized economies.

More sophisticated assessments of country risk are needed, which take into account the commercial interaction of borrowing nations with lending nations. My own group is now studying the country risk question from this more fundamental standpoint, with emphasis on the external environment for the heavy borrowers, as well as their political and institutional capacity to adapt to changing global pressures.

I do not sense a full appreciation of these issues in the management of our foreign economic policy. Rather, the bank regulation issues seem to be lodged in one place, the debt issues in another, and the trade question dispersed elsewhere.

THE TRADE DEFICIT

The U.S. trade picture is weak, but what are the weaknesses? The oil import situation is one element, but that is a complex matter in terms of its true effect, as noted above. High oil prices do alter the relative competitive positions of individual industries, and do generate inflationary pressures. High energy prices have brought about an urgent need for major restructuring of the economy, which in turn requires high investment. Since we are not investing at the necessary rate, the result is adjustment elsewhere, especially in the labor part of our economy. This leads to further government intervention, and some protectionism. The same is true in many economies. All of this is harmful to competitiveness and competitive adjustment. But oil by itself is not the whole story.

U.S. exports have been hurt by good harvests in many countries, as well as in the U.S., so that the surge in exports we relied on in the early 1970's in a suppliers' market has been replaced by surpluses in a buyers' market. The impact has been felt by U.S. farmers in a most disruptive way, since one-half of all grains production has lately been destined for foreign markets. The good harvests around the world were no more predictable than the economic demand surge and shortages of 1971–72. If agricultural sales are to operate on a free-market basis, such roller-coaster farm economics must be taken as a way of life. On the other hand, if a domestic floor is to be maintained for farmers' incomes, then stockpiling and trade policy must be an integral part of domestic farm policy. Whatever the course, U.S. competitiveness is not in question. The U.S. remains the world's most efficient producer of wheat, feedgrains, and soybeans, and therefore the U.S. will remain the ultimate food supplier. On the im-

port side, foodstuffs have jumped—but must of this has been a roller-coaster situation in coffee and cocoa, again not related to U.S. competitiveness.

U.S. exports of manufactures have also done less well than expected, but this is a result of sagging world demand resulting from the continued recession in most Western economies. About half of U.S. exports of manufactures are capital goods, the demand for which is weak throughout the world—because of sluggishness of investment. U.S. competitiveness again is not really being tested.

The U.S. trade picture in the near term doesn't worry me so much, at this juncture in history. (Although I do think that the Administration's push to eliminate DISC and tax deferral could not come at a worse time—and must be considered ill-conceived in terms of its threat to current exports.) Rather, it is the failure to recognize the underlying dangers of slow investment and growth, that creates the real threat. We now face a period of major restructuring of the world economy, with consequent effects on the U.S., but the Economic Report really does not get into this.

STRUCTURAL CHANGE IN THE WORLD ECONOMY

We have just experienced the worst world recession in forty years. During the recent period of shaky, exceptionally slow recovery, there has been in each nation a not-surprising preoccupation with domestic employment, inflation, and growth. But the problems are not soluble in a purely national manner.

As a couple of recent GATT reports suggest, we now face a quite considerable problem of long-term structural adjustment. As a result of the shocking rise in energy costs, we have a global problem of changes in relative prices within, and between, national economies. This requires a major rearrangement of production and investment priorities as well as consumption patterns. We also have to cope with a continuous process of exchange rate realignment. In addition, and potentially more significant in the long run, is the dynamic evolution of comparative advantage around the world, particularly as between the industrialized and the developing nations.

Comparative advantage cannot any longer be viewed as a slow-changing, but essentially stable situation. Yesterday, Japan was fretting over U.S. textile import restrictions which limited Japanese exports. Today, Japan is fretting over "disruptive" imports of textiles from Taiwan, Korea, and other developing countries. Tomorrow, the fast-growing LDC's will be trying to dampen adjustment pressures in their economies arising from imports of the lesser-developed economies. This process of rolling adjustment is invigorated by the propensity of buyers and producers to seek ever-new sources of supply in any nation that shows any proclivity towards industrialization. Moreover, the pressures to service debts to the U.S. and other developed nations require accelerated export drives on the part of the heavy borrowers.

At the same time, there has been a growing sense of unease about reliance on external supplies, and the whimsy of many foreign governments. Resource development at home, or in the essentially "safer" countries is viewed with even greater preference. But this raises the investment costs, as less "efficient," pollution-conscious, high-labor cost sources are developed. Or else, there is a tendency to give up growth, and try to hold steady.

THE CRITICAL ROLE OF INVESTMENT

A high level of investment activity is needed to cope with the need for restructuring national economies. Investment, however, has not in recent years been strong in the U.S. or in the other industrialized nations. Various explanations can be offered: (i) Uncertainty about future *patterns* of demand, as demand is redistributed following the shock adjustments of energy price changes. (ii) Uncertainty about future monetary developments, especially inflation, interest rates, and exchange rates. (iii) Decline of the share in profits in GNP as wages and other factor methods have risen relatively more than productivity and prices. (iv) Business accounting methods have automatically resulted in a higher rate of taxation of real business income because of inflation. (v) Lead times have lengthened for most major investment changes, especially those where new plant and equipment are required to alter the structure of the economy, for technological and institution reasons. These factors result in higher risk, lower expected profit, and longer lead times, which in turn make present values of new investment relatively unattractive.

The effects on investment are difficult to assess, but they all suggest growing capital needs:

1) There are cumulated problems of aged capacity, past short-falls, potential bottlenecks, and structural imbalances.

2) The long-term period of declining real price of energy has been followed by a new long-term period of rising energy prices relatively to other goods, which creates strong incentives for investment in energy alternatives and energy conservation. (Such investments have not yet taken place.)

3) In connection with raw materials, political uncertainties in LDC's and certain other nations have created an unfavorable climate for new investment and have increased the incentives to depend more on domestic resources relatively to imports, including development of higher-cost domestic alternative sources, recycling, conservation, and substitutes. These factors suggest a higher capital-output ratio than in the past.

4) Environmental considerations will not only continue to raise capital costs per unit of output; they will intensify as any growth results in compression and intensification of the problems, especially in the industrialized LDC's.

The Economic Report recognizes that U.S. business investment is inexplicably weak, but then states that, "In large measure, the lag of business capital outlays results from the depth of the last recession . . ." Low capacity utilization is deemed to be "important." The hope, of course, is that the pending tax proposals will be adequate, on the business side, to change gloominess to high hopes and fast action. The tax proposals, in my view, do not improve the investment picture significantly, especially if account is taken of the proposed corporate tax "reforms" and the impact of social security requirements. In addition, the energy program's reliance on taxes will probably further sap corporate profits (this is clearly anticipated in Treasury's revenue estimates of the House version of the Administration energy package).

As regards the international outlook for investment, the Economic Report states that:

"The generally sluggish behavior of business fixed investment has been a major factor keeping countries from achieving their goals . . . A number of explanations have been offered for the weakness of investment. No single explanation will suffice for all countries. Nevertheless a substantial portion of the current weakness of investment in every country is accounted for by the low current and prospective rates of capacity utilization and the effects of low levels of output on profits. In addition, the persistence of inflation has undoubtedly added to concerns that recoveries may not be sustained . . . Considerable attention has been focused, as well, on low after-tax returns on capital . . . there is substantial evidence that over the past 15 to 20 years [profits and total returns on capital] have declined relative to GNP and relative to capital stocks in many countries. Moreover, it appears—in contrast to the U.S. experience—that the fall in the return on capital has been too large and too prolonged to be entirely attributable to the recent recessions, at least in Germany, the United Kingdom, and Italy. (Council of Economic Advisors Report, p. 113)."

The Council of Economic Advisers believes that one way to call forth more investment "is to raise expectations and reduce uncertainties concerning after-tax returns on capital." But the major remedy offered is just to get capacity utilization up.

The fact is, we have in the industrialized world a common disease, with ostensibly different causes. Political uncertainties provide some source of variation, of course, but the fact of a common sickness ought to send us back to a new analysis of whether we really do understand the causes.

Looking to the future, there are some economists who seem puzzled why business expectations do not improve when tax relief and stimulus packages are announced—even long before programs are implemented. I think the answer is clear: the experience of recent years is that governments often falter on the way to implementation of new programs. Intentions and actions are something different. Between the cup and the lip are many a slip. The private sector has come to expect the worst, in this regard, in every nation. This is especially true in programs aimed at helping business, because helping business does not appear to be good politics for anyone these days.

The crisis of confidence is therefore far from over. Investment is still in danger. Without acceleration of investment, there will be little restructuring and job creation, and little improvement in productivity. Without investment, labor

will be under intense structural pressure from global economic change. Protectionism can therefore be expected to grow as investment continues sluggish.

A trade policy without a basic investment policy is meaningless, and likely to be eroded by political pressures.

Some reference is made, from time to time, to adjustment assistance programs. The Economic Report gives this matter ten lines, or about one-fifth of one page, out of 237 pages (not counting tables). Yet the long-promised reforms in this program are now nowhere in sight.

THE ECONOMIC OUTLOOK

Basically, the OECD Economic Outlook December report has to be considered as rather gloomy. But the figures are bad enough by themselves. The analysts who put together the projections were clearly even more pessimistic, as they noted in the report that "In the absence of new policy action . . . there could be an important downside risk in the forecast."

Listening to, or reading about, the optimism of some cabinet members or political leaders around the world, a false sense of well-being is generated for the wider public. For example, I was startled, while in Japan a week ago, to read in the newspapers there that Prime Minister Trudeau gave a forecast of 5.5 percent growth for Canada to the Federal-Provincial Conference. Private forecasts would be closer to 4.0 percent, and I wonder whether even that is achievable, given the high reliance of Canada on exports to the U.S. and to the world.

And that is the point—leaders tend to look at national economies as if they were isolated, when world forces are interactive and mutually depressing.

Stimulative policies are in most countries being discounted for the time being, on the grounds that politics are unpredictable these days. Investment shows few signs of strengthening in any nation.

Governments are more and more intervening to shore up troubled sectors. The governments of the European Community are so heavily involved in steel and shipbuilding that no one knows any longer where economic logic would lead, if market forces did in fact play a role. The trend is towards more intervention, not less. This means more competition among nations in terms of the strength of their respective Treasuries. It means more conflicting and distortive and mutually cancelling, wasteful policies. It especially means more uncertainty.

This in turn will lead to more and more cries of unfair competition and to intensified use of trade restrictions and subsidies. The movement of exchange rates intensifies this problem.

In other words, we are entering a period of haphazardly conceived intervention, aimed at *adjustment resistance* rather than promotion of structural change. Governments will wait in hope of revivals of capital formation, but so far with little sign of response.

And what if capital formation suddenly sprang ahead, worldwide? Then the flow of financial resources to governments now heavily in debt would become constricted. Coordination of that shift would become especially important. But that seems a remote problem.

Instead, the problems of structural change, political and exchange rate uncertainty, and policy ambiguity seem to augur for a very weak international market. The interaction of one economy on another seems tilted in a negative direction, taking into account the political tendency towards *adjustment resistence.*

Relying on exchange rate pressures to push along the recalcitrant members of the Western Club is likely to intensify the present state of confusion. Developing at home, in each economy, separate and often conflicting policies of intervention, can only compound the uncertainties.

Ad hoc, or patchwork remedies create an appearance of lack of foresight, or crisis reaction as a way of life. Energy policy, investment policy, trade policy, farm policy, and other seemingly unrelated matters are all interactive, not only in terms of short-term allocations, but in terms of long-term productivity and assurance of supply. In this connection, a Congressional tendency to worry about enhancement of supply of oil and gas, as opposed to reliance on conservation measures and reallocation of existing supplies, is a sound tendency. Political instinct is often more reliable than prescriptions of economic theorists.

One attempt to put order into the international policy chaos is the negotiating activity in the Multilateral Trade Negotiations in Geneva. Here, many countries have recognized that they must somehow pull together, or they will pull apart.

The outlook for success is not great, in the very unfavorable political and economic climate we now face. On the other hand, failure is considered too fearful to be allowed to happen.

The problems in the world of trade are, however, no longer the simple ones of tariffs and quotas. The Geneva talks will likely result in tariff cuts of 35 to 40 percent from present levels. But the significance of that is not so great, since average tariff levels in the U.S. and the E.C. average only 8 or 9 percent. A cut by one-third to two-fifths, phased over eight to ten years, will mean a cut of about 0.25 to 0.35 percent per year—hardly a threat to anyone near the average.

The tariffs are the easy part, in other words. The real issues are the roles of governments in intervening and guiding and aiding in, or thwarting, the conditions of world competition. Governments are now resisting any real change in their policies, or any new strictures on their freedom of action. In those cases where the objectives are converging somewhat, as in agricultural trade, there is fundamental confusion as to what to do. Should free trade be sought, or some form of international coordination of policy, or some form of stabilization agreement. to protect farmers from the vicissitudes of world economic forces? What forms of stabilization, should be considered? No one has the answer, and it is my feeling that even the U.S. and the EC have no clear idea of what they want.

Does all of this concern with trade really matter? The answer must depend on the scope of one's question. The Geneva talks by themselves are not so vital that the world's attention is riveted on them. Yet they are vital to economic well-being of each nation, in rather pervasive ways.

For the U.S., I noted that half of domestic grains productions goes to world markets. Farmers know this. What is less well recognized is the dependence of total production on trade. If we compare exports and imports to GNP, the figures today are double what they were in the hundred years up to 1970 (rising from an average of 3 to 4 percent to a level of nearly 8 percent). But this scarcely reveals the significance of trade to the U.S. economy. If we separate out services and compare U.S. exports to U.S. production of goods, the ratio is now about 23 percent, as contrasted with 11.5 percent in 1960, or 14.4 percent in 1970. If we compare U.S. imports in the same way, to U.S. production of goods, the figure is now about 24 percent, as compared with 8.5 percent in 1960 and 13.5 percent in 1970.

We tend to think of Japan as trade-dependent, but Japan's comparable figures were about 30 percent for exports and 34 percent for imports in 1974 (the latest year for comparable figures). Canada, by way of comparison, has figures of 75 percent and 78 percent respectively.

Still, nearly one-quarter of U.S. production of goods is involved with exports —and the imports role, including its effects on domestic prices, is rarely fully understood, without looking at such numbers.

The importance of trade is easy to understate, especially as the focus of great policymakers concentrates on simple indicators like exchange rates and comparative interest rates. The financial questions are easier to comprehend and easier to talk about—and regulation is more difficult as the liquidity of financial flows runs around, and under, and over, and through intricate capital control systems.

SUMMITRY AND ECONOMIC COOPERATION

The President has called for greater international cooperation. Other leaders are doing the same. Prime Minister Callaghan warned on February 15 in London that a rise in world unemployment, encouraging political extremism, was inevitable this year unless the industrialized countries cope with recession and financial instability. Towards this end, he stated that there must be a new level of international political and economic accord, recognizing that each nation has its own interests, but also that there was need of insuring that policies were in greater harmony.

A concerting of policies is the essential prerequisite to ending the market pessimism and disorder we now are witnessing. This takes a common analysis, and a common recognition that the politics of blame are no longer useful, or even relevant.

Senator Javits of this Committee recently made on the Senate floor a major assessment of Danger on the International Economic Front (February 8). He has, over the years, been one of the most insightful and far-seeing members of

the Congress, and his recent appraisal is, as usual, remarkably perceptive in my judgment. He examines many of the interactions of trade, finance, investment, and LDC change, and observed that there has been a signal failure to grasp the significance of the period of economic history in which we are living.

His recent pronouncements have sometimes been classed as too pessimistic. But I find myself in nearly full agreement with what he has to say in this statement about the forces of economic change. Ultimately he too calls for greater coordination in the West. In particular, he pointed out that "real structural adjustment cannot occur in the industrialized West on an individual country basis. Rather, orderly structural changes must take place through a concerted effort which will apportion the costs and benefits among the various countries." He warned, in conclusion, that if we fail to act reasonably, we could have "a serious economic crunch—recession or even depression—threatening in the 1979–80 period."

I believe that is correct, although the beginning of a downturn could well come later this year. Confidence is a vital part of where we go from here.

Here at home, a recent survey of the National Association of Accountants showed that 71 percent of the chief financial officers of the nation's largest corporations believe that lack of a long-term, credible, understandable economic strategy is the principal cause of stagnant economic conditions—*not* inflation, high energy costs, high interest rates, or a slumping stock market. The sample was based on 450 chief financial officers.

This, together with a stock market tripping over itself on a downhill run, should tell us something.

But a coherent policy in only one country won't be very viable. There has to be some consistency internationally, so that uncertainty is reduced, and the economy is once again aimed at long-term structural change, and less oriented toward short-term survival.

It is not enough to have summits of rhetoric. There must be common concepts, common analyses, and efforts to concert policies. The past economic summits have not in my judgment done much except create bureaucratic paperwork and a few ephemeral headlines.

If the common disease of inadequate investment could be addressed, together with the need for structural change, we could say the summit was dealing with the fundamental problems. If the conclusion was that policies must be made more steady, and uncertainty and volatility in international markets reduced, then the climate for the rest of our economies would be greatly improved. If mutual restraint was seen as more vital than runaway economic interventionism, even more firmness to the outlook would be created. And if the policy-makers commissioned a political management group to keep the Western system going on a sound and steady track, then the results of a summit might even become credible.

It is apparent that protectionism is growing and financial markets are growing disorderly. We are not yet in a great storm, but we soon will be, if we are not steered clear. The Economic Report provides little to guide us, beyond the well-known, and I think, rather outmoded, policies of the past.

Representative Bolling. Thank you.

Professor Modigliani, you may proceed as you wish.

STATEMENT OF FRANCO MODIGLIANI, PROFESSOR OF ECONOMICS AND FINANCE, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Mr. Modigliani. Thank you, Mr. Chairman.

I am sorry that I have been unable to prepare a written statement. I had very short notice. I was out of town at the time I was notified and have not been able to do all the homework I wanted to. Nonetheless I am glad to have an opportunity to review with you my concerns, hoping that they may provide some help to you in your legislative functions.

In some sense one is struck by the fact that the views of this side of the table and those views we have heard on that side of the table

are very close and there is even some risk of perhaps being boring. I have tried to avoid that risk by taking a somewhat broader view of the problem, less concerned with immediate problems, a little more concerned with understanding what are U.S. interests in the area of exchange rates and balance in current account.

From this point of view I have organized my remarks around four questions:

First, What does the level of the exchange rate and the movement of exchange rate mean to the U.S. economy? In other words, supposing that Congress could set freely the exchange rate, would it rather set it high, low, in the middle, stable, moving, et cetera?

Second, what actually does determine exchange rates, both what we might call the equilibrium level and what we might call the current market level, which presumably will tend to fluctuate around the equilibrium level for various and sundry reasons including errors? In other words suppose the Congress leaves the market to do it, how does the market do it?

The next question in the light of the second is whether the current dollar exchange rate is wrong, whether it is too high or too low.

Then the fourth question is this: Suppose it is wrong, what can we do about it?

There is, time permitting, a final appendix that says what should and can the other countries do about it?

Well, this is my program and let me pick up the first question: What does the level of the exchange rate and the related balance-of-payment on current account mean for the country?

You are certainly familiar with the fact that there are two quite opposite views on this subject. There is a traditional view which I always like to associate with the mercantilist and the French that says, "Set the exchange rate low. You want to undervalue your currency because that makes your goods more competitive in the world market, and in the domestic market; it makes good markets for your product. It makes for jobs, it makes for profits for your firms."

And it also makes for possibly an export surplus, which means that it enables you to invest abroad and that gives you control over and power in international affairs.

The other extreme view is set it high, because, if the exchange rate is high, that means that foreign goods are cheap, therefore the inhabitants of the country enjoy a higher standard of living. True, you may be able to sell less abroad, but if you know how to manage demand domestically, you can always create enough domestic demand to absorb any productive capacity, so there is nothing but advantages and you should be quite indifferent to the fact you may even have a deficit so long as somebody will finance it. That is fine. You will still enjoy the more favorable terms of trade and so long as the capital is used for investment, it will produce an income with which you can pay the interest and eventually the principal.

Furthermore, a declining exchange rate contributes to inflation, where there is a rising exchange rate—adjusted for relative inflation domestically and abroad—makes a contribution to reduced inflation.

Now, I think in this country most economists—and I hope Con-

gress—will take the view that in principle if it could, it would like to set a high interest rate. We have no interest in a depreciated exchange rate even though, as you know, the Europeans frequently accuse us, in fact, of plotting to bring about an over-depreciated exchange rate. We are told that the Americans talk the dollar down, and similar views.

I think this is not a very valid view and it certainly is not in our interests, and in particular at this time. I think a low and falling exchange rate is a special nuisance at this junction, because it does contribute to inflation at a time when I think inflation really ought to be, in many ways, our major concern. And it ought to be our major concern not only because inflation does have real consequences in terms of redistributions of wealth, but much more because we are so decided that inflation is a bad thing that whenever it is there, we take measures to kill inflation, and the only tools we seem to use is tight money policy and unemployment, and that is a very costly social cure. So anything which whips up inflation turns out to cost billions and billions of dollars and millions of jobs quite easily.

It is estimated that a 10-percent depreciation of the trade weighted exchange rate, which is twice as much as we had in the last year, might cause an additional inflation of something over 1 percent, perhaps a little more or less, but of that order of magnitude. But, of course, with today's behavior of wages that 1 percent tends to be an additional increment not merely in the price level, but also in the inflation rate. It tends to perpetuate, as wage increases depend on past inflation. So when you increase inflation, you tend to increase it permanently. On this account depreciation is costly.

Of course, Congress does not, in fact, have the explicit power to determine exchange rates. What then does determine exchange rates in the free market, if you have floating or market-determined exchange rates, which is, of course, what we supposedly have had since the 1971 abandonment of Bretton Woods?

This, is obviously a long and complicated subject. There is of course a superficial answer which you hear and read ad nauseam in the newspapers, that the exchange rate is determined by demand and supply. That is a correct but, at the same time, a most uninformative, empty statement, because the question is what determines demand and supply?

In particular it would be a serious error to assume that demand is the amount of dollars that foreigners wish to acquire in order to buy U.S. goods, and supply is the amount of dollars that people wish to sell to buy foreign currency to pay for foreign goods. This demand and supply is a meaningful thing, but it is very far from determining exchange rates. That demand and supply would determine a very jagged, very fluctuating market value. Maybe at 2 o'clock in the afternoon it happens that no one is there to buy or sell and the exchange rate for the dollar would sink to nothing or go to the sky.

Obviously that doesn't happen because a large part of that demand and supply is determined by capital movements in the broad sense and capital movements are controlled by the profitability of invest-

ing funds in alternative countries. For that reason one of the major determinants of demand and supply, is not just current trade, but the relation between the spot exchange rate and the expected future exchange rate. The spot rate can never significantly deviate from the exchange rate expected a bit later, because if it did, there would be huge capital gains to be made in buying or selling the dollar and people would come on to the market to do it.

So to really understand the picture, one has to distinguish between the long-run and short-run determinants. If you look at the long-run determinants, you have two main forces. One is what determines the balance of current account, and that is determined fundamentally by the real exchange rate, or purchasing power parity—that is, the relation between domestic and foreign prices expressed in the same currency by means of the exchange rate—and various other domestic and foreign conditions like aggregate domestic demand and aggregate foreign demand and developments of a long-run nature in tastes and technology.

This determines the long-run behavior of the net exports of a country, again complicated by the fact that the current account balance includes the income earned on previous investments.

The other major component is the long-term capital movements, which is determined by comparative returns domestically and abroad, adjusted for possible expectation of changes in exchange rates. In the long run one essentially must have the current account balance offset the long-term capital balance. In other words, the net exports of goods must be equal to the desired flow of long-term capital.

Now that condition determines the equilibrium exchange. It may gradually change depending on the relative growths of the two countries and other technological developments. Its value must continuously be estimated by market participants, based on various bits of information. The actual market rate should fluctuate around the long-term rate through the intermediation of short-term capital movements. If at some time there is a weakness of demand for dollars and the dollar tends to fall below the long run equilibrium, then short-term capital should flow in exploiting the gain to be made by the temporary decline.

Under the circumstances what causes movements in the exchange rates?

Well, first of all, one important element is whether there is a movement in the equilibrium rate, whether the market's view of this long-run equilibrium is changing as a result of new information. That information relates not only to technological changes, but things like the price of oil and whether some countries are expected to grow faster and some slower. All of that feeds into the expectation of what might be appropriate long-run equilibrium rates.

Then the market rate fluctuates around this because of all sorts of short-term vagaries and random events, which are typically of short duration, maybe months, or anyway not of very long duration.

Now, what sometimes seems to happen, unfortunately, is that when there are short-term forces which tend to weaken the spot exchange rate, and which call for a modest decline of the spot exchange rate relative to the long-run to attract short-term capital, the decline

in the short-run rate is accompanied by and is the cause of doubts about the long-run itself, so that as the short-run exchange rate moves relative to the long-run, both come down, and that does tend to create movements, some of which at least are unwarranted.

There may thus be overreaction to short-term developments and it is quite possible that to some extent this is the kind of thing that we may be witnessing today.

In the light of above considerations one may wonder how we managed to live for so long in a world in which exchange rates were fixed. If market clearing exchange rates are subject to so much change so that the behavior of the market for exchange rates is akin to that of the stock market—and to some extent it is—then how could we ever live with pegged exchange rates?

The answer that is important to understand and remember, is two-fold: In the first place in that system it is the Government's role to produce a large portion of the short-term accommodating capital movements. And, second, the essence of a fixed exchange system is not just exchange rates being fixed, but that governments take a commitment to make the fixed exchange system work. That means they make a commitment to shape the rest of the economy so that the equilibrium exchange rate is the fixed exchange rate, which, of course, is not true under the system of floating exchanges.

In the managed float, which has been the procedure of most foreign countries, including those that are now asking us to intervene like the Germans, the Government is participating with other people in the market to judge what is the equilibrium exchange rate and then provide some of the accommodating short-term capital movements that are consistent with that rate.

Now, if one looks at the U.S. rate now in the light of this picture, can we say anything as to whether at present the U.S. rate is right or wrong? I think the first point to consider is one that my colleagues have already made: While we tend to be impressed by the newspapers with regard to the wild depreciation of the dollar, the truth of the matter is that what is happening at the moment is that two or three currencies have been rapidly appreciating, rather than that the dollar has greatly depreciated.

This may seem like a play on words because one country appreciates and some other must depreciate. But what I mean is that the vast majority of currencies have not significantly changed values relative to the dollar, while a few currencies have appreciated relative to all others. So, while those that are appreciating are appreciating rather wildly, on the whole the dollar is not losing appreciably. In fact, with respect to most of the other countries it is hardly losing at all. It is actually gaining in some cases, though losing in others as many countries do choose a policy of straddling between the dollar and the mark. On balance there has been some depreciation, but that depreciation has been moderate. I think the overall view, among American economists anyway, is that it is very hard to conclude with confidence that it has been overdepreciated. After all, the rate now is only less than 10 percent below the peak it has been at since 1972—that peak was in mid-1976—with 100 being the prefloating

rate of May 1970—around 90—we are down to 82 or 83, something like that. So that is not very low.

Many people did feel that when it was at 90, it was overvalued. It is hard to see then that one can say with confidence that 10 percent lower is appreciably and unmistakably too low. I don't think there is very much evidence of that, although I think on the whole it is more likely to have moved too far than too little. In other words, if one thinks of the long-run equilibrium level, the current rate, even allowing for the need for a short-run accommodation through captial movements, I would judge it, on the whole, a bit too low, but not by a large factor, and not with such confidence that I would advise to friends to speculate heavily on a rising dollar.

If it sank appreciably lower, there might be some concern, but not too much at present.

The next question then is: Suppose it is a little bit low, what could we do about it?

Let me at this point comment on one of the forces that has been conspicuously fingered as a warranted cause of the devaluation; namely, the large deficit on current account. I suggest that it is not at all clear that the large deficit reflects a basic change such as to justify an appreciable downward revision in the equilibrium value of the dollar.

To be sure, one would expect that in the foreseeable future, the United States will be back in its traditional position of net capital exporter.

This conclusion is pretty safe if one thought that OPEC would come back to balance; that, however, may be very far into the future. If the OPEC remains a very large lender, then the situation is a little uncertain because one could imagine that the effect of OPEC, which so far has been to increase very much potential world savings, eventually may succeed in increasing very much world investment, which is again something that my colleague here has been stressing. Certainly that is what the world should do if we were rationally arranging matters. We should, in fact, be increasing our investment as long as OPEC continues to increase world potential savings. For OPEC countries have taken away resources from people who used to consume them to a large extent and they have largely saved these resources.

At the present time we are wasting that additional saving in two ways: By unemployment; that is, by reducing income enough so that other people will not save. That is one way we are wasting it. And the second way we are wasting it is by running gigantic Government deficits all over the world.

These deficits have served to stabilize the economy given the rather absurd monetary and credit policies which have been followed. It is the way we have been dealing with the OPEC additional savings. At some point we may become rational enough to use those savings for more investments, and then U.S. investment may become so large that it is conceivable that the United States would be turned into a capital importer.

However, this outcome strikes me as highly unlikely. At the moment I would think that sometime down the road we should look

forward to the United States returning to being a capital exporter which would require a positive balance on current account.

But, I also submit that a number of considerations would suggest that current exchange rates might well result in the appropriate surplus. This is because the current deficit will decline as we do something about oil; not perhaps very much, but some; because the current depreciation will help improve our competitive positions and because, hopefully, the relation between our growth and other countries' growths will also come back to something more normal. These considerations support my suggestion that the exchange rate is not grossly out of line again, though it might be a bit on the low side.

Now, suppose we concluded that the current rate was too low. What could we do about it? The usual answer, if you want to improve the exchange rate, would be to reduce the deficit. But here you have to be careful, because any measure which reduces the deficit just temporarily should, in a rational world, have very little effect on the exchange rate because only things that are permanent should have an appreciable effect.

Now, of those measures which have permanent effect, certainly one would be the energy program. The energy program presumably by making a permanent reduction in the demand for energy would contribute. Now, we do not want to talk here about the energy program. I certainly do hope, like everybody else here, I am sure, the Congress will pass the energy program. I wish we could pass a very stripped-down energy program which had nothing but allowing domestic prices to move to the world level and did not have these thousands of little details as to who should be encouraged to replace what kind of oil with what kind of coal on what day, which I think is the way I read some of the proposed legislation—I may be exaggerating perhaps, but I read some of the proposed legislation as being unnecessarily loaded with administrative details.

The important thing is to bring the price of oil back to the world level as quickly as possible and possibly to redistribute the capital gain that would arise to the producer by some device such as preferably ones that would reduce inflation. It would mean that the inflationary effect of the oil decontrol program would be offset by inflationary effects like reducing indirect taxes or social security and the like.

In the short run the effects of higher oil prices may not be very important, however, because the elasticity of demand for energy may not be very great in the short run. It might take time for response, and it is quite possible that the rise in energy prices might initially increase other imports, for instance, energy saving cars which are produced abroad. So you might find that some of the reduction in oil imports is made up by other imports in the short run. But given some time, the import saving effects would become important.

The second thing you can do to reduce the deficit, and please don't listen to me too much, is to squeeze the economy. Don't listen to this advice. This is a terrible piece of advice. It is the last thing we want.

First of all, it only has a transitory effect because no one would

believe we would squeeze the economy forever, so it might for a while slow us down with great costs to us, to our unemployed, and with final great cost to the rest of the world. It would mean that instead of getting Germany and Japan to act as locomotives as we have said, our own locomotive would stop and that I would think would be the worst thing we could do from any point of view.

The third thing we can do is to run a tight monetary policy, raising interest rates. A tight monetary policy makes it attractive for capital, short-term capital, to move to this country. This incentive tends to raise the spot exchange rate relative to the long run. So it would be helpful in this sense.

I am afraid that again I would hope that this advice would not be taken, because the current policy of the administration plus Federal Reserve already calls for a great deal of tightening, much more in my view than would be appropriate under the circumstances.

I do agree with the statement made by Mr. Malmgren that one should be less optimistic than the official forecast. I don't know exactly what his forecast is, so I don't know how pessimistic I am with respect to him, but I do believe the present forecast of the administration is too rosy especially when it is combined with the Federal Reserve announced targets, of 4 to 6.5 for M1 and 6 to 9 for M2, and I regard these to be inconsistent with the achievement of the administration's targets, therefore calling for very tight monetary policy.

I think there will be quite a serious problem of disintermediation in the housing market in the second half of the year. I would say, therefore, that that would be a very costly way of gaining a little bit on the foreign exchange market and it would be a little bit because it would be essentially transitory. It wouldn't change the long-run equilibrium value. It would just change the spot value compared to the long.

Representative BOLLING. I wish you could summarize the rest of your statement. I don't want to interrupt you.

Mr. MODIGLIANI. Yes; I am just coming to the end.

Now, the final thing is that the last possibility is market intervention and there are, I believe, two considerations. One general consideration about market intervention is the general negative view about market intervention; one that I subscribe to, given the gigantic size of the dollar market.

I don't share this view for other countries, for small countries, but for the United States there seems to be no point at all in intervention and, of course, as has been pointed out, since in the present case the intervention would be mostly in the German and yen market, there is even less case for a massive intervention of the United States in those markets. Let them intervene if they want. But one additional reason for nonintervention by us has been pointed out. The main leverage we have on them to behave the way we think they should from the international point of view—namely, pursuing an expansionary policy—is that their exports are affected adversely by the rising exchange rates.

They can respond to that by expansionary policies which will increase imports and reduce the threat to their exchange rates. So for this reason again I think we should not intervene and I think it is

very important that we make clear to the rest of Europe the fact that we are doing that in their behalf.

I have spent a lot of effort in Europe persuading people that when we do not intervene and when we let the German mark appreciate, we are helping them get the Germans to move, which is vital for most of Europe.

Well, I think I will say nothing about my last topic—what other countries could do—because I am afraid the time is up.

Thank you.

Representative BOLLING. Thank you, Professor Modigliani.

Mr. Wriston, will you join us at the table? We are grateful for your presence. I understand you received an urging to be here from Senator Javits.

Senator Javits is here and I understand he was called away in a fashion that he could not refuse. I believe he is at the White House right now.

Would you care to comment on anything that you wish?

STATEMENT OF WALTER B. WRISTON, CHAIRMAN, CITICORP

Mr. WRISTON. That is the best offer I ever had, I think.

Representative BOLLING. I am sure you won't take full advantage of it. [Laughter.]

Mr. WRISTON. I want to thank you, Mr. Chairman, for the opportunity to comment on the world economy. I think that both the Economic Report of the President and that of the Council of Economic Advisers are impressive documents. They bring the administration's views on current international policies and problems into sharper focus. And what is more, they provide a clear—and in my view welcome—beacon that points to the direction in which policies ought to move.

At a time when the heavy hand of Government intervention and control is so much in evidence, it is refreshing to read in these reports that the health of the international economy turns critically on the vigor of private economic interests. I also welcome President Carter's determination to maintain a liberal international order. As he puts it, "A keystone of our international economic policy is to work with our trading partners to protect a free and open trading system."

In your letter of invitation, Mr. Chairman, you asked, first, that I assess the impact of economic trends abroad on the performance of the American economy and, second, that I grapple with the problems of stabilizing the dollar and reducing the U.S. trade deficit. Let me then proceed in that order.

No one can deny that ours is an economically interdependent world, that trade flows and capital flows—together with a determination to cooperate in the solution of common problems—are shattering the walls behind which a particular country or groups of countries might seek isolation.

But in the economic policy area—especially where questions of the coordination of individual country policies arise—there is a tendency to exaggerate both the degree of interdependence and the

benefits that might accrue if national interests could somehow be subordinated to the achievement of international goals. It used to be said in the 1930's that when the U.S. economy sneezed, the rest of the world caught pneumonia. And now the onus for spreading disease seems to have shifted in some people's minds at least to Germany and Japan. But those sorts of analogies have never struck me as being very useful.

If forced to make a judgment, I would have to say that, on net, the U.S. economy has larger impact on the rest of the world than the rest of the world has on it. That is a conclusion that follows from the dollar's role as the principal vehicle currency—the one in which most of the world's trade is invoiced—and from our trading position as well.

But the ties that bind leave ample room for a rich diversity in the monetary and fiscal strategies that are being pursued around the world. That has been especially true since 1973 when the breakdown of the Bretton Woods system of rigidly pegged exchange rates freed governments from the obligation of supporting the dollar and permitted them to pursue more autonomous domestic policies.

A number of policy options are clearly apparent in the current economic recovery. The United States has pursued a more stimulative monetary policy and has recovered faster and more completely than Germany and Japan. Italy, Britain, and France are clearly willing to countenance more inflation than Switzerland. Some of these differences are deeply rooted in national cultures and lifestyles, some can be explained by political lessons painfully learned.

Britain, after three decades of sometimes crawling, sometimes galloping, inflation has now reached a crucial consensus on the proposition that there is no tradeoff between employment and price stability. A recognition of the futility of trying to produce jobs by creating more money is turning Britain around.

No such shock of recognition is evident in Rome. But the Italian style of coping with inflation by stagnation is nonetheless modestly successful. Japan is adapting to a more difficult economic environment while deliberately restraining its growth and reordering its domestic priorities. And in Germany, where the abhorrence of inflation is somehow mysteriously communicated from one generation to another—only Germans well over 60 have any firsthand memories of the disastrous hyper-inflation of the early 1920's—there is an iron determination to preserve a hard-won price stability.

Now for the contrast of those strategies with developments in this country. Our recovery game plan is unique in giving higher priority to restoring employment. So far we have succeeded. Employment has risen sharply since the recession touched bottom in April 1975 and inflation—while still very much with us—has slowed markedly. But progress has not brought us peace of mind.

Consider the paradox of the United States and Britain. Here the real GNP has advanced robustly since the second quarter of 1975 while in Britain it has stagnated, declining in several quarters, and making insignificant gains in others. And yet there is great optimism in Britain and pervasive anxiety here.

Why? Surely it cannot be simply a matter of misperceiving the current scene and extrapolating those misreadings into the future. That would assume that Britain is peopled by "Pollyannas" and the United States by "Jeremiahs." There is happily a more plausible explanation of those contrasting national moods.

In Britain there is a new confidence that stems from a fundamental turn in national policy, a recognition that it is not only futile, but positively counterproductive to push recklessly and relentlessly for higher growth. The Phillips curve simply does not work as was once believed. Governments can no longer opt for a higher rate of inflation confident that this will result in a lower level of unemployment.

This newly found British contentment is reflected in greater financial stability. In addition to the effects of the North Sea oil, there is an improved stock market, lower interest rates and a stronger pound sterling on the foreign exchange market. All of these gains were made in the face of an essentially stagnant British economy.

In the United States we have had the other side of the coin. Real economic growth has been far from stagnant. Never in history have so many people been employed. Seldom have jobs grown so rapidly. Yet we persist in behaving like the patient who is doing better, but feeling worse.

The trouble, I submit, is the gnawing apprehension that we have learned nothing from experience and, unlike Britain, are still bent on risking another cycle of go and stop.

My point is that the business and financial communities have learned something, and that is that there is a dire risk in increasing the pressure to achieve still more rapid economic growth. And the prevalent pessimism, as reflected in the equity and foreign exchange markets, stems from the fear that the lessons of the deep 1973–75 recession have not been assimilated by the economic policymakers.

And unlike the official view that is prevalent here, the concerns of foreign observers are less with U.S. economic growth and more troubled by the uncertainty as to where the plunge of the dollar will stop. Such fears are reasonable since the rise of their currencies—notably the deutschemark and the yen against the dollar—creates severe problems, profit squeezes and the like for their export industries. It also compounds the difficulties of U.S. multinationals whose trade and investment sweeps across the exchange markets.

The difficulties of the declining dollar—or the obverse, which is the strengthening of other major currencies—is in large part due to a more stimulative monetary policy in the United States than in other industrial countries. In turn, this has produced faster economic growth here than abroad. But the decline in the dollar has gone far beyond what can be explained by differences in recent monetary policies. It also reflects fears that these differences may continue or become more pronounced. It is hardly in the best interests of the United States to have expectations of further dollar weakness pervade the exchange markets. Not only do they cause great uncertainty for decisionmakers, but it intensifies inflationary pressures in the United States, not only by raising the prices of imports but weakening the competition that confronts domestic producers.

To halt this spiral of expectations, United States policymakers must communicate an unambiguous signal that their concern about

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another round of accelerating inflation is not subordinated to an enthusiasm for stimulative policies. In fact, it is stimulative policies that are very largely responsible for our outsized trade deficit.

It is true that if other countries had been growing faster in relation to the United States our deficit would now be much smaller. But it would not be wise to assume that the solution lies in persuading other countries to run the risk of higher inflation by switching to more stimulus. This would place all of us in the same boat, but it would be hazardous sailing.

In 1975, when the U.S. economy was just emerging from the recession it was growing more slowly than those of most other countries, and largely for this reason it imported less and exported more to produce a surplus on its merchandise trade account. That $11-billion trade surplus was achieved despite the absorption of the first full year's impact of the quadrupling of crude oil prices. Last year other countries, notably Germany and Japan, imported nearly 100 percent of their oil and nonetheless produced trade surpluses.

The recent decision to intervene in the exchange market is a welcome sign of official concern about the decline in the dollar. But it cannot be any more than a palliative unless there is a genuine shift in the direction of fiscal and monetary policies. Intervention can never alone turn the tide in the foreign exchange markets and, in fact, the gains made by the currency swap operations were quickly dissipated since the market was given no reason to expect changes on the economic policy front.

In the history of the last 10 years some countries have lost all or nearly all of their reserves in trying to prevent their currencies from declining in the exchange markets. Markets will not stabilize until participants perceive that a fundamental change in policies has been undertaken.

There is now evidence that inflation abroad is slowing. With policies overseas becoming somewhat more stimulative, national growth rates will not be so disparate as they have been. And this should result in a smaller U.S. trade deficit.

It is those U.S. policies which are at odds with the rest of the world that are at the roots of the uncertainty and anxiety pervading our markets. To restore confidence on a long-term basis, we must gradually, but resolutely, move toward a less expansionary monetary policy and achieve greater success in reducing our Federal deficit. Official pronouncements concerning our long-run economic strategy should emphasize stable policies rather than compensatory moves which seek to inject periodic stimulants.

Second, we must stop pretending that it is possible to fine tune our economy. Recent policy pronouncements suggest that we can move ahead at full steam without any hazard of touching off another round of double-digit inflation, but there is no reason to believe that such a course is not without great risk.

Third, we must stop accepting as inevitable a rate of inflation of at least 6 percent. What I have in mind are those fiscal and monetary policies that cause the demand for goods and services, the nominal GNP, to grow at about 11 percent in order to achieve at least a 4- to 5-percent real output because inflation is believed to be at an

irreducible minimum of 6 percent. It is quite apparent that the physical output of our economy cannot grow faster than 3.5 percent over time without experiencing more inflation.

We must end the uncertainties which hang over our energy industries and which compound the difficulties of making capital investment decisions. Price controls have never served to produce orderly markets, and this has been no less true with regard to energy than with any other commodity.

Next, the public sector now absorbs such a large proportion of the total national income as to place us at the point beyond which the efficiency of the economy begins to decline. I propose that Congress present to the country a constitutional limit on the proportion of national income which can be funneled to the Federal Government in peacetime.

We must also do more to match tax cuts with the Nation's requirements for capital investments. We all know that inflation produces a windfall for the Treasury under our present tax structure. But current tax proposals strike hard at those who invest in America and that is hardly compatible with current efforts to create incentives to build confidence.

Thank you, sir.

Representative BOLLING. Thank you very much, Mr. Wriston.

Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman. It seems to me that all four panelists agreed, but I will ask the question so we can have it straight.

You agree that the problems of the dollar are not really to be solved by exchange rate intervention other than the orderly conditions nor can they be solved by raising domestic interest rates over and beyond what one would want to do for sound domestic reasons. I think Mr. Solomon was particularly interesting on that when he pointed out that our interest rates were well above those of competitive countries for considerable periods of time, yet capital didn't move because of a variety of reasons, notably the expectation of further expansion rate deterioration.

Mr. SOLOMON. Yes.

Representative REUSS. So I think your composite view is that that is likely to prove an unsuccessful or solf-defeating exercise. Have I misstated anyone?

Mr. SOLOMON. I don't know if you would like to hear a little disagreement among the witnesses, Mr. Chairman, on that one point——

Representative REUSS. I assume there is agreement because I didn't hear anyone opening up. Excessive intervention and excessive interest rate-tinkering over and beyond that called for by domestic purposes is not the way out of our dilemma.

Mr. SOLOMON. I would like to make one observation related to that. Mr. Wriston's statement, much of which I agree with, contains the proposition more than once that monetary expansion has been greater and faster in the United States than in other countries.

Well, I have made the comparison between monetary expansion in the United States and in Germany since the deutsche mark was a

key currency that we are all concerned with, and I say with all respect that I think Mr. Wriston's facts are not correct.

I have embodied this piece of analysis, if I may put in a little plug, in a column in the Journal of Commerce on January 25th. I started writing this on the assumptions that Mr. Wriston's facts were correct, that the monetary expansion had been more rapid here, and I was still prepared to find that this was not an explanation for the exchange rate move because the demand for money had also risen faster here and our interest rates were higher. But to my amazement it turned out that, in fact, neither M1 nor M2 had risen significantly more here over the past year than in Germany.

I think that fact is somewhat relevant to your observations. That is why I bring it in.

Representative Reuss. Well, I think Mr. Wriston is right, however, that M1 and M2 in the last year or two in this country have risen faster than in the year or two before that.

Mr. Solomon. Certainly the year or two before the recession, yes, as they well should have.

Mr. Wriston. I would also like to say, sir, that in Germany the figures that Mr. Solomon used did not take the monetary aggregates which the bank uses nor did it take into consideration the velocity. If you take those two things into the balance of the equation, you will find that the German money supply, taking both velocity and monetary aggregates, has been falling steadily over the last 3 years while ours has been increasing steadily.

Mr. Solomon. If you include velocity, Mr. Wriston, of course you are correct. You would have to be correct because Germany's total income has risen less rapidly than ours.

Mr. Wriston. I think that is part of the equation.

Representative Reuss. I want to get on to something else, but I have had the feeling for some years that foreign central bankers, at least the proper foreign central bankers, tended to vote dry, but drink wet on monetary creation. They really sneak out more money than they ever like to tell us they do.

Any dissent from anyone on that observation?

Mr. Modigliani. It is true of M1, not M2.

Representative Reuss. M1?

Mr. Modigliani. Yes; it is true of M1 and we may see more of that if we come through with this legislation permitting automatic transfer of time deposits. That would have quite an effect on the velocity on reducing M1.

Representative Reuss. Let me turn to another subject on which my guess is that Mr. Wriston and Mr. Malmgren would probably agree with me, Mr. Solomon probably would not, I don't know. At any rate, I agree with Mr. Malmgren's observation that the economic advice we have been giving the Federal Republic of Germany has not been terribly good and that they probably have been quite right on not accepting it. Specifically we have said use macroeconomic Keynesian methods of growing faster. They give us a hard time on that.

My view is that they are quite right in giving us a hard time and that we ought to look at our own domestic economy to see whether

the advice we are giving ourselves is all that good, too. I for some time believed on the problem of unemployment that since so much is structural, if we put a greater effort into that and weren't so bewitched with neo-Keynesian upping everybody's income so they can buy more Japanese color television sets, we would probably be better off.

Recently I had a chance to communicate these views to quite important Germans who were over here, and they all agreed that their problem is not too different from ours. Much of their unemployment is structurally handicapped people, uneducated people, people in the wrong place, and that if we were to advise them to grow a little faster using as a stimulus, direct job-creating problems, that that advice would be judiciously taken. We wouldn't have the falling out with Germany that we are having, and the economy would be better.

Now, let me, first, see whether I have anybody who agrees with me. Mr. Malmgren, would you, roughly speaking, agree with that observation?

Mr. MALMGREN. I completely agree with the way you put it, Congressman Reuss. In a way what I said somewhere in my paper is that we have a policy of adjustment resistance in relation to structural problems, combined with this macroeconomic stimulus approach which tends to be inflationary. In other words, if we get in trouble in a particular sector like the TV industry or something similar, we shore it up with some kind of restriction on trade or put in a subsidy of some kind, and simultaneously we are pushing on the demand front in sort of a blunderbuss fashion, and that is a formula for trouble.

So structurally you have to focus in on the real problem.

That is why I put emphasis on investment. If you are to restructure, you have to have strong investment. You have no choice.

Second, you must have some concept in Government programs as to where the money is going, so that expenditures are tailored to the problem. In the whole of the Economic Report, for example, I noted there is about one-sixth of one page on adjustment assistance, which is a rather strange fact. You would have thought there would have been a lot of discussion of the adjustment problem, both in relation to trade, and generally.

Representative REUSS. How about you, Mr. Wriston? Part of what I said falls on friendly ears, I'm sure, but are you willing to go along and spend money in the public and private sector on structural unemployment?

Mr. WRISTON. I agree; yes, I think that as I pointed out, never in history have we created so many jobs in a 12-month period in the private sector. The performance has been absolutely outstanding.

Yet, we have youths, black and minority unemployment. It will not respond to macroeconomics.

I will give you one simple example. I live in a town called New York. We have 1,100,000 kids in school, and on any given day, 230,000 of them are absent. That is not only a number of absentees which is much greater than the population of many major cities in the country, but that means that these kids will come into the labor force with zero education. And they cannot be absorbed at the rates

which are required to be paid for them, and, therefore, it's a terribly important problem of this country to figure out how to deal with that structurally, rather than attempting to do it on a macrobasis.

Representative REUSS. Having heard that, last week I invited the American Bankers Association to a mutual burying of the hatchet at the Banking Committee, and in a week or two, we are going to have before our Banking Committee a score or so of the Nation's leading bankers—perhaps you would be among that number—to discuss with us what bankers as civic leaders can do about structural unemployment.

I'm glad you mentioned that. My time is up, Mr. Vice Chairman.

Mr. SOLOMON. There is an opposing view, Mr. Congressman.

Representative REUSS. My time is up, and I want to give you a chance then. I said I thought——

Mr. MODIGLIANI. I hope so. We have an opposing view, within limits.

Senator BENTSEN. Let me say, I apologize for my lateness of arrival. I had the same problem Senator Javits had. We had a meeting with the President on a point that Mr. Wriston has raised in trying to come up with a solution to the energy problem, to come up with something we could agree on.

I couldn't agree with Mr. Wriston more on how important it is that we resolve it.

I would address most of my remarks, I suppose, to him, since I listened to his comments.

I agree with you, we can't fine tune this economy. I made a speech last fall which is in the record, that we ought to work on long-term solutions and not worry so much about the month-to-month reports. Long-term solutions like capital formation and trying to find some innovative way of taking care of structural unemployment—and an energy bill—are the important matters.

I am not so sure it is so much our concern that we should increase growth even more in this country—and this is a subjective judgment—but I think our concern is more: Can we continue the growth we are having or are we going to fall on our faces?

One of my concerns—I might ask this of the gentlemen who are here, anyone of the others—do you feel that perhaps we are losing our competitive edge in world trade, that we are not keeping up from a technological standpoint?

Mr. Solomon, I address that one to you. I read some recent articles about the Japanese and what they have done with some of their management practices. We have given up the less profitable products, such as television, and watched them establish their markets here and develop their learning curves and then move finally to preempt the entire field.

Would you comment on what American management has done in that regard. Are we losing our competitive edge?

Mr. SOLOMON. I am not an expert on what American management has done in any concrete way, Mr. Bentsen.

I will say what I know on this general subject.

I might remind you that Hal Malmgren pointed out that it is true, as you said, that the Japanese have taken over the color televi-

sion industry. Some of Japan's industries, in turn, are being taken over by other countries at a lower stage of economic development—Korea, Taiwan, Philippines, et cetera.

This is a dynamic world and a changing world. I think one has to look at it that way.

On the specifics of the U.S. competitive position, I think it is very difficult to make a judgment.

Senator BENTSEN. But I think, too, the Japanese have moved into higher technology, and some of the——

Mr. SOLOMON. They have.

Senator BENTSEN [continuing]. Things they have lost are labor-intensive industries where wages are more a factor.

Mr. SOLOMON. That is right. They moved up the scale of industrialization to higher technology. No question about that.

Senator BENTSEN. Yes.

Mr. SOLOMON. Whether we have lost competitiveness is very difficult to judge in a period when private investment is low throughout all the industrial countries.

This is the point that Mr. Wriston and Mr. Malmgren addressed, and I agree with them that this is a serious problem. We may disagree on what prescription is best for solving the problem, but there is no doubt but that it is a serious problem.

We need more investment in the United States and all industrialized countries.

The relevance of my remarks is that in a period when the demand for investment goods is low in other countries, the demand for American exports is going to be low, because we tend to specialize, apart from agriculture, in capital goods.

It is very difficult therefore to separate the competitive effect of our relatively low exports from the income effects because of low demand abroad.

There is a little bit of evidence from a study done recently at Brookings which will be published in the next issue of the "Brookings Papers on Economic Activity," a little bit of evidence that we may have lost some competitiveness technically to Japan in 1975, when the Japanese yen moved down. It has since come back up again.

But as far as I know, there is not very strong evidence that we economists see of a significant loss of American competitiveness in the world markets.

Senator BENTSEN. I would like to address this one to Mr. Wriston.

I have a feeling that our tax structure has moved more and more against capital formation, with every so-called reform bill that comes up.

You have two kinds of investors in this country: you have risktakers and caretakers. Unless you leave something for the risktakers, I do not think there will be anything for the caretakers to care for.

I am concerned about specifics. I am on the Finance Committee, and I just left a meeting of that committee. I am concerned as to what we can do on capital formation.

Now, I would like some comment from you, Mr. Wriston.

Mr. WRISTON. Senator, the largest single source of capital formation in the United States is individuals. It far dwarfs the capital formation of industry. Individuals are ripped off by a thing called regulation Q, which means that the ordinary worker in Racine, Wis., cannot get as much on his savings account as somebody with $1 million.

The result is that we create by Government fiat, I think, this disintermediation which means that as a control led price is exceeded by the market, the money flows out.

One of the ways to create more capital formation is to get rid of regulation Q and let the ordinary guy wih a job participate and save his money instead of moving it into money market instruments.

The second thing is that the capital gains tax and the so-called reforms have the effect of destroying capital and risktaking businesses.

So the third thing is that since inflation keeps increasing the tax rates of ordinary people without the indexation of the threshold points, we will continue to destroy capital—capital being nothing but startup labor, because somebody has to work, and then spend less than they earn, to create capital.

It is really as simple as that. So if you tax everybody who saves, you will, in fact—and we have been—destroying capital in this country.

Senator BENTSEN. Mr. Wriston, the Finance Committee is looking at the capital gains tax now, 49.2 percent. We are getting all kinds of investors that say, why tax the rich.

Mr. WRISTON. Sure.

Senator BENTSEN. Today you cannot start a small company very effectively. There are very many fewer small companies than there were 10 years ago. The new issue markets are dead.

The company I started in 1955, I could not start today.

I do not know how to create competition in this country for the large companies unless small companies can start.

Mr. WRISTON. I agree.

Senator BENTSEN. We have taken the situation on stock options to the point where no longer can the small company pull top executives out of big companies, because they say why take the risk. And for new ventures, the vast majority of them fail.

So I think the problem is that our taxation law has said to people, you better play it safe. This is a matter of deep concern to me.

Now, let me ask anyone of you who might wish to respond, what impact do you think the Tokyo Round of negotiations is going to have on our economy, on U.S. employment, production, and on our national trade?

How significant do you think the concessions have been thus far?

Mr. WRISTON. I would take a pass at it.

The various tariff and nontariff barriers which have been erected in Japan and have been permitted to exist there for many, many years, ranging from a tax on the wheelbase of American cars in Osaka, to failing to liberalize import tariffs on electronic items except vacuum tubes—to give you two specific examples.

I think that the present negotiations Ambassador Strauss is engaged in have moved very significantly forward from the American point of view. I don't think that we are there by any manner of means, but I personally am extremely encouraged by the direction in which it is going, and the skill with which it is being done.

And in my contacts in Japan, which are reasonably extensive, I think there is a growing awareness that their economy will have to become more open to continue to participate.

So I personally view the negotiations as going far beyond specifics on imports, of rebuilding a Pinto car and all the rest of those things.

Senator BENTSEN. You think there has been a breakthrough in their state of mind—in their attitude really?

Mr. WRISTON. I believe that the Japanese move by consensus, and I believe that a consensus is forming that they have to change rather dramatically on this particular subject.

Senator BENTSEN. I hope you are right.

Mr. Malmgren, you have had substantial experience as the deputy special representative for trade negotiations.

I would like your comment.

Mr. MALMGREN. Senator, of course I was involved in the launching of this safari to Geneva, and worked extensively on the Senate side on the Trade Act that got us into a position to negotiate.

I wrote a short article on the negotiating situation for the European Community magazine in January. The editors asked me for a bird's eye view of what is happening. I can submit it for the record. It takes a sort of dispassionate, mid-Atlantic view, an independent stance, and it is basically very pessimistic about what is happening.

[The article referred to follows:]

[From the European Community, January–February 1978]

Deadline for the MTN's

If the prospects are gloomy, the alternative is worse

HARALD MALMGREN, *business and economic consultant in Washington; co-editor of* The World Economy, *London; and former Deputy Special Representative for Trade Negotiations, 1972-75*

THE NEED TO KEEP THE WORLD ECONOMY MOVING IN THE direction of more open and expanded trade was already perceived in the summer of 1967, just after the exhausting conclusion of the Kennedy Round. By the autumn of 1967, ministers of many governments had met in Geneva to initiate a new "work program" aimed at identifying the major problems that remained in world trade. Out of the agreement, for example, the famous inventory of nontariff barriers was developed.

By 1970 high officials in many countries were worrying about an apparent growth in protectionist tendencies particularly in the United States and Europe. Various high-level commissions and study groups were formed in several countries to recommend new departures in trade policy. The most prominent of these was, of course, the so-called "high-level group" in the Organization for Economic Cooperation and Development (OECD), chaired by Jean Rey, which urged in 1971 that a new effort be made to negotiate improvements in the world trading system. In the United States several prominent business and farm groups, and some members of Congress, made similar recommendations. Then President Richard Nixon appointed a Commission on International Trade and Investment Policy, which also proposed a new worldwide negotiating effort.

By December 1971 the United States, the European Community, and Japan had concluded officially that the time had come for a new multilateral negotiation, to keep world trade from deteriorating under the pressures of the new protectionism. As part of the Smithsonian Agreement on exchange rates in December of that year, the three great trading entities agreed to embark on a new, broad-based trade negotiation.

From then to now, six years have elapsed. Ministers met in 1973 in Tokyo to give formal approval to the new trade talks. Teams of negotiators were sent to Geneva to begin a long, tedious exchange of views, arguments, and analyses. A veritable war of computer print-outs began. But little really happened. In February 1975 a further stimulus was provided when the United States announced in the Geneva meetings that the US Trade Act of 1974 had finally become law and Congress had expressed its readiness for serious negotiations. Still, there was scarcely any real momentum in subsequent months. Negotiators found themselves spending more and more time learning to ski, or to sail on the lake by Geneva, and the computers

Trade was foremost on the agenda of US President Jimmy Carter's visit with EC Commission President Roy Jenkins in Brussels January 6.

W. Michael Blumenthal, now Secretary of the Treasury (center), led the American delegation in session at the Kennedy Round of Multilateral Trade Negotiations in Geneva, June 1967.

relentlessly printed more and more calculations.

How did it happen that the major governments labored so much and yet did so little? The answer is that all governments were caught in conflicting pressures, with some domestic groups favoring negotiation and liberalization, and others urging a defensive, hold-the-line policy. The world economy was thrown into turmoil, first by an economic boom and raging inflation at the beginning of the 1970's and by the oil shock and subsequent recession of the mid-1970's. Unemployment began to rise everywhere. Investment in the future fell to exceptionally low levels, and failed to recover, throughout the industrialized world.

In 1977 world economic recovery continued slowly, but unemployment did not improve, investment continued to be virtually stagnant, and world monetary uncertainties intensified. With great effort high US and EC trade officials met several times to establish a timetable for the Geneva trade talks, to give the clear impression to the world economy that expanded trade, not protectionism, was the right answer. In the new timetable January 15, 1978, was designated as the ultimate date for putting all the trade issues on the table in Geneva. By then draft codes on nontariff issues were to have been made ready for the final stages of negotiation. Tariff rules would be set. Agricultural problems would be made ready for new, pragmatic solutions.

THIS DATE HAS NOW PASSED. WHERE ARE WE? The answer is not clear. On the one hand, the world has so far avoided a descent into neo-isolationism and rampant protectionism. The negotiations are moving. There is hope for "progress" in 1978. On the other hand, each of the industrialized countries has been undertaking some trade-restricting actions—and this is especially true in the United States and the Community. In Geneva the positions that have been laid on the table contain little new. The draft codes are empty with respect to the key issues. Agriculture is still a thoroughly confused situation.

In a way, then, one could say that the true trade negotiations are only now beginning. In the meantime the world economic outlook is rapidly becoming less favorable. In the absence of significant change in the private investment outlook, or a major change in official policies, the industrialized OECD countries face continued unemployment and a slow-down in growth—perhaps even the beginning of recession by the end of 1978. Inflation is picking up steam. Energy problems appear to be intractable to many investors. Governments are busier than ever, intervening sector by sector, without any overall concept, often with conflicting or self-cancelling policies.

The frustrations among politicians are acute. No politician is prepared to admit that he is unable to "solve" the problems, or that his policies are inadequate. Instead, political leaders all over the world are blaming foreigners

or foreign influences for troubles at home. Japanese export unfairness, or the sinking dollar, or the protectionism of the Community and the United States in agriculture, steel, autos, televisions, and so on, are all blamed. The strong, locomotive countries are blamed for putting too little steam into their engines of growth. The weak are blamed for timid policies. And everywhere, it is said that national politics are in an especially delicate stage.

A particularly popular criticism is that there is an absence of political leadership. In this connection one might well recall the immortal words of Senator Russell Long: "There are plenty of leaders around. Too many in fact. We don't have an absence of leadership, we have an absence of 'followership.' No one is ready to yield to anyone else."

In this inauspicious set of circumstances the trade negotiators have to work. In particular they are confronted by three specific problems. *First,* there is an accelerating growth in protectionist thinking. Both the United States and the Community are in the forefront of this trend, in areas ranging from steel to textiles, from ball bearings to televisions, from butter cookies to beef. *Second,* there is the tendency of all governments to blame external pressures for internal difficulties, and to solve economic and financial difficulties through trade policies (including pushing the locomotive countries to do more). *Third,* there is a strong tendency in every nation for governments to intervene more and more, to "correct" each problem as it occurs. There can be a philosophic argument over whether accelerating interventionism is socially good or bad. There can be no argument that the state interventionism we now see is ill-coordinated, conflicting, expensive and often wasteful, and highly nationalistic—or even regionalistic.

These three key problems together have one result: Nontariff barriers and distortions to trade are becoming worse, not better. The Geneva negotiators are working against a strong tide going the other way.

In the specifics the negotiators of various nations appear proud of their accomplishments to date, but they have primarily achieved procedural victories rather than substantive results. On tariffs there is a dispute between the United States and the Community about how firmly to aim at roughly a 40 per cent reduction in present tariffs—the reductions to be phased in over 8-to-10 years. (This means the present average tariff of about 8 per cent in the United States and the European Community will be cut by only about 0.3 percentage point per year, hardly an amount worth arguing about, in the case of most products.)

On agriculture neither the United States nor the Community has any real clear idea of what to do, although both agree something new is necessary. Japan and other nations are relatively happy at the absence of new ideas. There is a potential for breakthrough in cereals in the recent move of international discussion of wheat from London to Geneva, so that grains can be looked at in conjunction with the rest of the agricultural and industrial negotiations. Yet even here the various governments have not been able to bridge the technical differences in perception of how the cereals market can be managed, as between the objectives of expanded trade, access, stockpiling, and stabilization. The trouble here reminds one of the old dictum that it is too important to leave it to the technicians and grain specialists. If grains issues could

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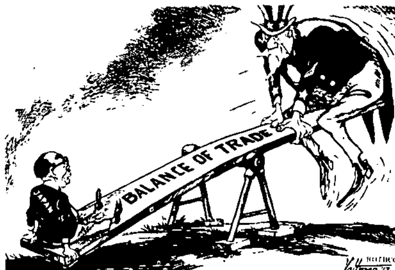
"The problem these days isn't keeping up with the Joneses, it's keeping up with the Tokoshiamas, the Fukodas, the Yamzawas, the Miazakis. . . ."



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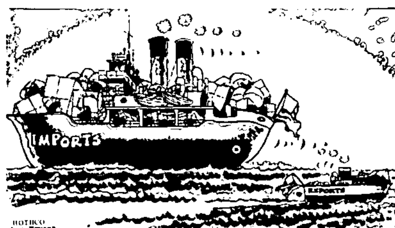

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be resolved, a good part of the rest of agriculture would fall into place easily.

On nontariff matters fundamental difficulties are ahead. Of all the issues a code on subsidies and countervailing duties is the most important. The US side cannot satisfy Congress without a serious new code that covers all official aids. The Community and some national governments believe that most aids are a matter of national sovereignty and should not be circumscribed by new international rules. The Geneva discussion therefore mirrors in a way the discussion within the Community itself about regional and national subsidies. There is also the issue of how to handle agricultural subsidies as compared with industrial aids. On this the United States and the Community are in total conflict. At present the various positions on aids are far apart, no meaningful draft of a code exists, and governments are intervening more and more everyday.

MARKET DISRUPTION is another area that is catching the attention of governments. Two or three years ago no government wanted to talk about changes in the rules on so-called "safeguard" actions. Today several governments find themselves taking action to limit imports and needing some way to legitimize what they are forced to do politically. Suddenly there is a search for a new safeguard code. But even here the differences are great. The United States appears to want much stronger multilateral surveillance and international dispute settlement procedures. The Community and some national govenments appear to be opposed to this. Recent tightening of the textile import regime in the Community seems to work in direct conflict with what the United States has in mind. In any event for many people the newfound interest in safeguards is to make trade restrictions *easier* to apply, and this must bear close scrutiny.

As for other nontariff barrier issues, modest progress has been made on government purchasing policies, but there is still ample room for disagreement. Industrial standards and valuation practices are in better condition from the negotiating perspective, but national legislatures may not welcome what the negotiators are trying to do. The biggest uncertainty lies in the handling of the developing countries. On the whole their issues have been left to the last. Their governments work even more slowly that the industrialized countries. They are not likely to favor the types of agreements which are negotiable by the spring of 1978.

In fact the timetable looks ominous. With good will and major political effort, the United States, the Community, and Japan could have their tentative deal by the summer of 1978. But then would come the August holidays. After that the Council of Ministers would take two or three sessions to clear the Community position. The US Congress is entitled to 90 *working* days to consider any draft nontariff agreements if changes in law are involved. Since Congress will have to recess for elections, it is virtually certain that final US approval would have to come in 1979, even if the broad outlines are settled by the summer of 1978. For Japan there will be great controversy in the Diet. In Canada there will be stresses between the provinces and the federal government at a time when the Quebec issue is coming to a head. In other countries politics will be uncertain.

In other words, the real negotiations of 1978 are in trouble just as they start in earnest. It will be a rough year. The issues are hard, the world economic outlook is not good, the tendency towards protectionism and national intervention is growing, and the political base of interest for a liberal world order are on the wane. It took a long time to get here—10 years from the end of the Kennedy Round. And we have not in fact gone very far.

Yet if this sounds gloomy—the alternative is much worse. A failure in 1978 would create a crisis of confidence in the functioning of the world economy. It would intensify all the problems, and tend to tip the world into a slide towards economic nationalism. The consequences of that are too fearful, and that is why the United States, the European Community, and others are still going ahead valiantly. They have to. But they will need quite a bit of skill, and even more luck.

Mr. MALMGREN. Now, I would say that failure in the Geneva talks would be so bad that it is not to be contemplated. I am pessimistic, but I am also somewhat confident that no one will let it completely fall apart.

Bob Strauss is fantastically skilled as a negotiator, and I admire him, and if anybody can keep this on track, he can.

Senator BENTSEN. I have had to put up with him for years, and I share the same admiration.

Mr. MALMGREN. Yes; and he has a tough job. But as I look at it, what he did with Japan has been very effective so far. That has been somewhat underrated in the press. There is, for example, a commitment in the communique that relates to what Japan will do in the negotiations in Geneva, and not just what it will do in the short term.

I think that is positive. The Japanese will cut their tariff rates down to the average of the United States and the European Community, at the end of the negotiations. That is a big plus.

The Geneva tariff concessions themselves, in my view, as a longtime hand in this, are not crucial. I think they are important, but there is more than tariffs at stake. It is better to cut tariffs than leave them where they are, but we are talking about a reduction in the average tariff rate from around 8 to 9 percent now, to around 5 percent at the end of 8 to 10 years. That means rather small numbers in terms of change per year.

So the tariffs are useful, but the real tough issues are the questions of subsidies, countervailing duties, government procurement policies, and a long list of nontariff barriers you could make. I am sure you have heard about the problems from your constituents.

In these areas I am not too optimistic about what has been done so far. Especially, I am worried about agriculture. In that area, I think everybody agrees that something significant should be done about agriculture, and particularly about grains. I have a lot of experience working with American farmers, and the farm organizations, and I think I understand grains pretty well. I would say today we, as a Nation, are completely divided about what to do in the negotiations, and that everybody else we are negotiating with knows that we have deep differences of views. We have people in favor of free trade, and people who favor stockpiling, or other commodity stabilization schemes. We appear to be all over the map.

When you are divided, you are not a good bargaining partner for somebody else who has to negotiate a deal.

So I am very worried about not only the climate internationally, but a certain amount about our divisions at home. When people all have different views, they are quiet until the deal is struck; then they complain to the Congress.

So, to conclude, right now I am worried about the Tokyo round, and I think it is going to take some clever maneuvering to bring it off. To me, to get the climate right, to get the governments more or less comfortable with the situation, to keep us off a protectionist course, which it is strongly headed toward, will take sound management at the economic Summit level, with the President and Chancellor Schmidt and other people.

Let me sum up the situation as I see it. The United Kingdom has been over the years a strong free trade element in the world negotiating context. Today, I would say that the United Kingdom has become a protectionist element in the negotiation. It is a complete switch. I would say Germany, traditionally the capital of free trade thinking, is now becoming somewhat protectionist. France is clearly in the throes of a political stiuation which leads it in the direction of shoring up its troubled sectors and telling the world to keep their distance.

The rest of the confusion in Europe is very negative. So if you put that together, you have got a strong drift toward protectionism in the European Community as well as other nations, and away from open markets. To negotiate in that atmosphere is very difficult.

So I do not think we should have any illusions that somehow this is all going right. So far, it is not going well at all.

But it better not fail. That is, I think the consequences of failure are even worse.

Senator BENTSEN. Thank you very much.

Representative REUSS. Thank you, Senator Bentsen.

I just want to give Mr. Solomon an opportunity to comment on the point I was making before, which we were talking about, the proposition: Resolved, that this country would do better using a little more micro and a little less macro and doing a little more about structural unemployment than it is doing, and a little less about undifferentiated demand stimulation.

Proposition two was that with respect to Germany, we would perhaps be brighter and certainly get further, if we advised our German friends to stimulate their economy modestly by direct structural unemployment programs, which would bring down their overall unemployment rate, because so much of it is structural.

Mr. SOLOMON. I will try to be very brief in response, just so the other views will be in the record as well.

As far as the United States is concerned, I must say, as I look back over history, and I find myself looking back over more history every year, every time unemployment rises to a high level, somebody comes up and tells us it is all structured. It is a cyclical phenomenon that I have noticed time and again. No doubt about it, there is structural unemployment.

I don't have any reason to disagree with the facts that Mr. Wriston brought out, about truants in New York City. But not every unemployed person is structurally incapable of filling a job.

My answer to you is; no, I am not sure we need less macro. I think the macro program that has been put forward by this administration is not a wild program by any means. We are having 1 year of stimulation which is already underway. It is going to level off. The best estimates I see for growth of the real GNP over the next year do not look frightening in the least.

That is, the consensus forecast does not look frightening to me. So I would answer your question by saying that we may need more micro programs to help cope with structural unemployment. That does not means we need less macro.

Perhaps we need both. So much for the United States.

On Germany, we have to distinguish between our tactics and what we think about Germany. I believe by now we have passed the point of diminishing returns in trying to persuade the Germans to do something. It is counterproductive to make further speeches to the Germans about stimulating the economy.

That is a question of tactics, how we handle the situation.

The second question is how do we analyze the German economy, and what do we see as the appropriate set of policies for that country to adopt in its own interest, as well as in the interests of the rest of the world, because Germany has a big impact on the rest of the world.

My own view of Germany for what it is worth to you is that the German economy is capable of expanding faster than at a rate of 1 percent a year, and that is what has happened since the beginning of this year.

I cannnot believe that structural unemployment—that the unemployment is so completely structural and that capacity is so unusable that Germany cannot expand at a rate of more than 1 percent per year. That is a very low rate of expansion.

Now, I also had occasion to be exposed to some of these German visitors of whom you spoke, Congressman Reuss, and I found it interesting that while at one point they stressed very much that all this unemployment is structural, later in the conversation they were boasting about how efficient training programs are in Germany. Now, I found a little inconsistency in those two statements. They were proud of their ability to train people who needed training.

Second, Germany has sent home one-half million foreign workers in the past year, or 1½ years. These people were working until they were sent home. Why were they sent home? Because aggregate demand has been inadequate in Germany. I assume they are reabsorbable into Germany if demand were to grow more rapidly.

So I would like to put forward this view: Yes, there may be structural problems in Germany, too. And those structural problems call for structural prescriptions, just as our structural problems do, but I don't think the problem in Germany is totally structural. I think Germany does need a more rapid expansion of domestic demand, not only to put its own unemployed to work, but to absorb some of that large current account surplus which incidentally has been temporarily depressed this year by special factors that I will not go into.

So I am giving you, I think, the same prescription for both the United States and Germany. Certainly, use structural programs where necessary. But that is not the full answer to the problem. We do need macro-policies in both countries, too.

Representative REUSS. Thank you very much, and I think we should bring this to a close, particularly since some members of the panel have a plane to catch.

I would add one more thought in what I hope would be a continuing dialog with my friend Mr. Solomon; that is, micro can become macro. If you really do something about the 2 or 3 million structurally unemployed in this country, and the million-plus structurally unemployed in Germany, it is just remarkable what a micro-

fellow with a job and some do-re-mi in his pocket can do by way of creating demand, but the demand created will probably be the greatest bang for a buck, or a mark, because his spending power will tend to be expanded on things that are available without bringing the general economy too close to the alleged Phillip's curve line.

At any rate, thank you all very much for a great morning. We are pleased to have you. We are grateful.

The committee stands recessed.

[Whereupon, at 12:04 p.m., the committee recessed, to reconvene at 10 a.m., Monday, February 27, 1978.]

30-496 O - 78 - 4

THE 1978 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 27, 1978

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, Dirksen Senate Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Long, and Brown of Michigan; and Senators Javits and McClure.

Also present: John R. Stark, executive director; Louis C. Krauthoff II, assistant director; Richard F. Kaufman, general counsel; Lloyd C. Atkinson, G. Thomas Cator, Thomas F. Dernburg, Kent H. Hughes, L. Douglas Lee, Katie MacArthur, Deborah Norelli Matz, and George R. Tyler, 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.

Representative BOLLING. The committee will be in order.

I would like to do a little housekeeping before I get to my opening statement.

During the course of our annual hearings, I and other members have referred to two staff studies prepared for the committee as background material.

One of the studies examines various macroeconomic policy alternatives; the other discusses the new social security legislation.

For the sake of completeness I ask unanimous consent that these be included in the record.

[The staff studies referred to follow:]

MONETARY-FISCAL POLICY ALTERNATIVES FOR 1978 AND 1979

The current economic expansion has shown itself to be considerably stronger than we had supposed it to be a few months ago. Talk of a "growth recession" in 1978 has all but disappeared and there is general consensus that the expansion has another year of life left in it. On a year over year basis, real Gross National Product (GNP) rose 4.9 percent; the unemployment rate fell from 7.7 percent to 7.0 percent, and prices as measured by the implicit price deflator for GNP rose 5.6 percent. Because the economy was very weak at the end of 1976, fourth quarter over fourth quarter comparisons paint an even stronger picture of economic performance in 1977. Such a comparison reveals real GNP growth of 5.7 percent and a reduction in the unemployment rate of 1.3 percentage points from 7.9 percent in the fourth quarter of 1976 to 6.6 percent in the fourth quarter of 1977. Unfortunately, inflation also moved at a more rapid pace as shown by the rise in the GNP deflator of 5.9 percent since the last quarter of 1976. Nevertheless, and although inflation remains far too rapid for comfort, there is

little indication at this time that the inflation rate is in serious danger of accelerating.

Forecasters of economic activity have had little difficulty in arriving at a consensus for 1978. The anticipated rate of real economic growth will be only 4.5 percent. This is strong enough to avoid a growth recession but not enough to reduce unemployment by more than 0.3 or 0.4 percentage points to the 6.6–6.7 percent range in 1979. In anticipation of the continuation of 8 to 9 percent upward wage adjustments, unit labor costs will continue to rise at roughly 6 percent and the inflation rate is apt to be in that neighborhood.

Table 1 shows selected economic indicators for 1977 and compares these with the forecasted values for 1978 and 1979 of the Data Resources (DRI) model. The DRI results are representative of the mid-range of present forecasts. The staff simulations of the effects of alternative policies that are reported subsequently were also obtained by use of the DRI model.

TABLE 1.—SELECTED ECONOMIC INDICATORS [1]

[Calendar years]

	Actual 1977	Forecast 1978	Forecast 1979
Gross national product	1,890.4	2,096.3	2,305.3
Rate of growth of gross national product	10.8	10.9	10.0
Implicit price deflator for gross national product (197=2100)	141.32	149.95	158.37
Rate of growth of gross national product deflator	5.6	6.1	5.6
Gross national product in 1972 prices	1,337.6	1,398.0	1,455.6
Rate of growth of real gross national product	4.9	4.5	4.1
Unemployment rate [2]	7.0	6.6	6.4
Rate of growth of money supply (M_1)	7.4	5.8	6.4
Treasury bill rate (3 mo)	5.27	6.38	5.90

[1] All growth rate are year over year rates except for M_1 which is a fourth quarter over fourth quarter rate.
[2] The unemployment rates were level-adjusted to reflect the lower than anticipated unemployment rate of the fourth quarter of 1977.

It is very important to note that the DRI forecast—and this is true of nearly all other current forecasts—has built into it expectations with respect to President Carter's budget. Specifically, unified budget outlays of roughly $500 billion were assumed, and it was also assumed that taxes will be reduced by $25 billion effective October 1, 1978, in a ratio of two to one between persons and corporations. These expectations have conformed very closely to the President's recommendations.

Without the tax reduction the economy would be very weak at the end of 1978, and even with the tax reduction a marked slowdown is expected in 1979. This expectation suggests that the Administration budget for FY 1979 is not sufficiently stimulative to reach the unemployment target of 4¾ percent for 1981 that the Administration has enunciated or the 4 percent for 1983 that is specified by the Humphrey-Hawkins bill. At the same time the failure to grow at a rate sufficient to meet these targets will mean the continuation of an ample supply of un- or underutilized productive resources, and this should permit more expansionary policies to be adopted without the threat that such policies will add substantially to inflation.

The next section of this memorandum provides a capsule summary of the Administration's major budget proposals. Thereafter the results of the staff's simulations of alternative monetary and fiscal policy combinations are presented and discussed.

PRESIDENT CARTER'S BUDGET FOR FISCAL YEAR 1979

President Carter's first Budget has been characterized by the press as "lean and tight." The $500 billion outlay level proposed by the President leaves little room for new programs or proposals. Nevertheless, the budget represents a major break with the budget philosophies of Presidents Nixon and Ford. Instead of drastic cuts in domestic spending programs, President Carter provides small increases. Defense spending is also increased. On the tax side the budget contains a modest tax reduction proposal designed to offset fiscal drag and sustain economic expansion. This contrasts with President Ford's efforts to use

tax reduction as an inducement to lower Federal spending and to reduce the relative size of the Federal sector. Instead of concentrating on the philosophy of government's role in the economy, the budget focusses on practical issues such as the amount of stimulus needed to sustain economic expansion. Congress, for its part, must consider whether the proposals are adequate for their intended purpose.

A major innovation in the 1979 budget is the way in which the budget proposals are presented. For the first time the budget shows a current services level of outlays that can be compared with the President's policy recommendations. For example, one can see that in FY 1979 it would cost $492.4 billion to maintain the same level of services as provided in 1978, and that the President has proposed spending an additional $7.8 billion in FY 1979. This new form of presentation has long been advocated by the JEC which began, in 1973, to publish its own current services estimates.

Table 2 shows a comparison of the current service outlay estimates with the Administration proposals. As can be seen in the Table, the only significant changes occur in national defense (+$1.0 billion) and energy (+$2.0 billion). Of the remaining $4.8 billion increase, about $3 billion is needed to adjust the non-automatically inflation indexed programs, and $1.7 billion is designated as an allowance for contingencies. Therefore, of the President's $7.8 billion increase above the current services level, the only real spending increases are in the defense and energy areas.

TABLE 2.—CURRENT SERVICES OUTLAYS BY FUNCTION

[In billions of dollars]

		Current services		1979
	1977 actual	1978 estimate	1979 estimate	administration proposals
National defense	97.5	107.7	116.8	171.8
International affairs	4.8	6.7	7.4	7.7
General science, space, and technology	4.7	4.8	5.1	5.1
Energy	4.2	7.5	7.6	9.6
Natural resources and environment	10.0	11.7	12.0	12.2
Agriculture	5.5	9.0	5.5	5.4
Commerce and housing credit	(1)	3.5	3.1	3.0
Transportation	14.6	16.3	17.1	17.4
Community and regional development	6.3	9.5	8.5	8.7
Education, training, employment and social services	21.0	26.9	29.4	30.4
Health	38.8	44.3	50.3	49.7
Income security	137.0	147.5	159.2	160.0
Veterans benefits and services	18.0	18.9	18.9	19.3
Administration of justice	3.6	4.0	4.1	4.2
General government	3.4	4.1	4.2	4.3
General purpose fiscal assistance	9.5	9.9	9.5	9.6
Interest	38.1	43.8	48.7	49.0
Allowances:				
Civilian pay raises			1.1	1.1
Contingencies				1.7
Undistributed offsetting receipts:				
Employer share, employee retirement	−4.5	−5.0	−5.2	−5.2
Interest received by trust funds	−8.1	−8.6	−9.1	9.1
Rents and royalties on the Outer Continental Shelf	−2.4	−2.0	−1.8	−1.8
Total	401.9	460.4	492.4	500.2

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

The Administration estimates that receipts would be $463.8 billion in the absence of any changes in tax policy. After deducting the proposed tax cut, receipts would total $439.6 billion. In our judgement the estimate of $463.8 billion is excessive and a level of $460 billion would be more consistent with the Administration's own economic assumptions.

The appropriate size of the tax reduction that is generally believed to be necessary will be a topic of lively debate. Much of the tax reduction seems necessary merely to offset other tax increases. As shown subsequently, the fiscal drag that arises from social insurance tax increases and from the progressivity of the personal income tax will be about $15 billion in 1978, and an additional and even larger drag can be expected in 1980. Thus social insurance and personal

income taxes produce enough drag in 1978 to eat up two-thirds of the stimulative effect of the President's proposed tax reduction. And this calculation does not include the energy tax proposals which, although they have little budgetary effect as proposed by the President, may prove to have significant effects in the forms that emerge from the Congress.

The 1979 budget continues some of the positive changes that were initiated in the 1978 budget presentation. The budget shows fairly detailed estimates for 1980, and it gives much more information than in the past about the five-year budgetary picture. President Carter does not repeat President Ford's recommendation that many off-budget items be included in the budget totals.

Table 3 shows 1979 outlays compared with estimates for 1978. The large decline shown for agriculture reflects the reduced price support payments which result from large setaside requirements. The decline in commerce and housing credit are the consequence of large receipts (counted as negative outlays) of the Federal Deposit Insurance Corporation and a substantial sale of mortgage paper by the Federal Home Loan Bank Board. The declines shown for community and regional development are spread throughout this function and cover such areas as disaster relief, community block grants, and local public works projects. The large increases—both absolutely and in percentage terms—are for income security, energy, and national defense.

TABLE 3.—1978 AND 1979 OUTLAY PROJECTIONS

[In billions of dollars]

	1978	1979	Dollar change	Percent change
National defense	107.6	117.8	10.2	9.5
International affairs	6.7	7.7	.9	14.0
General science, space, and technology	4.8	5.1	.3	6.7
Energy	7.8	9.6	1.8	22.9
National resources and environment	12.1	12.2	.1	.8
Agriculture	9.1	5.4	−3.7	−40.3
Commerce housing credit	3.5	3.0	−.6	−15.8
Transportation	16.3	17.4	1.1	6.7
Community and regional development	9.7	8.7	−1.0	−10.5
Education, training, employment, and social services	27.5	30.4	3.0	10.7
Health	44.3	49.7	5.4	12.2
Income security	147.6	160.0	12.4	8.4
Veterans benefits	18.9	19.3	.3	1.8
Administration of justice	4.0	4.2	.2	4.8
General government	4.1	4.3	.2	4.5
Revenue sharing and general fiscal assistance	9.9	9.6	−.2	−2.3
Interest	43.8	49.0	5.2	11.8
Allowances and contingencies		2.8	2.8	
Undistributed offsetting receipts	−15.6	−16.0	−.4	2.6
Total	462.2	500.2	38.0	8.2

The President's proposals will cause many taxpayers to avail themselves of the standard deduction rather than to itemize deductions. Tax rates also will be lower. Both factors will cause tax expenditures to fall in many categories. According to the Administration's estimates, tax expenditures will fall by some $15 billion.

The full employment budget deficit is projected by the Administration to increase from $10 billion in 1977 to $32 billion in 1978 and to $37 billion in 1979. This implies that fiscal policy in 1978 is quite stimulative relative to 1977, but that only a tiny amount of additional stimulus is proposed for 1979 despite the inclusion in the budget of a proposed tax reduction of about $25 billion. The JEC staff has made its own calculations of the full employment budget deficit. These estimates show the full employment deficit increasing to $28 billion in 1978 and to $32 billion in 1979. The conclusions are the same: The 1978 budget is stimulative relative to 1977, but there is very little additional stimulus in 1979. If the economy weakens in late 1978, President Carter's proposals will prove inadequate unless they are accompanied by a sharply more expansionary monetary policy. The simulations reported in the next section show the importance of more stimulative monetary policy and they also show the economic effects of some alternative budgetary strategies.

ALTERNATIVE FISCAL AND MONETARY POLICIES

(1) *Expansionary Monetary Policies.*

The Administration has been painfully silent about monetary policy. The Economic Report of the President barely mentions the subject, and nowhere is there to be found any indication of a desirable rate of monetary growth, a desirable path for interest rates, or the relationship between monetary policy and the performance of the economy. Recent policy actions, moreover, are not encouraging. The decision to raise the Federal Reserve's rediscount rate to 6½ percent was an attempt to shore up the international value of the dollar at the expense of the kinds of monetary and credit conditions that would support the growth of the domestic economy. Such use of monetary policy for international objectives has long been opposed by the Joint Economic Committee and it is to be hoped that the Committee will strongly insist on reversal of the unfortunate present retrogression of monetary policy.

The need for more stimulative monetary policy is evident from the persistent failure of capital spending to revive to prosperity levels and to the growing fear that financial disintermediation may interfere with the continued strength of the residential building industry. Moreover, under the President's budget proposals, the economy will receive no additional stimulus from fiscal policy until late 1978. Lessening the danger of a slowdown prior to that time could be effected by a more generous rate of monetary growth than is anticipated by present forecasts.

Although the nominal quantity of money (M_1) grew more rapidly in 1977 than in any year since 1972, this 7.4 percent growth rate appears to be regarded by most forecasters as having been unintentionally high, and, as can be seen in Table 1, DRI's expectation is that it will decline to rates of 5.8 and 6.4 percent in 1978 and 1979 respectively. It may also be noted that the 5.8 percent growth rate in 1978 is not sufficient to finance the projected 10.9 percent growth of nominal GNP without a rise in short term interest rates of more than 100 basis points.

Under present and prospective economic conditions a rise in interest rates is harmful and undesirable. It is the likelihood of such a rise that is perhaps the most important factor making for the meager 4.5 percent and 4.1 percent real growth rates forecasted for 1978 and 1979 respectively.

The results of the first staff simulation are reported in Table 4. This simulation assumes that the rate of monetary growth is stepped up in a way that reduces the 3 month Treasury bill rate to its 1977 average of 5.3 percent and that holds the bill rate at that level throughout 1979. The fiscal policy assumptions are the same as in the basic forecast.

TABLE 4.—SIMULATION RESULTS: RAISING THE RATE OF MONETARY GROWTH TO LOWER THE TREASURY BILL RATE TO 5.3 PCT.

	1978	1979
Levels:		
Gross national product	2,106.6	2,344.5
Difference from forecast	10.3	39.5
Gross national product in 1972 prices	1,404.1	1,476.0
Difference from forecast	6.1	20.4
Implicit price deflator for gross national product	150.0	158.8
Difference from forecast	.1	.5
Unemployment rate	6.45	5.90
Difference from forecast	−.10	−.50
Treasury bill rate	5.27	5.28
Difference from forecast	−1.12	−.63
Budget deficit (NIA basis)	45.4	36.5
Difference from forecast	−3.7	−13.4
Difference from forecast:		
Nonresidential fixed investment	+1.1	+7.4
Residential construction	+4.2	+13.5
Net exports of goods and services	+.2	−2.1
Growth rates:		
Money supply (M_1)	6.9	8.2
Difference from forecast	1.1	1.8
Gross national product	11.5	11.3
Difference from forecast	.5	1.3
Gross national product in 1972 prices	5.0	5.1
Difference from forecast	.5	1.0
Implicit price deflator for gross national product	6.1	5.9
Difference from forecast	0	.3

As can be observed in Table 4 attainment of the interest rate target requires that the rate of M_1 growth be stepped up by 1.1 and 1.8 percentage points in 1978 and 1979 respectively. The results are gratifying. Since monetary policy affects the economy with a considerable lag, there is little effect in 1978 even though our simulation assumes an immediate increase in the rate of monetary growth. Thus in 1978 nominal and real GNP increase only $10.3 billion and $6.1 billion respectively and there is virtually no change in the inflation rate or in the unemployment rate.

The main effects of a faster rate of monetary growth begun immediately will be in 1979 when the economy will most need support. Relative to the consensus forecast GNP will be $40 billion higher, the real growth rate will be a full percentage point higher, and the unemployment rate will be one half of one percentage point lower. Thus a somewhat more rapid—though hardly excessive—rate of monetary growth can eliminate all risk of recession in 1979, and can contribute some 500,000 additional jobs in that year.

The greater strength shown by the economy as the consequence of more rapid monetary expansion is mainly in the investment sector. The simulation indicates that non-residential fixed investment may be $7 billion higher in 1979 and that homebuilding may rise by more than $13 billion. In view of our lingering fears over the behavior of investment, it seems clear that a more generous monetary policy should be high on our list of policy priorities.

Unlike stimulative fiscal policies expansionary monetary policy reduces the Federal budget deficit. As shown in Table 4, the deficit may be reduced by from $10 to $15 billion by a monetary policy that does no more than bring short-term interest rates back to their 1977 average. The stronger economy will generate additional revenues from all taxes—personal, business, social insurance, and indirect—and it will reduce outlays for unemployment compensation and welfare. Meanwhile the lower interest rates will reduce the interest cost of financing the national debt.

It is true, of course, that the inflation rate will rise somewhat. But this will happen as the consequence of all expansionary policies, and the simulation results indicate that the rise will be modest because the economy continues to have underutilized capital and labor at its disposal so that the danger of generating excessive demand is quite minimal. Moreover, since expansionary monetary policy tends to augment the investment share of GNP, whereas expansionary fiscal policies augment the government and/or consumption shares, expansionary monetary policies will yield productivity gains that will help to moderate inflation in the future.

(2) *An Additional $15 Billion Tax Reduction.*

President Carter has recommended a net tax reduction of $25 billion to be made effective October 1, 1978. Because a tax reduction of this magnitude will not sustain growth at an acceptable rate in 1979, there are many who believe that a more substantial tax reduction is desirable. The Chamber of Commerce, for example, is recommending a reduction of $40 billion. Our next staff simulation examines the consequences of such a policy. It is assumed in this simulation that the two to one ratio of relief for persons and corporations is maintained.

The $25 billion tax reduction may be inadequate because of the tax increases that will take place automatically in 1978. For example, if social insurance taxes were to rise by the same 10.9 percent as the forecasted rise in nominal GNP for 1978, the taxes would increase by $13.0 billion. However, the forecasted increase is $18.7 billion, the extra increase of $5.7 billion being attributable to the fact that both the social security tax rate and base rose at the beginning of 1978, and to the fact that the minimum taxable Federal base for unemployment insurance increased from $4,200 to $6,000, thereby raising Federal taxes on employers, and forcing many states to raise their unemployment payroll taxes.

Because of the progressivity of the personal income tax, this tax tends to rise automatically by an amount equal to 1.5 to 1.6 times the percentage rise in personal income. If income taxes were proportional, they would rise by $18.6 billion in 1978. But because of the progressivity factor they will rise by $28.8 billion. The difference of $10.2 billion between the two figures is the fiscal drag attributable to the personal income tax. Added to the $5.7 billion disproportionate social insurance tax increase, this amounts to a net fiscal drag from these

two sources of about $16 billion, and this wipes out about two-thirds of the stimulus that would be provided by a $25 billion tax reduction.

Table 5 shows the economic effects of adding $15 billion to the President's proposed $25 billion tax reduction. Because the reduction does not take place until October 1, 1978, there is virtually no effect this year. In 1979 both nominal and real GNP are higher by about one half as much as the increase achieved by the monetary policies of the earlier simulations. The reduction in the unemployment rate and the rise in the inflation rate are reduced accordingly.

TABLE 5.—SIMULATION RESULTS: $40 BILLION TAX REDUCTION

	1978	1979
Levels:		
Gross national product	2,097.5	2,323.7
Difference from forecast	1.2	18.4
Gross national product in 1972 prices	1,398.8	1,466.1
Difference from forecast	.8	10.5
Implicit price deflator for gross national product	149.9	158.5
Difference from forecast	0	.1
Unemployment rate	6.6	6.2
Difference from forecast	0	−.2
Treasury bill rate	6.38	5.90
Difference from forecast	0	0
Budget deficit (NIA basis)	53.4	66.0
Difference from forecast	+4.3	+16.1
Difference from forecast:		
Nonresidential fixed investment	+.1	+3.5
Residential construction	+.1	+1.7
Net exports of goods and services	0	−1.5
Growth rates:		
Money supply (M_1)	5.9	6.4
Difference from forecast	+.1	0
Gross national product	11.0	10.8
Difference from forecast	+.1	+.8
Gross national product in 1972 prices	4.6	4.8
Difference from forecast	+.1	+.7
Implicit price deflator for gross national product	6.1	5.7
Difference from forecast	0	+.1

The simulation was conducted without any attempt to accompany the fiscal expansion with an accommodative monetary policy. Evidently, however, an additional tax reduction of $15 billion is so tiny that it fails to put any upward pressure on interest rates and it therefore produces no crowding out of investment spending.

One-third of the tax relief is granted to business. This, combined with stronger product demand unimpeded by higher interest rates, raises non-residential fixed investment by $3.5 billion, or about one-half the amount of the first simulation. However, the less favorable monetary conditions implied by this simulation limit the rise in residential construction to a very modest increase. As usual, the bulk of the strength that results from the additional tax cut is in the consumption sector. More expansionary monetary policy, on the other hand, would have mainly stimulated the lagging capital spending sector and thereby set the basis for more rapid subsequent production advances.

It should be noted, finally, that the additional tax reduction adds substantially to the Federal deficit whereas the expansionary monetary policy reduces the deficit. This is not a decisive advantage of monetary policy in all instances, but it is a factor that should be kept in mind.

(3) *An Increase in Federal Outlays of $7.5 Billion Above President Carter's Recommendation.*

Those who prefer expanded expenditures to tax reduction as a means of providing fiscal stimulus have been put at a disadvantage by the persistence, throughout FY 1977, of a $15 billion expenditure shortfall. However, recent indications are that this shortfall has been eliminated and that FY 1978 outlays are now on target with respect to timing. This has two important consequences. First, it means the economy is currently in the process of receiving some welcome stimulus and may be stronger than expected in early 1978. Second, it means that additional outlays can be approved without danger that such action will merely add to the magnitude of the shortfall.

Nevertheless, it is not easy to find ways of spending more money both quickly and constructively. The staff has estimated that Congress may be able to add about $7.5 billion to FY 1979 outlays, but that any more than that would be difficult to spend in non-wasteful ways without major program initiatives. Our assumption is that $1 billion could be usefully put into each of the following categories—Energy, National Defense, CETA, General Purpose Fiscal Assistance, and Housing, that $2 billion could be added to outlays for Health and Education, and that $0.5 billion in fiscal relief could be granted to urban governments. For NIA purposes we put $2 billion into Federal Purchases, $1 billion into subsidies, and $4.5 billion into grants to State and local governments.

The economic effects of this $7.5 billion increase in Federal expenditures are reported in Table 6. Since Federal grants will be reflected in State and local purchases, the impact on GNP and unemployment per dollar of budget cost is greater for the present mix of increased Federal outlays that for tax reduction. On the other hand, because the assumed tax reduction provided business tax relief, the effect on investment of that policy was more powerful than the increase in Government expenditure.

TABLE 6.—SIMULATION RESULTS: INCREASED FEDERAL SPENDING BY $7,500,000,000 IN FISCAL YEAR 1979

	1978	1979
Levels:		
Gross national product	2,098.2	2,317.9
Difference from forecast	+1.9	+12.6
Gross national product in 1972 prices	1,399.2	1,463.1
Difference from forecast	+1.3	+7.6
Implicit price deflator for gross national product	149.9	158.4
Difference from forecast	0	0
Unemployment rate	6.6	6.2
Difference from forecast	0	−.2
Treasury bill rate	6.38	5.94
Difference from forecast	0	+.04
Budget deficit (NIA basis)	50.3	53.1
Difference from forecast	+1.2	+3.2
Difference from forecast:		
Nonresidential fixed investment	+.1	+1.1
Residential construction	+.1	+.5
Net exports of goods and services	0	+1.3
Growth rates:		
Money supply (M_1)	5.9	6.5
Difference from forecast	+.1	+.1
Gross national product	11.0	10.5
Difference from forecast	+.1	.5
Gross national product in 1972 prices	4.6	4.6
Difference from forecast	+.1	+.5
Implicit price deflator for gross national product	6.1	5.7
Difference from forecast	0	+.1

The expenditure expansion clearly helps the economy in 1979. The real growth rate is raised by 0.5 percentage points and unemployment drops to 6.2 percent of the labor force. The risk of a growth recession is therefore greatly reduced by this modest addition to the budget. Finally, because the GNP impact per dollar of outlay is greater than for tax reduction, the positive feedback to the Treasury is considerably higher and the policy therefore adds considerably less to the Federal deficit than would be the case if additional tax reduction were the chosen alternative.

Conclusions

(1) President Carter's proposed $25 billion tax reduction is an appropriate measure of fiscal policy provided that it is supplemented by other policies. Without this tax reduction the economy would be extremely weak in late 1978 and a growth recession would be very likely in 1979.

Because of very heavy fiscal drag, the weakness of investment, and the weakness of the foreign sector, the $25 billion tax reduction will sustain growth in 1979 at the very meager rate currently forecasted to be only 4.1 percent in real terms. Supplementary policies are therefore needed.

(2) The most promising supplementary policy would be an immediate and continuing rise in the rate of monetary growth. By reducing interest rates this

will stimulate capital spending and ensure the continuation of strong performance by the homebuilding industry. This, in turn, will provide higher GNP and more jobs in the short run, and faster productivity growth and less inflation in the long run. Unlike the tax reduction and the expenditure increase, expansion through monetary policy reduces the budget deficit.

The only possible disadvantage to more expansionary monetary policy is that the reduction in short-term interest rates implied by the policy will cause short-term capital to flow to higher yield financial markets abroad. This will reduce the demand for the dollar and possibly cause its value to fall relative to other currencies. Whether or not this is a gain or a loss is open to serious dispute.

Those who wring their hands over the "integrity" of the dollar complain that the rising costs of imports will add to domestic inflation. Those who believe that the dollar should fall in value in response to our massive trade deficit believe that the higher cost of imports is desirable because it will lead to the substitution of domestic production and employment for imports and that it will also encourage exports. Such analysts therefore welcome declining interest rates not only because this encourages capital spending but also because it tends to improve our balance of trade and thereby stimulate our economy.

(3) Tax reduction in excess of the President's $25 billion proposal would not be inappropriate, nor would additional expenditure expansion. Both policies would provide insurance against a slump in 1979. These policies are, however, inferior to expansion through monetary policy because they have less of an impact on capital spending and because they raise the budget deficit whereas the expansionary monetary policy lowers it.

(4) In view of the consensus forecast, an optimal policy might combine the President's $25 billion tax reduction with an additional $7.5 billion rise in Federal outlays, and it would combine both of these policies with an expansionary monetary policy that seeks to reduce short-term interest rates to their 1977 average. This combination of policies would raise the real growth rate for 1979 by 1.5 percentage points, and it would reduce the unemployment rate to 5.7 percent. Such a policy combination would not be dangerously inflationary. It would, however, put the economy on the track of the Humphrey-Hawkins recovery path.

Social Security Legislation

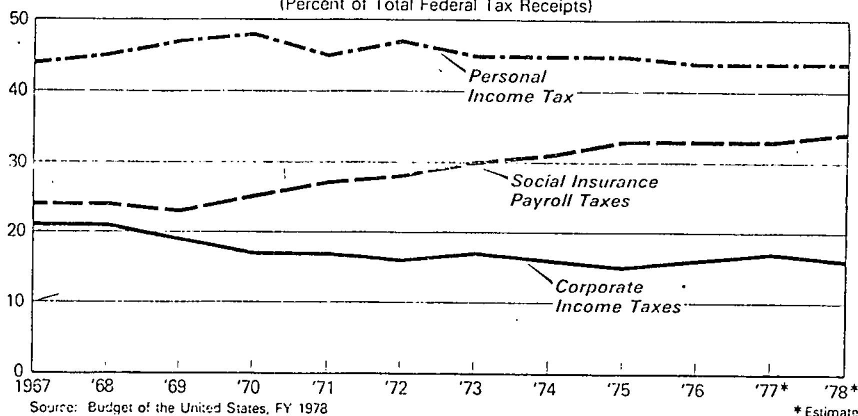
INTRODUCTION

In December 1977, the Congress approved a social security financing bill which will raise payroll taxes by a cumulative sum of about $185 billion in eight years, beginning with a $6.4 billion increase in 1979 and building to a massive $40 billion by 1986. The bill also makes reductions in benefit levels that will come to $7.0 billion in 1986 and cumulate to $25 billion by that year. Thus, in 1986 this single piece of legislation will imply a net deflationary budget impact upon the economy of close to $50 billion.

This analysis was prepared because the legislation obviously has major significance for economic policy and because of Congressional indications that the legislation will probably be reviewed quite soon. In general it is clear that while the legislation will erase the financing problems of the social security system, the increasing payroll taxes will lead to slower economic growth, higher unemployment, and faster rates of inflation than under alternative means of financing.

FASTER GROWING FORM OF TAXATION

As Chart I shows, social insurance payroll tax receipts rose faster than all other forms of Federal revenue in the past decade. From less than one-quarter in 1967, payroll taxes have now risen to one-third of Federal receipts. Meanwhile, the share of the personal income tax has remained a 44 percent and the share of the corporate income tax has dropped from 21 percent to 17 percent. In 1967, payroll taxes for social insurance were $36.7 billion, only slightly more than the corporate income tax. In 1977 payroll taxes for social insurance totaled $105.7 billion, while corporate taxes amounted to only $55.9 billion.



NATURE OF PAYROLL TAXES

Payroll taxes are, but need not be, proportional taxes collected up to a maximum taxable wage base. For example, in 1978 under present law, the tax rate for employer and employee alike is 6.05 percent applied to a maximum taxable base of $17,700 so that the maximum tax per person is $1,071. While the statutory tax burden is borne equally between the employer and the employee, these higher social security payroll taxes are widely believd to either lower wages or raise consumer prices.

INCIDENCE AND ECONOMIC EFFECTS OF PAYROLL TAXES

A rise in the employee tax reduces disposable income just like an increase in the personal income tax. Consumption therefore declines and the resulting additional slack in the economy reduces production and employment. A rise in the tax base affects only higher income workers, where as a rise in the tax rate affects all workers. Thus, there are some distributional effects resulting from different combinations of rate-base changes. However, there is no conclusive evidence that taxes collected by raising the base will have a significantly different effect on aggregate consumption that an equal amount of revenue generated by higher tax rates.

The economic effects of an increase in the employer payroll tax are more difficult to assess. The tax increase may lower profits, it may be shifted back to lower wages, or it may be shifted forward into higher prices. Because such tax increases are generally viewed as additions to labor costs, they may reduce employment directly. If they also are pushed forward into higher prices, consumer real income and consumption will be reduced. Finally, the higher prices will reduce the real quantity of money and this may raise interest rates and reduce investment. Increases in employer payroll taxes may therefore be harmful because they may add simultaneously to inflation and to unemployment.

Faced with an increase in their payroll taxes, firms appear sooner or later to be able to pass through some of the additional cost. Though the "pass-through" effect does not dramatically alter the inflation rate, this effect is sufficiently large to sustain a higher price level at a lower level of real economic activity than would have been the case had the tax been placed on employees. While the employee payroll tax does not damage the economy as much as the employer tax, it is important to bear in mind that it operates as a regressive income tax. It taxes only wage and salary income and it taxes low wage workers at a higher rate than workers whose wages exceed the taxable base.

BUILT-IN STABILITY

Normally, the social security system is credited with acting as an automatic fiscal stabilizer. Social security payroll tax collections fall during recessions and rise during recoveries as employment and wages fluctuate with the business cycle. However, the tax increases just passed by Congress will have the effect of increasing tax collections in an already weak economy. With the unemployment rate at 5.3 percent and much idle plant capacity available, no sensible person would propose to raise personal income taxes to recapture revenues lost as a result of the recession. However, that is exactly what is invariably proposed for social security. Pursuing this discretionary policy, therefore, will negate the automatic stabilizing effects of the current system. In addition, increases in payroll taxes will add to inflation and, as detailed in the Joint Economic Committee's "1977 Midyear Review of the Economy," promote reluctance to adopt full employment policies.[1]

SOCIAL SECURITY'S RECENT SHORT-RUN FINANCING PROBLEMS

Between 1973 and 1977, the combined assets of the Old Age and Survivors Insurance (OASI) and Disability Insurance (DI) trust funds fell from 80 percent of annual outlays to 25 percent. The major cause of this financial deterioration in the OASDI Trust Funds was the chronic stagflation that has plagued the economy since 1974.

Because of high unemployment and wages lagging behind price increases, social security payroll tax revenues grew less than expenditures. In addition, the number of people claiming disability insurance increased as Congress liberalized Medicare benefits to which disability insurance beneficiaries are entitled.

The rise in benefit levels, combined with the depressed labor market, may have induced more persons to retire earlier, thus adding to the increase in benefit payments. It has been estimated by an Health, Education and Welfare study that a rise in the unemployment rate of 2 percentage points which lasts for two years, increases the number of retired workers by 1.0 percent, and it leads to 5.4 percent more persons receiving disability payments.[2]

The result of the deterioration in the economy and the increase in benefit levels programmed under the law existing prior to December 1977 was that the DI trust fund would have been depleted by 1979 and the OASI trust fund by 1983. Therefore, Congress had to choose between raising taxes, lowering benefit payments, or using general revenues from the Treasury to supplement social security. Table 1 shows the dwindling of assets which would have occurred had there been no new legislation, and Table 2 shows the effects of the new law. The taxes implied by the old law are shown in Table 3. All such projections, of course, are based on an underlying growth path of the total economy. When this underlying path changes, the projections must be revised accordingly.

TABLE 1.—OLD LAW—ESTIMATED OPERATIONS OF THE OASI, DI AND HI TRUST FUNDS

	Funds at beginning of year as a percentage of outgo during year		
	OASI	DI	HI
Calendar year:			
1977	47	48	66
1978	38	24	55
1979	31	3	56
1980	24	(1)	53
1981	18	(1)	45
1982	11	(1)	50
1983	3	(1)	50
1984	(1)	(1)	44
1985	(1)	(1)	34
1986	(1)	(1)	20
1987	(1)	(1)	10

[1] Funds exhausted.

Source: Social Security Administration.

[1] "1977 Midyear Review of the Economy," Report of the Joint Economic Committee, September 1977.

[2] "Short-run Behavior of the Social Security Trust Funds," Technical Analysis Paper No. 8, Office of Income Security, Department of Health, Education, and Welfare, July 1976.

TABLE 2.—NEW LAW—ESTIMATED OPERATIONS OF THE OASI, DI AND HI TRUST FUNDS

	Funds at beginning of year as a percentage of outgo during year		
	OASI	DI	HI
Calendar year:			
1977	47	48	66
1978	39	24	55
1979	30	23	48
1980	26	23	45
1981	26	23	39
1982	30	31	47
1983	36	38	50
1984	41	41	47
1985	45	42	39
1986	52	53	29
1987	58	63	22

Source: Social Security Administration.

TABLE 3.—TAXES UNDER OLD LAW

	Tax rates [1] (percent)	Wage base	Maximum tax	Annual amount exempted under retirement test for beneficiaries aged 65 and over
Calendar year:				
1977	5.85	$16,500	$965	$3,000
1978	6.05	17,700	1,071	3,240
1979	6.05	18,900	1,143	3,480
1980	6.05	20,400	1,234	3,720
1981	6.30	21,900	1,380	3,960
1982	6.30	23,400	1,474	4,200
1983	6.30	24,900	1,569	4,440
1984	6.30	26,400	1,663	4,680
1985	6.30	27,900	1,758	4,920
1986	6.45	29,400	1,896	5,160
1987	6.45	31,200	2,012	5,400

[1] Combined contribution rate for employees and employers split equally between them.

Source: Social Security Administration.

THE LINK BETWEEN CONTRIBUTIONS AND BENEFITS

Although the intention has been to link benefits to past contributions, the OASDI system runs on a pay-as-you-go basis. Revenues are collected from the social security payroll tax and are paid out to retired workers, their dependent spouses, and survivors of deceased workers. The trust funds cover only a tiny fraction of the future liabilities of the system. Their main function is to cushion the system from short-term fluctuations in the economy. In recent years, the funds have been depleted as social security benefits have outpaced recession-depressed receipts.

If social security were a provident fund, contributions by a worker and his employer would be invested so that the interest on the investment plus the investment itself would go directly to supporting the worker in times of old age or ill health. Under social security, however, the workers and employers of today are paying payroll taxes that support workers who have retired previously or are in ill health. Because of productivity gains, the present working generation earns more and can provide benefits to recent pensioners far in excess of these pensioners' personal past contributions to the social security system. Thus the funding link between a worker's contributions and a worker's benefits is tenuous at best. Upon retirement, today's worker will depend upon the earnings and wages of his children's generation for social security financing and upon the political decisions of future Congresses for his benefits.

GENERAL REVENUE ASSISTANCE

In view of the strong income transfer elements of social security, as well as the economic drawbacks of increased payroll taxation, it has often been argued that alternatives to exclusive reliance on earmarked payroll taxes should be developed. The most widely suggested alternative is the use of general revenue assistance. Such assistance would reduce the regressivity of the social security system and it also would make available the borrowing power of the Federal Government. The latter is particularly important during period of economic slack when increased taxation in any form is undesirable.

Many people object to general revenue financing without realizing that the social security system already has a considerable impact on these revenues. First, to the extent that the employer's portion of the wage tax is borne by businesses, it reduces profits and tax liabilities. Second, the earned income credit was passed in 1974 with the clear understanding that its purpose was to rebate the social security taxes paid by low income workers. In addition, several of the recent proposals considered by the Congress entailed the use of general revenue assistance. In May 1977, the Administration proposed legislation that would have transferred funds from the general fund of the Treasury to social security to meet revenue shortfalls whenever the unemployment rate exceeds 6 percent.

The House-passed bill relied on stiff payroll tax increases for both employees and employers. But in order to maintain traditional parity of employer and employee contributions and still generate sufficient revenues in recession periods, it authorized the social security system to borrow general revenue funds from the Treasury if the assets of the Social Security Trust Fund drop below 25 percent of the preceding year's benefits.

The Senate bill, on the other hand, raised the wage base for employers above that for employees. Proponents of this proposal claimed two advantages: (1) no additional pension entitlements would be created, and (2) employers could deduct these higher payroll taxes from their taxable business income. This second feature would mean that the increase in social security tax liability would be partially offset by a decline in corporate tax liability.

Given the present financing problems of social security, the long-term demographic shift toward an older population, and the political difficulty of reducing benefits, increased financing is necessary, and it appears inevitable that further payroll tax hikes will bring in fewer dollars from fewer and more heavily burdened employers and employees. Resorting to general revenues will therefore become an increasingly attractive alternative. Otherwise the tax system will become more regressive. The payroll tax route, moreover, is in danger of becoming less and less acceptable to the present generation of workers. As Professor James N. Morgan of the University of Michigan has recently written:

"Simple raising payroll taxes on current workers will surely create a cumulative and massive problem for the future. When those generations get to retirement age they can appropriately ask why, since they paid much higher payroll taxes, they don't get proportionately higher retirement benefits. We could postpone the showdown a while by raising payroll taxes again, but the problem would recur with the next generation." [3]

ALTERNATIVE METHODS OF FINANCING SOCIAL SECURITY

The Administration's package, the House bill, and the Senate bill each contained innovative proposals for financing the social security system. Although these proposals were ultimately rejected, they will be debated when social security financing again becomes an issue, as it well may if economic and demographic trends prove to be less favorable than anticipated.

The Administration Proposal

The Administration's recommendations would have increased social security revenues and slowed the rise in benefits. This proposal would have reduced the Old Age Survivors Disability Hospital Insurance trust fund deficits immediately.

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[3] James N. Morgan, "Myth, Reality, Equity and the Social Security System," Economic Outlook USA, Autumn 1971, p. 59.

and for the next 25 years it would have ensured that annual contributions would normally exceed annual benefits.

As Table 4 outlines, the Administration's program would have employed four revenue raising devices during the period 1978 to 1986:

(1) Until 1982 a direct transfer of general revenue funds in years in which the unemployment rate exceeds 6 percent.

(2) An increase in the employer's maximum wage base subject to tax;

(3) In 1985 and 1986 an increase over present law in employee and employer tax rates;

(4) An internal transfer of funds from the solvent Hospital Insurance (HI) Trust Funds to the depleted OASI and DI trust funds.

TABLE 4.—ADMINISTRATION PROPOSAL

	Tax rates [1] (percent)	Wage base		Maximum tax	
		Employers	Employees and self-employed	Employers	Employees and self-employed
Calendar year.					
1977	5.85	$16,500	$16,500	$965	$965
1978	6.05	17,700	17,700	1,071	1,071
1979	6.05	23,400	19,500	1,416	1,180
1980	6.05	37,500	21,000	2,269	1,271
1981	6.30	(2)	23,100	(2)	1,455
1982	6,30	(2)	24,600	(2)	1,550
1983	6.30	(2)	26,700	(2)	1,682
1984	6,30	(2)	28,200	(2)	1,777
1985	6.55	(2)	30,300	(2)	1,985
1986	6.70	(2)	32,100	(2)	2,161
1987	6.60	(2)	33,900	(2)	2,171

	Transfers from general funds under guarantee provisions (billions)	Funds at beginning of year as a percentage of outgo during year		Net increase in funds, OASDHI (billions)
		OASDI	HI	
Calendar year:				
1977	$5.5	47	66	−$5.5
1978	3.6	37	58	+2.5
1979	2.8	34	60	+3.2
1980		32	60	+5.2
1981		32	59	+9.6
1982		34	65	+8.9
1983		36	67	+6.4
1984		36	64	+2.4
1985		35	56	+1.2
1986		36	44	+6.7
1987		37	38	+2.5

[1] Rate for employers and employees, each, OASDHI.
[2] Employer base removed.

Source: Social Security Administration.

By instituting special countercyclical general revenue financing, the President hoped to replace, with the least damage to the economic recovery, a portion of the social security taxes and interest income that were lost as a result of the recent recession. As indicated above, the Administration's plan for general revenue financing does not provide a pretext for granting higher social security benefits because the general revenue transfers would be curtailed after the period of high unemployment. Nor would this change to general revenue financing lead to any weakening of a person's "earned right" to draw benefits, because payroll taxes would still finance the bulk of the program.

By 1981 the President's program would remove any ceiling on the wage base used to determine the employer's share of the social security payroll tax. The employer would then pay taxes in proportion to his entire payroll. The employee, on the other hand, would continue to pay taxes on wages up to a maximum wage base which would be $23,100 in 1981. Because of the link between benefits and employee contributions, raising revenue from higher employer tax contribu-

tions has the advantage of not raising future benefits. The macroeconomic drawbacks of an increase in employer payroll taxes, however, are extremely serious.

Under the Administration's plan, the ultimate financing of the proposed shift of hospital insurance revenues into OASI and DI trust funds would have depended upon the degree to which the expected rise in hospital costs could be contained. Even if the Administration's cost-containment proposal were enacted and proved effective, the HI trust fund would be exhausted by the mid to late 1980s. With the proposed transfers of revenues out of HI and no additional payroll tax collections planned for HI, the hospital insurance program would eventually have to be financed out of general revenues. However because benefits under HI are not related to payroll tax contributions except that these contributions determine the eligibility, general revenue financing would do no damage to the contributory philosophy of social security and, in fact, this proposal has been recommended by the Joint Economic Committee in its 1976 Annual Report.

The House Bill

The House bill relied upon higher payroll taxes to refinance social security and retained the traditional parity in payroll tax contributions between employers and employees. Table 5 outlines the bill's components and its projected impact upon social security income and outlays.

TABLE 5.—H.R. 9346 AS PASSED BY HOUSE OF REPRESENTATIVES

	Tax rate[1] (percent)	Wage base[1]	Maximum tax[1]
Calendar year:			
1977	5.85	$16,500	$965
1978	6.05	19,900	1,204
1979	6.05	22,900	1,385
1980	6.05	25,900	1,567
1981	6.55	29,700	1,945
1982	6.65	31,800	2,115
1983	6.65	33,900	2,254
1984	6.65	36,000	2,394
1985	6.95	38,100	2,648
1986	7.10	40,200	2,854
1987	7.10	42,600	3,025

	Annual amount exempt under retirement test for beneficiaries aged 65 and over	Funds at beginning of year as a percentage of outgo during year		Net increases in OASDHI funds (billions)
		OASDHI	HI	
Calander year:				
1977	$3,000	47	66	$-5.6
1978	4,000	37	55	-2.0
1979	4,500	31	49	-1.4
1980	5,000	27	42	-1.5
1981	5,000	25	32	+9.6
1982	(2)	26	40	+8.8
1983	(2)	28	42	+6.2
1984	(2)	29	39	+2.4
1985	(2)	30	31	+6.8
1986	(2)	34	19	+8.9
1987	(2)	37	[3] 12	+5.3

[1] Employers and employees, each, OASDHI.
[2] Retirement test removed.
[3] HI funds exhausted in 1988.

Source: Social Security Administration.

By 1986, this bill would have moved tax rates up more quickly and to higher levels than the Administration proposal. In addition, it would have increased the taxable wage base for higher income workers. These actions would have increased taxes on higher paid workers substantially, thereby reducing the regressivity of the social security employee payroll tax. This effect is shown in Table 5 in the column titled "Maximum Tax." Also, the House bill was designed to generate a small average surplus in the OASDHI trust funds over the next 25 years.

The Senate Bill

The Senate bill was distinct from the House Bill in that it boosted the taxable wage base for employers to $50,000 in 1979 and $75,000 in 1985, thus increasing employer tax contributions far more than employee contributions. The taxable wage base for employees was raised less than in the House measure, thereby generating smaller benefits in future years.

As Table 6 shows, tax rates were boosted slightly faster in the Senate version than in the House bill, but by 1986 these tax rates would have been a bit lower than the rates in the House bill. Because of its higher benefit levels and its attempt to ensure an average surplus in the OASDHI trust funds for the next 75 years, the Senate Bill's tax rates were much higher than those in the Administration plan.

TABLE 6.—H.R. 9346 AS PASSED BY THE SENATE

	Tax rates (percent)[1]	Wage base		Maximum tax	
		Employers	Employees and self employed	Employers	Employees
Calendar year:					
1977	5.85	$16,500	$16,500	$965	$965
1978	6.05	17,700	17,700	1,035	1,035
1979	6.135	50,000	19,500	3,068	1,196
1980	6.135	50,000	21,000	3,068	1,288
1981	6.60	50,000	23,100	3,300	1,525
1982	6.65	50,000	24,600	3,325	1,636
1983	6.65	50,000	27,700	3,325	1,776
1984	6.65	50,000	28,200	3,325	1,875
1985	7.05	75,000	30,300	5,288	2,139
1986	7.10	75,000	32,100	5,325	2,277
1987	7.10	75,000	33,900	5,325	2,406

	Annual amount exempt under retirement test[2]	Funds at end of year as a percentage of outgo during year	Net increase in funds (billions)
Calendar year:			
1977	$3,000	41	−$5.5
1978	4,500	30	−5.8
1979	6,000	26	−1.0
1980	6,480	24	−.1
1981	6,960	27	+5.9
1982	7,440	29	+7.1
1983	7,920	32	+6.7
1984	8,400	33	+5.5
1985	8,880	39	+14.7
1986	9,360	44	+15.6
1987	9,840	48	+15.1

[1] Employers and employees, each, OASDHI.
[2] Under the Senate bill, the exempt amounts shown for 1977–81 apply to all beneficiaries under age 72. Beginning in 1982, the age at which the retirement rest ceases to apply would be reduced from age 72 to age 70 and the same exempt amount would apply from then on to all beneficiaries under age 70. Ad hoc increases are made in the exempt amount in 1978 and 1979, with automatic increases thereafter.

Source: Social Security Administration.

The Final Bill

On December 9, 1977, House-Senate Conferees agreed on the largest social security tax boost in history. More than $184 billion in taxes will be raised in the eight years beginning with 1979. Table 7 outlines the expected increases in tax rates, maximum wages taxed, maximum taxes, and the amount exempt from the retirement test. The bill raises the taxable wage base for employers and employees to the higher levels of the original House bill and it raises the tax rates by more than either of the original bills. Benefits are also reduced more than in either the House or the Senate bill because the compromise legislation puts a lower ceiling on outside income exempt from the retirement test.

TABLE 7.—H.R. 9346 AS AGREED TO BY HOUSE-SENATE CONFEREES, DEC. 13, 1977

	Tax rates [1] (percent)	Wage base [1]	Maximum tax	Annual amount exempt under retirement test for beneficiaries aged 65 and over [2]
Calendar year:				
1977	5.85	$16,500	$965	$3,000
1978	6.05	17,700	1,071	4,000
1979	6.13	22,900	1,404	4,500
1980	6.13	25,900	1,588	5,000
1981	6.65	29,700	1,975	5,500
1982	6.70	31,800	2,131	6,000
1983	6.70	33,900	2,271	6,660
1984	6.70	36,000	2,412	6,720
1985	7.05	38,100	2,686	7,080
1986	7.15	40,200	2,874	7,440
1987	7.15	42,200	3,046	7,920

[1] Employers and employees, each, OASDHI.
[2] From 1977–82, retirement does not apply to those persons over age 72. From 1983 onward, retirement test does not apply to those persons over age 70.

Source: Social Security Administration.

The final legislation rejects the Senate-passed increase in employers' relative contributions and it rejects the use of general revenues to assist nonprofit institutions and State and local governments. Also rejected was the House provision that repayable loans could be made by the Treasury to the trust funds when the trust fund balances fell below 25 percent of the previous year's benefits. The assumption is that the bill's tax rates and bases are set so high that the trust funds will never fall to a fourth of the previous year's payout. Thus, all of the various ways that had previously been considered to utilize general revenue assistance for social security have been completely and systematically rejected.

The social security bill will ensure the long-run financial integrity of the social security system only under reasonably favorable economic and demographic conditions. Protracted economic stagnation, slow growth of productivity, continuing rapid inflation, and a decline in the fertility rate below present expectations could put the social security system into long-run deficit despite the measure that has been passed by Congress. Under such adverse conditions, the entire social security system would have to be reviewed.

ECONOMIC EFFECTS OF THE ALTERNATIVE SOCIAL SECURITY FINANCING PLANS

For the year 1982, Table 8 provides a convenient summary of the economic effects of the specific social security proposals discussed in this paper.

Table 8 discloses that by 1982 there would be very little difference in the economic effects of the Administration, House and Senate bills, and that the only significant difference results from the final version. The various proposals do differ significantly in terms of their provisions, but an excess of taxes in one proposal is sometimes offset by differences on the benefit side in another. While the Administration proposal holds down tax increases relative to the Senate bill, the latter raises social security benefits and the Administration bill reduces benefits. Cumulatively, the net budget drag from both the Administration and the Senate proposals is $48 billion through 1982. While the House bill implies a cumulative deflationary add-on of $56 billion through 1982, some of this is overcome by 1982 because the House bill begins to raise taxes in 1978, and because the House version splits the taxes evenly between employers and employees. Thus the deflationary impact per dollar of add-on is somewhat less than in the Administration and Senate versions.

TABLE 8.—COMPARISON OF ECONOMIC EFFECTS; 1982 EFFECTS

	Gross national product	Real gross national product	Gross national product deflator	Unemployment rate
Administration bill	−29.72	−23.11	+0.44	+0.91
House bill	−33.76	−26.28	+.46	+.99
Senate bill	−38.18	−24.76	+.46	+.94
Final bill	−42.38	−33.78	+.66	+1.30

Source: Social Security Administration.

The final bill clearly has the greatest macroeconomic impact. The cumulative tax increases are greater than for all other measures and benefits are reduced, whereas both the House and Senate versions raise benefits. The result is a cumulative deflationary add-on for 1982 of $62 billion, or $6 billion more than the House bill. It is therefore not surprising that real GNP is $7.6 billion lower in 1882 and that the unemployment rate is 1.3 percent higher.

SUMMARY AND CONCLUSIONS

In the last months of 1977, Congress was under great pressure to rescue the social security system from short-run financing difficulties caused by the recent recession. It passed legislation to guarantee the solvency of the social security system for the immediate future. Congress did not seek to overhaul the entire system. As a result, the new social security legislation does not address many fundamental issues regarding the future of the social security system.

For example, the payroll tax continues as the sole sources of revenue for social insurance. As long as this is true, the payroll tax burden on workers will continue to rise. Employers will have to pay higher payroll taxes that will raise labor costs and ultimately cause price increases.

Because payroll tax increases will be occurring at a time when economic restriction is undesirable, income tax relief is necessary to offset the adverse economic effects of the higher payroll tax. The result of substituting a lower income tax for a higher payroll tax is that our total tax system becomes less progressive.

While increasing payroll tax rates provides a short-term increase in revenues, it also produces a longer-term increase in benefits. It is reasonable to conclude therefore, that the recently passed legislation will only solve the social security financing problem for the immediate future and that after a few years Congress will again be faced with this issue.

There are numerous ways to end the reliance of the social security system on payroll taxes. As suggested earlier, the use of countercyclical general revenue financing would be a beneficial change in terms of general economic effect. It would mean that Congress would not be forced to raise taxes whenever a weak economy caused receipts to drop.

Those who oppose this approach claim that general revenue assistance would be viewed as converting a social security into a "welfare" program and that such a step would therefore be opposed by the elderly who feel they have earned their retirement benefits. This argument, however, overlooks the possibility that continued increases in the payroll tax will create resentment on the part of today's workers—a resentment that could provoke a taxpayers' revolt and rupture the inter-generational income transfer process that is effected by the social security program. More and more citizens are realizing that social security is not a provident fund and that today's retired person is supported by the taxes paid by today's workers.

In such programs as Disability Insurance (DI) and Hospital Insurance (HI) there is no relationship whatsoever between a person's payroll tax contributions and his benefits. For this reason, it has been suggested that DI and HI be separated from Old Age and Survivors Insurance (OASI) and funded via general revenues. In calendar year 1978, payroll taxes receipts for DI and HI will reach $32.7 billion or one-third of all social security payroll tax receipts. A sound alternative to the Administration's recent income tax proposals would be to (1) cut these payroll taxes, (2) fund DI and HI with general revenues and

(3) reduce each worker's tax burden, including the worker who earns so little that he pays no personal income tax. Legislation to achieve this has recently been introduced (S2503). The Joint Economic Committee has previously endorsed this proposal for Hospital Insurance.

It is clear from the analysis presented here that any reduced dependence on payroll taxes will leave the economy with a lower rate of inflation and a more equitable tax system. The limited use of general revenues is a viable alternative to higher payroll taxes.

Opening Statement of Representative Bolling, Chairman

Representative Bolling. First of all, I have to announce with regret that Robert Gordon of Northwestern University has a bad case of the flu and I am sure we all sympathize with him. That made it impossible for him to be here. We will miss him because he added a dimension to our panel.

I am sure that this panel of the remaining two will be very interesting.

Inflation is getting to be like the weather in Mark Twain's remarks, everyone talks about it but no one does anything about it.

At least no one has been able to do anything about it that works. It is fair to say that with the possible exception of the unemployment problem, our inability to deal successfully with inflation has been our most humbling experience.

Surely we have learned by now that the policy of slow growth is no solution. The home-style remedy of starving the fever is just the wrong thing to do.

It is worth repeating that the high unemployment rates of recent years, rates that have soared up to 8 percent and the low levels of industrial capacity have not checked inflation.

We ought to also remind ourselves that chronic stops and starts are a low form of economic policy, that any attempts to deal with inflation have been the pits.

Phase 1, phase 2, ad nauseam, it will be recalled, were supposed to be anti-inflation programs.

The Carter administration cannot be accused of inconsistency in this area primarily because it has not yet developed a clear-cut inflation program.

I do not say this to be critical; here, perhaps more than anywhere it is better to be safe than sorry. I think the administration recognizes the mistakes made in the recent past.

Whether those mistakes point the way to a wiser course is another matter.

The trick, of course, is to devise an anti-inflation program that is not an anti-expansion program to keep recovery going while driving prices and unemployment down.

I think we also must realize that we are dealing with appearances as well as realities.

A large part of the problem is that people perceive continuing high rates of inflation and they naturally act accordingly to protect their interests.

We now turn to our distinguished panel in the hopes that their incisive analysis will be sharp enough to cut the Gordian knot of inflation.

Gentlemen, you have distinguished yourselves in the area of economics and collectively you represent the best of the business, government, and academic communities. We will listen very attentively to your remarks.

I will ask Mr. Duncombe to begin.

STATEMENT OF HENRY L. DUNCOMBE, JR., VICE PRESIDENT AND CHIEF ECONOMIST, GENERAL MOTORS CORP.

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

Mr. Chairman, my name is Henry L. Duncombe, vice president and chief economist of the General Motors Corp. and I am most appreciative of the opportunity to participate in this review of inflation in the United States.

Mr. Chairman, I have a reading statement which is briefer than the full prepared statement that I would like to submit.

Representative BOLLING. Your prepared statement will be included in full, and you may proceed as you wish.

Mr. DUNCOMBE. Thank you very much.

Persistent inflation combined with continuous high rates of unemployment is a relatively new experience for which we have no easy answers.

While I believe that the roots of the current inflation trace to rapidly rising government expenditures, large deficits and an accommodative monetary policy, there are, of course, many additional contributing factors including increases in energy and resource costs, minimum wages, dollar exchange rates and government regulations.

Rather than attempt to cover all of these factors it seemed best to focus on one element of the inflation question—the impact of regulation on rising costs and lagging productivity.

This is an area in which I believe positive action by the Congress can make a significant contribution.

With respect to the impact of regulation on costs and hence inflation, the President's economic message correctly observes, and I quote, "There is no question that the scope of regulation has become excessive and that too little attention is given to its economic costs."

The report concludes, and again I quote, "Today, the economic significance of regulatory activities of the Federal Government approaches that of direct tax and expenditure decisions."

The analogy of regulatory costs to a direct tax is, I believe, appropriate.

As a tax, it is partly paid by the purchasers of the product and is reflected directly in the price index. It also reduces earnings and productivity and therefore has longer term and even more disturbing implications than its immediate price effects.

These results could be expected whether or not there was a showing that the social benefits of regulation were commensurate with the costs.

The requirement to internalize social costs, which formerly were not accounted for, now makes them accountable in the economy as a cost of doing business and, of course, in the price of products.

Presumably, if it were demonstrated that the mandated actions were cost beneficial and cost effective, the associated additional tax could be justified.

Nevertheless, the upward pressure on prices would not be reduced by such a showing, and the results would still contribute to the inflationary ratcheting of wages and prices with which we are all too familiar.

The magnitude of the expenditures required to comply with regulation is but one measure of the scope of the problem.

According to estimates prepared by the Department of Commerce, business spent $6.6 billion in 1975, $6.8 billion in 1976, and planned to spend $7.5 billion in 1977 to abate air and water pollution.

From 1974 through 1976 General Motors alone spent $3.3 billion in complying and preparing to comply with regulations imposed at all levels of government.

These costs averaged about $200 per car in 1976 and required services equivalent to 22,900 full-time GM employees.

But as large as they are, they do not include the equipment and other direct costs associated with the product. Further details are provided on this in the attachment to my written statement.

According to estimates prepared by the Bureau of Labor Statistics, the increase in the cost of an automobile due to safety and emissions standards alone, one measure of the burden borne by the consumer, from the 1968 to 1977 model year was $565.

In other words, based on this calculation in the 1977 model year when 11.2 million new cars were purchased, consumers paid $6.3 billion more than comparable 1968 automobiles would have cost in 1977 had these standards not been imposed.

Moreover, we estimate that Federal safety, emissions and fuel economy standards with which we must comply in the early 1980's could add several hundred additional dollars to the average price of an automobile.

In short, the inflationary impact of regulation in the automotive sector of the economy alone is significant.

These inflationary pressures are exacerbated when regulatory standards imposed through statute or by regulatory agencies have not been subjected to thorough and impartial cost-benefit analysis.

Based on our experience in the motor vehicle industry, it would appear that standards often have been set to achieve purely technological goals, rather than the attainment of levels consistent with consumer welfare.

The attitude all too frequently appears to have been to achieve a level of technological performance that has been arbitrarily specified.

These are costly shortcomings in our approach to regulation which the Congress can insist be corrected.

The economic analysis of the proposed NHTSA standards for light-duty trucks by the Council on wage and Price Stability provides an example that could well be followed in the future.

The Council concluded after lengthy study that, and I quote here, it:

Fears that implementation of the proposal in its present form could further exacerbate the inflationary pressures and seriously hinder the administration's efforts to achieve a deceleration of price increases.

As important as the finding is in this particular instance, we are encouraged by the fact that the proposed regulation was subjected to an inflation impact analysis before the standards were finalized by NHTSA.

One approach to evaluating the need for regulation was demonstrated by a recent experiment. An EPA report early in 1975 warned of the potential future danger to health of roadside accumulations of sulfates from automotive catalytic converters.

In order to assess the extent to which sulfates could accumulate along the roadside, General Motors, with the cooperation of EPA and other auto companies, conducted an actual test at the GM proving ground in October 1975.

The National Academy of Sciences, after reviewing the results of the tests, concluded that the sulfuric acid accmumulation due to catalytic converters did not pose a serious threat to human health and, therefore, sulfate regulations were not necessary.

Conducting this test was costly but far less costly than the imposition of a standard which was demonstrably unnecessary.

In addition to subjecting proposed regulations to cost-benefit and inflation impact analysis prior to their implementation, there are clearly cost-saving opportunities in simplified compliance procedures.

For example, the Environmental Protection Agency currently conducts four tests to insure compliance of new cars with emission standards and it is also planning to impose two additional tests for this purpose.

Three of the tests duplicate each other. This adds to the cost of government and to the manufacturers costs, with obvious inflationary implications.

We cite these examples only to make the point that congressional insistence on the orderly and systematic assessment of regulations before they are enacted can reduce their inflationary impact.

Beyond this, we are convinced that there are substantial economies possible in the administration of regulation and compliance procedures.

The second element I would like to focus on is the impact of regulation and productivity. This is an area where constructive congressional action is necessary. In my view, this represents possibly our best hope for moderating inflationary pressures.

The national record has been far from satisfactory and substantially below that of other advanced industrial nations.

For example, output per labor-hour in the nonfarm business sector increased at an average annual rate of 2.5 percent from 1950 to 1968 but in the last decade, 1968 to 1977, the rate of increase was only 1.6 percent.

There are many reasons for the decline in productivity growth over the period 1973 to 1975.

The Department of Commerce estimates of capital expenditures by business for pollution abatement have amounted to almost 5.5 percent of total nonfarm plant and equipment expenditures during the period 1974–77.

Within the manufacturing sector alone, this percentage has been over 8 percent during the same period, and these data measure only

capital expenditures for air, water, and solid waste abatement, excluding operating costs and other expenditures to meet safety and other regulations.

The effect of the diversion of capital expenditures to meet mandated standards is particularly serious in a period when the rate of investment is declining.

From 1950 to 1968 when productivity was rising 2.5 percent per year, the capital-labor ratio grew at an average annual rate of almost 3 percent.

Since 1968, this ratio has grown by only 1 percent per year. This fall is partly due to the rapid growth in the labor force during the latter period and partly a result of the slowdown in the rate of investment.

If, however, adjustment is made to exclude equipment required to meet pollution standards, the growth in this ratio is even less than 1 percent.

Whenever there is a slowdown in the investment that reduces productivity advance, the potential growth of real income is reduced and the potential for inflationary bottlenecks is increased.

There is an urgent need to understand the impact of regulations on productivity. Even where there are clearly established benefits, stringent standards can delay the construction of new plants, the use of more productive processes, and threaten already marginally profitable firms.

Moreover, to the extent that U.S.-mandated standards are substantially higher than those of overseas producers, the competitive position of domestic producers is impaired both at home and abroad.

To meet GM's investment requirements in the 1980's will require annual expenditures of $5 billion, considerably more than the $3.6 billion GM spent in 1977 for plant facilities and special tools.

The rising costs we have already incurred have not been totallv recovered either in price or productivity, and this has led to a decline in our profit margin.

In 1977, the return was only 6.1 percent down from 10.3 percent in 1965, and 6.7 percent in 1973.

GM's real net income in 1977 was only 2 percent more than in 1973, even though real dollar sales were 13 percent higher.

This pattern is, of course, typical of much of U.S. manufacturing and accounts in part for the slowdown in capital formation.

The burden of proof must be on those who mandate new and still higher standards. It must be demonstrated that the standards are both cost beneficial and cost effective, and the inflation impacts must be assessed.

Our economy cannot afford mandated waste. The opportunity costs of mandated expenditures must be evaluated against other expenditures not made; the productivity increases not achieved: the higher rate of inflation we have experienced; the research and development we did not undertake; the number of people we did not employ; the output that is not, and will not be, forthcoming.

I believe that positive action can be taken to reduce unnecessary costs that contribute to inflation. There is clearly an opportunity for the Congress to review systematically prior and proposed legislation in terms of its economic impact.

With the prospect that meeting regulatory standards will continue to divert investment funds, there is an especially urgent need to increase resources allocated to investment.

Opportunities do exist for changing tax policy to remove impediments for investment in the private sector.

Specifically, consideration must be given to proposals for faster depreciation of capital investment, to the reduction of the corporate tax rate, and to special tax treatment for those investments required to meet mandatory Government regulation.

The President's tax proposals have addressed some of these problems, and, no doubt, they will receive thoughtful congressional review.

Improving the incentives for investment is our best hope for raising productivity and reducing long-term inflationary pressures.

Eliminating excessive regulations to reduce inflation and to increase productivity does not mean we must stop efforts to improve the quality of our lives and environment.

Economic goals and quality-of-life goals are not mutually exclusive.

I believe we can improve the quality of our lives, our environment, our health, and the safety of our people and still continue to increase our material standard of living.

A reexamination of the growing number of standards that are not cost justified is an essential first step toward accomplishing these objectives and reducing the pressures of inflation.

Thank you very much, Mr. Chairman.

[The prepared statement of Mr. Duncombe, together with attachments, follows:]

PREPARED STATEMENT OF HENRY L. DUNCOMBE, JR.

Regulation and Inflation

Mr. Chairman and members of the Joint Economic Committee, my name is Henry L. Duncombe, Jr., Vice President and Chief Economist of the General Motors Corporation. I am most appreciative of the opportunity to participate in this review of inflation in the United States.

Persistent inflation combined with continuous high rates of unemployment—a combination commonly referred to as "stagflation"—is a relatively new experience for which we have no easy answers. Macroeconomic policies to reduce unemployment involving large federal deficits heighten concern about inflation, while an aggressive policy to moderate inflation by restrictive fiscal and monetary measures could intensify short-term unemployment. Thus, it seems clear that if we are to make progress in meeting our equally pressing employment and price stability goals we must look beyond the simple prescriptions of large doses of fiscal stimulation or restraint.

This is not to deny that the basic cause of the inflation we have experienced is the monetization of persistently large federal deficits throughout most of the current decade. Equally disturbing is the persistent rise in these deficits. For example, in the five year period of fiscal 1975 through estimated 1979, the deficit is projected to average an amount approaching $60 billion or four times the average in the prior five years—1970–1974. This earlier level, in turn, was two times the level in the five years 1965–69. These figures, of course, exclude the off-budget deficits which also have been rising rapidly in recent years.

One consequence of the persistently large deficits in the decade of the seventies has been a rapid growth in the money supply with M–1 rising an average 6.4 percent per year between 1970 and 1977 and M–2 by 9.5 percent—substantially higher than the potential growth of the economy as measured by real GNP.

I believe that the roots of the current inflation trace to rapidly rising government expenditures, large deficits and an accommodative monetary policy. Others participating in these hearings will, no doubt, be assessing these issues in great depth—including whether and at what cost government expenditures can be reduced (or taxes raised) and the implications of a less accommodative monetary policy along with its potential risks.

There are, of course, many additional factors that have contributed to persistent inflation and unemployment—significant increases in energy and resource costs, accelerated increases in minimum wages, trade restrictions, a declining dollar exchange rate, restrictive labor practices, agricultural policies, and government regulations. Opinions are divided among economists as to the relative importance of some of these factors but most would agree that all are contributing to the persistent rise in prices.

Rather than attempt to cover all of these factors it seemed best to focus on one element of the inflation question—the impact of regulation on rising costs and lagging productivity. This question was briefly discussed in the Economic Report of the President. It is an area in which I believe positive action by the Congress can make a significant contribution.

With respect to the impact of regulation on costs and hence inflation, the President's Economic Message correctly observes that: "Government regulations also add to costs and raise prices. To some extent this is the inevitable cost of much needed improvements in the environment and in health and safety of workers and consumers. But there is no question that the scope of regulation has become excessive and that too little attention is given to its economic costs."

The Council's Report concludes: "Today the economic significance of regulatory activities of the federal government approaches that of direct tax and expenditure decisions."

The analogy of regulatory costs to a direct tax is, I believe, appropriate. As a tax, it is partly paid by the purchasers of the product and is reflected directly in the price index. It also reduces earnings and productivity and therefore has longer-term and even more disturbing implications than its immediate price effects.

These results could be expected whether or not there was a showing that the social benefits of regulation were commensurate with the costs. The requiremnt to internalize social costs, which formerly were not accounted for, now makes them accountable in the economy as a cost of doing business and, of course, in the price of products. Presumably, if it were demonstrated that the mandated actions were cost beneficial and cost effective, the associated additional tax could be justified. Nevertheless, the upward pressure on prices would not be reduced by such a showing, and the results still would contribute to the inflationary racheting of wages and prices with which we are all too familiar.

The magnitude of the expenditures required to comply with regulation is but one measure of the scope of the problem. According to estimates prepared by the Department of Commerce, business spent $6.6 billion in 1975, $6.8 billion in 1976, and planned to spend $7.5 billion in 1977 to abate air and water pollution.

From 1974 through 1976 General Motors alone spent $3.3 billion in complying and preparing to comply with regulations imposed by all levels of government. A breakdown of these expenditures by categories has revealed that about $2 billion was spent to comply with regulation of motor vehicles—$1.1 billion for auto safety, $826 million for auto emission control, $45 million for vehicle noise control. In addition, expenditures to comply with plant pollution control regulations were $502 million. Occupational health and safety expenditures were $216 million and expenditures on government reports and administrative costs related to regulation were $589 million.

These costs include only research and engineering, reliability, inspection testing, facilities, tools and rearrangement. Costs averaged about $200 per car in 1976 and required services equivalent to 22,900 full-time GM employes. But as large as they are, they do not include the equipment and other direct costs associated with the product. They do not include any expenditures to improve fuel economy of GM cars, or any taxes or workers' compensation claims paid. Further details are provided in the attachment to my written statement.

According to estimates prepared by the Bureau of Labor Statistics, the increase in the cost of an automobile due to safety and emissions standards only—one measure of the burden borne by the consumer—from the 1968 to 1977 model year was $565. In other words, based on this calculation in the 1977 model year

when 11.2 million new cars were purchased, consumers paid $6.3 billion more than comparable 1968 automobiles would have cost in 1977 had these standards not been imposed. Moreover, we estimate that federal safety, emissions and fuel economy standards with which we must comply in the early 1980's could add several hundred additional dollars to the average retail price of an automobile.

In short, the inflationary impact of regulation in the automotive sector of the economy alone is significant. With expenditures of these magnitudes, it is appropriate to ask whether the regulatory tax on the new car buyer yields commensurate benefits. But even when we find affirmatively on this question, we need to know whether we are maximizing our return—that is, realizing the greatest benefit—on an annual expenditure already over $6 billion and very likely to increase.

These inflationary pressures are exacerbated when regulatory standards imposed through statute or by regulatory agencies have not been subjected to thorough and impartial cost-benefit analysis. Based on our experience in the motor vehicle industry, it would appear that standards often have been set to achieve purely technological goals, rather than the attainment of levels consistent with consumer welfare. The attitude all too frequently appears to have been to "hold the industry's feet to the fire" to achieve a level of technological performance that has been arbitrarily specified. This approach to environmental and social regulation is guaranteed to be wasteful and inflationary, to impose costs that outweigh anticipated benefits, or to set deadlines that preclude the use of more cost effective alternatives.

There are costly shortcomings in our approach to regulation which the Congress can insist be corrected. We strongly endorse, among other requirements, inflation impact statements as an adjunct to each proposed regulation. As a society, we may accept cost-push pressures that yield corresponding benefits even though they raise prices faster than would otherwise occur. But there is no case to be made for cost-raising regulation for which careful cost-benefit and inflation impact assessments have not been conducted. In spite of some of the efforts of the Office of Technology Assessment and by the Council on Wage and Price Stability, we have, I am convinced, only scratched the surface of this problem.

The economic analysis of the proposed NHTSA standards for light-duty trucks by the Council on Wage and Price Stability provides an example that could well be followed in the future. The Council concluded afer lengthy study that it "fears that implementation of the proposal in its present form could further exacerbate the inflationary pressures and seriously hinder the Administration's efforts to achieve a deceleration of price increases." As important as the finding in this particular instance, we are encouraged by the fact that the proposed regulation was subjected to an inflation impact analysis before the standards were finalized by NHTSA.

One approach to evaluating the need for a regulation was demonstrated by a recent experiment. An EPA report early in 1975, based on a mathematical model of atmospheric dispersion of sulfates, warned of the potential future danger to health of roadside accumulations of sulfates from automotive catalytic converters. In order to assess the actual—rather than the hypothetical—extent to which sulfates could accumulate along the roadside, General Motors, with the cooperation of EPA and other auto companies, conducted an actual test at the GM Proving Ground in October 1975.

Preliminary findings indicated that EPA's original estimates of the potential sulfate buildup at ground levels along busy freeways were up to 20 times too high. The National Academy of Sciences, after reviewing the results of the tests, concluded that sulfuric acid accumulation due to catalytic converters did not pose a serious threat to human health and, therefore, sulfate regulations were not necessary. Conducting this test was costly but far less costly than the imposition of a standard which was demonstrably unnecessary.

A recently published study by L. B. Lave and E. P. Seskin "Air Pollution and Human Health," provides an example of where costs exceed benefits in controlling motor vehicle pollutants. Based on National Academy of Sciences estimates, the cost of reducing nitrogen oxide emissions from motor vehicles to the level of .4 grams per mile approaches $11 billion a year in 1985 measured in 1973 dollars. Health benefits were estimated at $5 billion a year in 1985, which the authors cite as a most liberal interpretation of the possible health benefits. In other words, costs are expected to exceed benefits by a factor of two.

In addition to subjecting proposed regulations to cost-benefit and inflation impact analysis prior to their implementation, there are clearly cost-saving opportunities in simplified compliance procedures. For example, the Environmental Protection Agency currently conducts four tests to insure compliance of new cars with emission standards and it is also planning to impose two additional tests for this purpose. Three of the tests duplicate each other. This adds to the cost of government and to the manufacturers' costs, with obvious inflationary implications.

We cite these examples only to make the point that Congressional insistence on the orderly and systematic assessment of regulations before they are enacted can reduce their inflationary impact. Beyond this, we are convinced that there are substantial economies possible in the administration of regulation and compliance procedures.

The second element I would like to focus on is the impact of regulation on productivity. This is an area where constructive Congressional action is necessary. In my view, this represents possibly our best hope for moderating inflationary pressures. The national record has been far from satisfactory and substantially below that of other advanced industrial nations. For example, output per laborhour in the non-farm business sector increased at an average annual rate of 2.5 percent from 1950 to 1968 but in the last decade—1968 to 1977—the rate of increase was only 1.6 percent.

Many reasons for the decline in productivity growth have been offered by those who have examined the problem. However, regulations mandating large capital expenditures by business which do not contribute to improving efficiency have surely contributed to our poor record.

A study of the impact on productivity growth of mandated expenditures for pollution abatement and safety regulations has recently been published by Dr. Edward F. Denison, a highly respected student of productivity analysis. Based on this analysis, mandated expenditures accounted for almost one-half percentage point reduction in total factor productivity growth over the period 1973 to 1975.

The Department of Commerce estimates of capital expenditures by business for pollution abatement have amounted to almost 5.5 percent of total non-farm plant and equipment expenditures during the period 1974–77. Within the manufacturing sector alone, this percentage has been over 8 percent during the same period. These data measure only capital expenditures for air, water and solid waste abatement. They do not include operating costs associated with these expenditures nor those required to meet safety and other regulations administered by government agencies at all levels; and they do not include the administrative costs of agencies generating regulations and monitoring compliance.

While no doubt a substantial part of these expenditures have produced a significant improvement in air and water quality, they have contributed little to and in fact have impeded productivity advance. This problem is especially acute in the manufacturing sector, where the mandated diversion of investment expenditures to meet environmental requiremnets has been so large.

The effect of the diversion of capital expenditures to meet mandated standards is particularly serious in a period when the rate of investment is declining. From 1950 to 1968 when productivity was rising 2.5 percent per year, the capital-labor ratio grew at an average annual rate of almost 3 percent. Since 1968, this ratio has grown by only 1 percent per year. This fall is partly due to the rapid growth in the labor force during the latter period and partly a result of the slowdown in the rate of investment. If, however, adjustment is made to exclude equipment required to meet pollution standards, the growth in this ratio is even less than 1 percent. Whenever there is a slowdown in investment that reduces productivity, the potential growth of real income is reduced and the potential for inflationary bottlenecks is increased.

There is an urgent need to understand the impact of regulations on productivity. Even where there are clearly established benefits, stringent standards can delay the construction of new plants, the use of more productive processes, and threaten already marginally profitable firms. Moreover, to the extent that U.S. mandated standards are substantially higher than those of overseas producers, the competitive position of domestic producers is impaired both at home and abroad.

A rapid growth of the labor force is expected to continue into the middle of the next decade. If employment increases are to match and exceed this growth,

the rate of investment in productive equipment will have to be significantly higher than the rates recently experienced. Meeting the need for increased productive investment together with investment required to meet government standards will surely require a rethinking of the standards themselves and reexamination of the existing tax impediments to capital formation.

Once more citing General Motors as an example, we will be required to meet stricter emissions, fuel economy, and safety standards for the automobile as well as stricter fuel economy, noise, and emission standards for trucks. We also will be required to conform to regulation of our production processes and of our plants in areas dealing with occupational health and safety as well as pollution abatement.

To meet these investment requirements for the 1980's will require annual expenditures of $5 billion—considerably more than the $3.6 billion GM spent in 1977 for plant facilities and special tools. The rising costs we have already incurred have not been totally recovered either in price or productivity and this has led to a decline in our profit margin. In 1977 the return was only 6.1 percent down from 10.3 percent in 1965, and 6.7 percent in 1973. GM's real net income in 1977 was only 2 percent more than in 1973—even though real dollar sales were 13 percent higher. This pattern is of course typical of much of U.S. manufacturing and accounts in part for the slowdown in capital formation.

The burden of proof must be on those who mandate new and still higher standards. It must be demonstrated that the standards are both cost-beneficial and cost-effective and inflation impacts must be assessed. Our economy cannot afford mandated waste. The opportunity costs of mandated expenditures must be evaluated against the expenditures not made; the productivity increases that were not achieved; the higher rate of inflation we have experienced; the research and development we did not undertake; the number of people we did not employ; the output that is not, and will not be, forthcoming.

I believe that positive action can be taken to reduce unnecessary costs that contribute to inflation. There is clearly an opportunity for the Congress to review systematically prior and proposed legislation in terms of its economic impact. The President has established a review panel in the Executive Branch to eliminate burdensome, costly and unnecessary regulations and we support this. This process should be accelerated. We also recognize that the Office of Technology Assessment could make a contribution in these areas. These processes represent clear opportunities for evaluating the effectiveness of regulatory controls.

With the prospect that meeting regulatory standards will continue to divert investment funds, there is an especially urgent need to increase resources allocated to investment. Opportunities exist for changing tax policy to remove impediments for investment in the private sector. Specifically, consideration must be given to proposals for faster depreciation of capital investment, to the reduction of the corporate tax rate and to special tax treatment for those investments required to meet mandatory government regulation. The President's tax proposals have addressed some of these problems and, no doubt, they will receive thoughtful Congressional review. Improving the incentives for investment is our best hope for raising productivity and reducing long-term inflationary pressures.

Eliminating excessive regulations to reduce inflation and to increase productivity does not mean we must stop efforts to improve the quality of our lives and environment. Economic goals and quality of life goals are not mutually exclusive. I believe we can improve the quality of our lives, our environment, our health, and the safety of our people and still continue to increase our material standard of living. A reexamination of the growing number of standards that are not cost justified is an essential first step toward accomplishing these objectives and reducing the pressures of inflation.

ATTACHMENT A

IMPACT OF GOVERNMENT REGULATIONS ON GENERAL MOTORS—GENERAL

General Motors spent more than $3¼ billion in complying, and preparing to comply, with regulations imposed by all levels of government in the three years 1974–1976. That amount does not include the cost of equipment added to GM products to meet government standards, nor any taxes or workers' compensation

claims paid. Neither does the $3¼ billion reflect the cost of lost opportunities, misplaced priorities and misused resources.

In 1976 alone, government regulation cost GM more than $1 billion, and required the equivalent effort of 22,900 full-time GM employees.

Total expenditures, by major category, for the three-year period were estimated to be:

	Millions
Regulation of motor vehicles	$1,986
Regulation of plant facilities	502
Occupational safety and health	216
Government Reports and administrative costs related to regulation	589
Total	3,293

During the same three years the equivalent number of full-time employes required to comply with government regulations ranged from 22,300 to 25,300. Attachments B and C show the impact on costs and employment in detail.

Significantly, the nearly $2 billion spent on the regulation of vehicles does not include expenditures to improve the fuel economy of GM cars. In our view, such costs are competitive expenditures at this time. General Motors undertook the redesign of its vehicles for this purpose well before the government mandated fuel economy standards—an undertaking in response to consumer demands rather than government requirements.

In arriving at the cost and employment data, no attempt was made to differentiate between what might be considered necessary and unnecessary government regulation. While we believe much is unwarranted and should be eliminated, any attempt to separate such regulation would require subjective judgment. Our purpose was to be as objective as possible in arriving at the total cost of regulation.

ATTACHMENT B

[Expenditures in millions of dollars]

	Calendar year			
	1974	1975	1976	3-yr total
Regulation of vehicles:[1]				
Auto safety	$414	$347	$354	$1,115
Auto emission control	454	184	188	826
Vehicle noise control	16	15	14	45
Total	884	546	556	1,986
Regulation of plant facilities:				
Plant pollution control:				
Air	77	57	58	192
Water	56	54	56	166
Solid waste control	48	39	57	144
Total	181	150	171	502
Occupational safety and health	79	62	75	216
Government reports and administrative costs related to regulation:				
Business statistics	3	3	3	9
Energy management	21	23	25	69
Environmental activities	43	41	40	124
Industrial relations	44	48	61	153
Legal activities	26	25	34	85
Marketing functions	3	4	6	13
Taxes	12	12	13	37
Other	38	29	32	99
Total	190	185	214	589
Grand total	1,334	943	1,016	3,293

[1] Includes research and engineering, reliability, inspection, testing, facilities, tools, and rearrangement costs. Does not include the direct cost associated with the product (except direct insepction).

ATTACHMENT C

	Employment [1]—calendar year		
	1974	1975	1976
Regulation of vehicles:			
Auto safety	12,300	10,400	10,500
Auto emission control	4,800	4,000	3,900
Vehicle noise control	400	300	300
Total	17,500	14,700	14,700
Regulation of plant facilities:			
Plant pollution control:			
Air	800	800	800
Water	500	500	500
Solid waste control	500	500	600
Total	1,800	1,800	1,900
Occupational safety and health	1,100	1,100	1,100
Government reports and administrative costs related to regulation:			
Business statistics	100	100	100
Energy management	200	100	200
Environmental activities	1,000	1,000	1,000
Industrial relations	1,400	1,500	1,700
Legal activities	800	700	900
Marketing functions	100	100	100
Taxes	400	400	400
Other	900	800	800
Total	4,900	4,700	5,200
Grand total	25,300	22,300	22,900

[1] These estimates of employment including technical, clerical, and other support personnel, were based on total hours worked as a result of regulations. Those hours were then converted to the equivalent number of employees working a calendar year.

Representative BOLLING. Thank you, Mr. Duncombe.

Next, we will hear from Charls Walker, who appears today representing the American Council for Capital Formation.

STATEMENT OF CHARLS E. WALKER, CHAIRMAN, AMERICAN COUNCIL FOR CAPITAL FORMATION

Mr. WALKER. Thank you, Mr. Chairman.

My name is Charls E. Walker, and I appear on behalf of the American Council for Capital Formation, a rapidly growing group of individuals, trade union organizations, and business corporations that are deeply concerned about the lagging pace of capital formation in this country. I am also president of Charls E. Walker Associates, Inc., a consulting firm specializing in Federal Government relations.

Mr. Chairman, this Nation's economy is in trouble. Since we live in what is predominantly a market economy, markets in effect tell us when things are "out of whack." The stock market—a priceless asset which instantaneously transmits signals reflecting the fears, hopes, and judgments of literally millions of investors—is at or close to its lowest point in 3 years and shows no signs of recovery. In foreign exchange markets, the dollar is weaker than at any time in your memory or mine. Participants in credit markets are as nervous as the proverbial cat on a hot tin roof, and expectations of even higher interest rates appear to be strengthening.

In my view, this existing malaise, which could be replaced by tomorrow's turmoil, reflects the strongly held opinion of decision-

makers both here and abroad that U.S. policymakers have in effect thrown in the sponge in the battle against inflation, that at least implicitly we have decided to try to live with inflation of 5 percent or more. Markets can, and often do, overreact. But speaking for myself, I find it very difficult to identify any cohesive and credible plan for bringing inflation to heel.

Before presenting my own views on how to attack inflation, let me emphasize that although I am a Republican who served three Republican presidents, my criticism is not partisan. Current and prospective inflation had its genesis in bad economic policies that emerged in the mid-sixties. Subsequent steps to control inflation have failed and there is plenty of blame to go around. The problem is too pressing to permit partisan considerations to hamper the development of policies aimed at its solution.

There are those who disagree with the view I have stated and believe instead that we can live with a significant rate of inflation. I would answer those critics by first pointing to the record.

Despite two wars, inflation—GNP deflator—averaged only 2.6 percent between 1950 and 1970, with the rate in the second decade slightly lower than the first. In the seventies, the rate has more than doubled, averaging 5.8 percent, a figure that most economists believe to be close to the basic rate today.

In addition, experience during the seventies has convinced most expert observers that there is no lasting tradeoff between inflation and unemployment. Indeed, many are convinced that if overall stabilization policies are to help minimize unemployment, the first order of business is to get inflation under control.

Success in this effort will require patience and persistence. The problem is especially difficult because we have, in effect, let the inflation genie escape from the bottle; it would have been much easier to keep him there than to stuff him back in today.

The primary reason is that the so-called money illusion has been virtually destroyed and participants in all types of markets tend to bargain in real rather than in monetary terms.

The two markets where this is most apparent, and from which the greatest damage arises, are the credit market and the jobs market. In the former, interest rates have come to include a premium to allow for inflation. If savers hope to obtain a real return of, say, 3 percent, the nominal interest rate will amount to three percent plus the expected inflation rate. The impact on individuals seeking mortgage money or businesses that seek to expand is obvious.

The impossibility of living with a high inflation rate becomes even clearer when we consider the impact on wage settlements. If workers believe that the cost of living will rise by 6 percent annually, they will seek wage increases sufficient to offset that rise, plus another 3 percent or so in an effort to raise living standards. If that additional 3 percent could be offset, as in earlier years, by an equivalent increase in output per man-hour or productivity, the inflation rate need not rise.

But the fact is that productive investment, the major long-run source of productivity gains, has become increasingly sluggish in recent years. Capital per worker grew at a rate of 3.6 percent in the

first half of the fifties, but according to the Congressional Budget Office, fell to 1.6 percent in the first half of this decade and 1 percent since then.

If productivity rises by only 1 percent instead of 3, cost-push pressures on prices will intensify as workers seek wage increases that exceed—by two points—the existing inflation rate plus productivity gains. In other words 6, plus 3 for inflation, totaling 9 percent.

The viciousness of the circle is further demonstrated by the depressing effect that high inflation has on the productive investment which would foster the productivity gains necessary to keep wage increases from adding further to cost-push pressures.

Inflation is the enemy of capital formation because it creates uncertainty and therefore induces caution among savers and money managers, as well as the corporate officials who make the decisions relative to new projects; it reduces funds available for investment because of a system of depreciation that relies on historical cost, thus allowing insufficiently for asset replacement; and it diminishes both the willingness and ability of individuals to save as their inflation-swollen incomes move them into higher tax brackets with a resultant transfer of a larger portion of that income to the Federal Government—the biggest "dissaver" of all.

The outcome of this type of cost-push pressure, a wage-price spiral, is not difficult to forecast. If accommodative monetary policies allow inflation to accelerate, we shall either return again to the world of stop-go stabilization policy, or worse still, turn again to wage and price controls.

Neither of these outcomes is inevitable. All that is required is that economic policymaking return to fundamentals.

It is fashionable to state that inflation is a very complex phenomenon. I disagree.

That it is difficult to control in our type of political/economic system goes without saying. But the fact is that inflation is now, has always been, and will always be a simple phenomenon, best summed up in one short phrase: "Too much money chasing too few goods."

This is nothing more nor less than a verbal restatement of the venerable "equation of exchange," which has its place in every beginning economics course. It is a truism. As such it tells us nothing about cause and effect, but it does provide a useful starting point for diagnosing and dealing with the problem.

The first fundamental is that if inflation is to be brought under control, total spending must be held to a rate consistent with the Nation's ability to produce new goods and services. Therefore, today's situation requires either a relative cutback in total spending, an increase in output, or some combination of the two.

Further light can be shed on the matter by asking why the rate of inflation has doubled over the past two decades and is expected by many to accelerate.

I would argue that the proximate reason, and perhaps monetarists would say the only reason, has been excessive growth in the money supply during most of the 1970's. From a policy standpoint, the strict monetarist might argue that inflation could be eliminated if only our "independent" Federal Reserve authorities would screw

up their courage and curb excessive monetary growth. But here is precisely where the complexities arise, and the reason I refer to excessive monetary growth as the proximate rather than the fundamental cause of inflation.

Members of Congress need not be reminded that our Government institutions, particularly the Congress, are, and properly so, responsive to the will of the people. And the simple but hard fact is that, as it directly affects their individual lives, people prefer more, not less, Federal spending; lower, not higher, taxes; and cheap and easy loans, not credit which is expensive and tight.

Given these preferences, the "making of inflation" in our society is easy to describe and understand. The story is best told with figures.

In the 6 fiscal years ending in September 1978, Federal spending will have doubled, rising from about $230 billion in 1972 to $460 billion in 1978. That represents an increase of 12 percent a year, or some three to four times the long-term growth rate in the economy as a whole.

Given this huge gap, a pay-as-you-go approach, through an attempt to raise Federal income taxes, would be out of the question. Federal income taxes have not been raised in this country, except during war, since 1932. Voters would rebel, just as they are now rebelling against rapidly rising social security taxes. And even if Congress could be persuaded to take the pay-as-you-go route, the negative impact of higher taxes on employment and output could be severe.

The result? The outsized deficits of this 6-year period, 1972 to 1978—a whopping $274 billion—had to be financed out of saving or money creation. To the extent savings were unavailable, the deficits had to be covered by monetary creation engineered, or at least tolerated, by Federal Reserve authorities.

Monetarists might argue that savings would be "sufficient" if the Fed held firm against the tide; market forces would equate the amount of genuine savings demanded and supplied. But that would have resulted in higher interest rates and a degree of public and congressional stigma that even the doughtiest central banker is reluctant to bear. In addition, application of proper monetary policy is complicated by disagreement as to the economic importance of monetary aggregates as compared to interest rates. To the extent Keynesian ideas still prevail, the case for keeping interest rates low was persuasive so long as output and employment fell short of national goals. Monetarists would say this creates too much money.

If, as I suggest, bad fiscal policy begets bad monetary policy which in turn begets inflation, then the first fundamental step toward stuffing the genie of inflation back into the bottle is to do the same thing with the genie of Federal spending.

President Carter's proposed budget for fiscal year 1979, with no new major initiatives, is a step in that direction, although I would have preferred a proposal for no real growth and a firm pledge to veto spending measures that would cause total spending to cross that line.

The problem of too much money chasing too few goods can also be attacked by increasing output. What are the prospects?

There is still some slack in the economy, although how much is a matter of debate. Over the longer term, however, maximum-efficiency output will be achieved, and inflation minimized, if we: One, follow sensible monetary and fiscal policies, thereby avoiding "stop-go" and providing consumers and business with a more stable environment for economic decisionmaking;

Two, cut back sharply on the regulation and red tape that is curtailing energy output and driving many businessmen, particularly those who run smaller enterprises, up the wall; and

Three, move quickly and forcefully to reduce the existing bias in the tax laws that favors consumption and discourages saving and productive investment. Steady and large increases in output require a high rate of productive investment.

I have already given my views on how to improve monetary and fiscal policies, and I shall leave the discussion of excessive government regulation to those better qualified than I. Let me instead concentrate on productive tax reform to promote capital formation.

I do not mean to be either flippant or lacking in respect, but what does Congress have against saving? Instead of hailing thrift in the image of the Puritan Ethic and Poor Richard's Almanac, we approach saving as if it were a sin. Bear with me for a quick example.

Joe and I make the same income, enjoy the same deductions and credits, and therefore pay the same income tax. But, wait a minute. Assume that Joe saves 10 percent of his income, perhaps putting it into a savings account or corporate stock, whereas I spend all of mine, and perhaps more, on consumption.

Does Joe get even a pat on the head for his thrift? Or, do I get penalized for my profligacy? Not by any means. We both pay the same tax and that's no way to encourage thrift.

But that's not all. Having spent all of my income, I am through with the tax collector. But if Joe puts his money in a savings account, he pays additional Federal income taxes up to a top rate of—not 50—but 70 percent. Or, if he tries to put a little life into the equity market by buying corporate stocks, the company is taxed up to 48 percent on each dollar of net income and then Joe's taxed up to 70 percent—again, not 50 percent—or any dividends he receives. If he sells the stock at a profit, he is taxed again.

To repeat, why do we throw tax after tax at thrifty Americans?

Tax policy with respect to the investment side of the saving-investment process is subject to similar criticism. High business taxes impede capital formation in at least two ways, by decreasing the after-tax return on new projects and by reducing the flow of cash available to finance them.

Moreover, the lack of logic in our approach is underlined by the fact that we do not even know who really pays the taxes levied on business, except that business itself does not. A corporation, for example, is nothing more than a legal approach to doing business, and a very successful approach at that. But corporations as such "pay" taxes only in the first instance; they are, in effect, "surrogate collectors" for the Internal Revenue Service. Such taxes are either passed on to consumers in the form of higher prices, and to this extent are probably regressive, or backward to the factors of produc-

tion, including the savers and investors who make capital formation possible.

The case for reducing business taxes is therefore strong, and it is especially gratifying that President Carter has proposed a significant reduction in the corporate rate. I only wish that he had gone further. The major argument against large cuts, namely, the assumed negative impact on Federal revenues, is open to serious challenge.

The administration estimates that its proposed gross reductions in corporate taxes will "cost" $8.3 billion in 1979 and $10.5 billion in 1980. Experience since World War II leads to the opposite conclusion: Reductions in the tax burden on business through rate cuts tend to increase, not decrease, revenues, and usually within a relatively short period of time.

Unfortunately, the estimated revenue impact of Federal tax changes is derived from "demand-oriented" economic models which, in my view, greatly underestimate the "feedback effects" of soundly structured tax cuts. Both the American Council and the National Association of Manufacturers are working on new models which should remedy these defects. If so, future projections of the revenue impact of tax cuts should be more consistent with past experience.

A higher rate of capital formation will not only help restrain inflation through increased output, it will also provide jobs for a growing labor force. As Treasury Secretary Blumenthal has noted, and as the figures cited earlier indicate, our stock of "human capital"—the workers in the labor force—has been growing faster than our stock of "real capital."

This view of the matter is especially useful, inasmuch as there are more than a few 20th century Luddites who believe that new and efficient machinery eliminates jobs.

To be sure, a new machine may result in a temporary reduction in employment in some firms or industries, but the longrun relationship between jobs and capital formation is indisputable. Business spending for new plant and equipment during the past two decades approached $1.5 trillion. But, jobs did not disappear. Quite the contrary; employment rose from 64 million to 93 million, an increase of 45 percent.

Productive tax reform to promote capital formation will therefore pay double dividends: Job creation and inflation control.

Today, in my judgment, the most urgent economic task before Congress is, of course, to complete work on the energy bill, moving it as far as possible toward reliance on market forces to promote energy production and conservation.

As to stabilization policy, I would urge this committee, in its forthcoming report, to single out inflation control as our paramount goal, not simply because price stability is in itself a worthy national objective, but also because success in meeting other goals, such as minimizing unemployment, is likely to be only transitory if some degree of price stability is not restored.

This would be especially true if identification of inflation as public enemy No. 1 were followed by a very firm congressional hand on the budget, with a spending ceiling for fiscal year 1979 no higher, and

preferably lower than the $500.2 billion recommended by the President.

Even then the prospects for net tax cuts in excess of those recommended by the administration could push the deficit much higher.

If so, the Federal Reserve should neither be forced nor cajoled into what would surely be a self-defeating attempt to keep interest rates from rising by excessive money creation.

As to tax policy, our economic goals would be better served if the so-called reforms were set aside and full attention devoted to enacting an early and well-structured tax cut. As to the shape of the cut, I see no convincing argument for increasing the progressivity of what is already a nicely progressive Federal individual income tax system. And the approximately $8 billion in gross busines tax cuts to directly promote capital formation is a bare minimum.

Indeed, business confidence would be significantly bolstered if the business cuts were, say, doubled, with the impact on the deficit minimized, if not eliminated or reversed, through "feedback" by phasing the reductions in over a period of years.

Congress' role in economic policymaking is never easy; it is especially difficult in 1978. Inflation must be attacked forcefully, but it cannot be eliminated overnight. Still, a credible start can be made.

Congressional identification of inflation as our paramount problem would in itself be highly beneficial.

I am convinced that markets would respond positively to this congressional initiative, thus setting the stage for the inevitably slow and torturous return to high output and employment without inflation.

Thank you very much.

Representative BOLLING. Thank you, Mr. Walker.

Congressman Long.

Representative LONG. Thank you, Mr. Chairman.

The enormity of the problem is, of course, obvious, as both of you gentlemen have clearly stated.

One small point. Mr. Duncombe, please give us the benefit of your expert opinion on how to draw the line between protection of the environment, on the one hand and being ridiculous with costly regulations on the other.

This is, perhaps, one of the biggest problems facing this country, and this generation, particularly when you consider the need to extract and employ our natural resources.

One of the things that the Joint Economic Committee is considering for recommendation in its annual report is a report from the Council on Wage and Price Stability on governmental activities, regulatory and otherwise, that have added to inflation, or that may have reduced inflation.

Those activities which have had a significant impact will be then examined in detail, one way or the other. They would be examined in detail and we would try to make a quantitative statement of the impact.

Since we are dealing with complex things, we have to look for complex remedies.

Perhaps this one is overly complex, but in your opinion, and in your experience, are there any advantages to this?

Would it perhaps improve public awareness, and perhaps also sensitize the Government to its impact of what it is doing on inflation?

Sometimes I don't think we are properly sensitized. Would you be willing to support such a recommendation? And, do you think that the business community would cooperate with the Council on Wage and Price Stability in trying to develop the estimates that might be necessary in this regard?

Mr. DUNCOMBE. That's a good question, and the answer to whether or not I would support a conscious effort on the part of some branch of the Government to make these inflation impact studies, I would answer that definitely in the affirmative.

I think that we need this. I think that it would help to focus attention. The one study that I believe the Council has made dealt with an element in our business, that is, the question of standards applicable to the light-duty trucks, and while they had to make that study very quickly, it nevertheless pointed, I believe, to a technique that can be profitably used in a great many areas.

You mentioned extractive industries and I surely believe the technique can be used there to give either ACCF or the Council of Economic Advisers or some other special group with expertise the responsibility for reporting to the Congress on the inflation impact of regulation.

With respect to your second question about whether the business community would cooperate, I think that you could count completely on business cooperation in this area with only one reservation that the business community would be reluctant to release proprietary or competitive types of data. But I think with that one exclusion, this represents an area where a very effective government-business cooperation is possible, is in the national interest, and would help us to put this very complex question in balance.

Representative LONG. In this regard, also, last year Senator Humphrey introduced a bill which would impose upon this committee the responsibility for analyzing the economic effects on employment, production, prices, and purchasing power of all major bills that are introduced in the Congress, something comparable to an environmental impact statement, really, in a little different light.

Mr. DUNCOMBE. Yes.

Representative LONG. Perhaps a little more extensive than the economic statement as presently construed.

What chance that bill has, I really don't know yet, but it is certainly a step toward making Congress aware of its effect in each instance.

One thing that concerns many of us—and the frustration of that concern is shown by something that has been happening—is that the statutes enacted by the Congress often result in something that the individual Members of Congress did not foresee at the time the statutes were enacted.

There are probably a number of reasons why this is so, but one reason is that the people in the regulatory agencies, when they start drawing the appropriate regulations for the enforcement of those statutes, tend to seek out the worst possible situation that could ever occur, and try to cover that situation in their regulations.

Second, the people who are in these regulatory agencies and drawing these regulations are basically people very interested in the particular field, and are greatly concerned about what that particular area is doing, either progressively or regressively, in relation to the American economic and environmental scene; consequently, they sometimes overextend themselves.

The extent that that has been frustrating is shown by the fact that over 200 Members of the House have signed a bill that would call for a legislative review of rules and regulations.

Now, that seems like a very good solution at the beginning, but when you start looking at the paperwork and start looking at the impact, the simplistic solution to a very complicated problem, it is really not a solution at all.

It may be something that causes more problems than it resolves.

But something does need to be done, in my opinion, and we need to address it, and to seek ways to make Members of Congress more aware.

Any contribution that could be made by the private sector in this regard—and I know that Mr. Walker, particularly, recognizes this problem—would be helpful.

One other short question, Mr. Duncombe. Almost all of our witnesses have singled out lagging capital investment as perhaps the weakest spot in the U.S. economic performance, and the President is, as all of us know, proposing a modest increase in the permanent investment tax credit.

How much will changes of this sort—and this one, specifically—affect General Motors investment plans, and when do you think this response to it would come?

Mr. DUNCOMBE. Well, I have always felt that the tax policies with respect to corporate income need to be stabilized.

What the business community needs most of all is to have a dependable planning base, making the investment tax credit permanent. I think this would be a step in the right direction.

Taxes alone, of course, are going to have an effect insofar as they improve corporate cash flows. They will enable business to make the investments that are required.

I think that from this point of view it is important.

I mentioned in my longer prepared statement a little more on this question than I referred to in the oral statement. The sort of investment programs, for example, that General Motors has scheduled from now into the early 1980's, I used a figure of $5 billion in my oral statement, will really stretch General Motors financial resources as they have never been stretched before, even assuming that we have a period of good business.

So, a permanent investment tax credit will help us to meet our problem.

I would like to add one other thing, if I might, in this connection: One of the disturbing things to me personally is that such a large part of that $5 billion will make virtually no contribution to improving productivity.

It is in large measure an investment being made to accommodate regulatory standards and in this particular case to accommodate to the fuel efficiency standards.

The contribution to productivity of these rather large investments entailing tremendous market risks as we have learned already this year will be minimal.

I guess that the fast answer to your question is that making the investment tax credit permanent will certainly be a step in the right direction.

Representative LONG. Thank you, Mr. Chairman.

My time is expired.

Representative BOLLING. Congressman Brown.

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

Mr. Walker, as one of my former mentors, and still my mentor, I guess, there is one statement in your prepared text that I think you might like to reconsider.

I think you said that there have been no tax increases since—when was it?

All I am suggesting is that there may not have been a tax rate increase, but I respectfully suggest that there has been a greater tax take on real income, and it has continued if not accelerated.

In fact, Secretary Blumenthal sat where you are sitting a while back, and I think he said in the year 1979—I could be off 1 year—that all of the President's tax reduction programs, if all were enacted, that at an income level of $17,000 it becomes awash, otherwise below that family income level you get somewhat of a tax reduction.

At $17,000, above $17,000, even with his reduction program enacted in full, you have a tax increase if you take into consideration social security taxes and basically inflation shoving you into higher brackets, et cetera.

Mr. WALKER. Could I agree with you on that?

I stand corrected.

Representative BROWN of Michigan. Would you like to comment?

Mr. WALKER. Yes, I stand corrected. The sentence should have read that there have been no legislated increases through increases in rates in traditional ways, no question about that.

Representative BROWN of Michigan. You know, in discussing with Secretary Blumenthal the other day the tax reduction package, it just seems to me that it doesn't go in the right direction.

I don't know what the figures are, you probably have them, but I would wager that when we talk about productivity, we are talking much more today about the productivity related to capital than productivity related to manhours of input.

If we look at that productivity, I would suggest that your productivity today comes in your more skilled activities because of the capital investment and capital worker contribution to productivity.

So, if you want to improve productivity, it seems to me it should be a general principle that you should enhance, if you can, those activities which possess the greatest potential for productivity increases through special incentives.

Therefore, a tax reduction, it seems to me, if you want it to result in more productivity, should basically be directed more at those who are in the middle to high middle income worker group since they are generally more skilled and contribute greater productivity. Because to the extent that a person is able to retain, under

a marginal tax rate structure, more of his earnings he will contribute more, he will have greater productivity.

That leads me to a further question. I noticed that you have talked about new models that you are using. It seems to me the econometric models that have been used to date really only look at the demand side without looking at what I think you characterize as feedback or supply side considerations.

What are you doing with those models?

What is different about the models you have been looking at and the ones now used?

Mr. WALKER. The major difference is they bring in the supply side factors that relate to incentives to work, save and investment, both from the standpoint of the individual and from the standpoint of the business.

For four decades we have lived in a world dominated by Keynesian views where mountains are moved and the motivator comes from aggregate demand; that is, your basic force for investment comes from demand and the so-called accelerator effect that is transmitted back to business. Business runs short of capacity and your investment is, in effect, pulled up by its bootstraps. Most of the existing models just look at one side of the equation—demand.

But as we learned in Economics I, people prefer more to less. If I were taxed 100 percent on my earnings I think that you would zero taxes out of me.

So, the basic theory and thrust of the model that are developing—and we hope will be ready in the relatively near future—would be to factor what we learned in Economics I—people prefer more to less, and if you tax more of something you will have less of it produced, and if you subsidize production, you will have more of it.

That is the basic thrust.

Representative BROWN of Michigan. Thank you.

Mr. WALKER. Incidentally, I just happen to have a press release on our new model, which I gave the Detroit Economic Club on January 9. It describes more in detail what the model is all about.

[The press release referred to follows:]

[For release 12:00 noon EST, Monday, January 9, 1978, Detroit Economic Club, Detroit, Michigan]

AMERICAN COUNCIL FOR CAPITAL FORMATION
Washington, D.C.

WALKER ANNOUNCES NEW ECONOMIC MODEL IN SPEECH BEFORE ECONOMIC CLUB OF DETROIT

In a speech today before the Economic Club of Detroit, Dr. Charls E. Walker, chairman of the American Council for Capital Formation, announced the construction of a new econometric model which is expected to demonstrate that carefully structured Federal tax cuts reduce Treasury revenues less than generally estimated—and, in fact, may increase them. "This is because," Walker said, "the new model will allow fully for the revenue feedback that results from increased incentives of individuals and businesses, with reduced taxes, to work, produce, save and invest."

The model is being developed under the direction of the nationally known economist, Dr. Arthur B. Laffer. Now at the University of Southern California, Dr. Laffer served earlier as economist in the Federal Office of Management and Budget and at the Treasury Department.

At the outset, Walker—a former Deputy Secretary of the Treasury and now a Washington consultant—stated that "this nation is confronted with an increasingly serious and potentially crippling problem—an impending dearth of the productive investment needed to help restore full employment, contain inflation, and balance our international transactions." He pointed to several supporting studies by highly respected authorities, and noted that both President Carter and Secretary of the Treasury Blumenthal favor business tax cuts to promote capital formation.

Walker said that press reports indicate a presidentially proposed business tax cut of $6 to $7 billion over the next few years, an amount that he labeled as much too small. Walker said that there are two major reasons for the inadequacy of the business tax reduction.

"First is the political factor. Most voters still believe the myth, propagated by the press and some politicians, that businesses can be taxed without affecting people. That's nonsense. All taxes are ultimately borne by individuals in their roles as consumers, workers, savers and investors.

"The second reason—and this is precisely why our new model is so important—is the often stated contention that the Government cannot 'afford' to lose the revenue because that 'loss' will swell an already huge Federal deficit."

In answering this argument, Walker pointed out that every Federal tax cut since World War II has been followed by a net increase—sometimes very large. Rather than a drop in Treasury revenue, businessmen have long believed that these revenue gains were not accidental, but instead resulted from the fact that the tax burden was too high and any well structured reduction in that burden would increase incentives, boost output and employment, and therefore enlarge taxable incomes of individuals and businesses sufficiently to more than offset the rate cuts.

Walker also noted that most existing econometric models fail to measure revenue feedback because they concentrate almost solely on aggregate demand, thereby all but ignoring the supply side of the picture.

"This is indeed unfortunate," he said, "because most introductory economics courses as well as common sense tell us that if taxes on a product are increased, less will be produced, and if a product is subsidized, more will be produced. Dr. Laffer's new model will correct this deficiency by emphasizing the impact of changes on incentives to work, produce, save and invest. The term 'supply-side model,' is used to differentiate this model from the widely used demand oriented approaches.

The model is gaining support in the business community. In addition, Senator Russell Long (D.-La.), chairman of the tax-writing Senate Finance Committee and a long-time critic of official revenue estimates which ignore feedback, has endorsed construction of the model. (See attached letter.)

Walker concluded: "I am not going to anticipate precisely what our new model will show with respect to Carter's tax proposals. However, I do believe that a $6 to $7 billion cut in business taxes—calculated by traditional revenue-estimating techniques—will not 'lose' anything like that much revenue. Indeed, if history is any guide, the Treasury, within a year or two, will come out ahead of the game. If I am correct, business taxes—which are really taxes on individuals—should be cut at least $10 billion and preferably much more."

Information about the new model can be obtained from the American Council for Capital Formation.

Attachment.

UNITED STATES SENATE,
Washington, D.C., December 5, 1977.

DR. CHARLS E. WALKER,
Chairman, American Council for Capital Formation, 1425 K Street, N.W., Washington, D.C.

DEAR CHARLY: As you know, it has been apparent to me for some time that the revenue estimates of tax changes generated by the well-known and widely-used econometric models have a way of being very far off-base because of their failure to anticipate everything that happens. Therefore, I am very pleased to learn that the American Council for Capital Formation's "Center for Policy Research" is planning to sponsor the development and production of an econometric model which will generate revenue estimates more in line with reality by bringing supply considerations directly into the model's assumptions.

I do not believe that the econometric models currently in use pay enough attention to the effect of incentives on the willingness of people to work, produce and invest. These supply factors are vital to obtaining revenue estimates which truly measure the impact of public policy alternatives on the future growth and prosperity of this country. Adding equations to existing models is not the answer. New and innovative research, such as the Center is proposing, is needed so that the effect of public policy alternatives can be more correctly anticipated.

I hope you will keep me and my staff informed as work progresses on the Center's econometric model.

With warm personal regards, I am

Sincerely yours,

RUSSELL B. LONG.

Representative BROWN of Michigan. Mr. Duncombe, I was interested in your discussion about regulations with my colleague, Representative Long.

There is this great push to have the Congress review all regulations, et cetera, and many other proposals have come forth.

We now have a requirement that a committee must provide at least a statement of the estimated cost to the Government of different legislation when it reports its bill to the House.

Some have suggested, as I have suggested, that every time an agency promulgates a regulation, a proposed regulation, it must, in addition to asking for comment or permitting comment on the substance of the regulations that the agency would have to state what it estimates the cost to Government to be of that regulation, plus cost to the private sector or those regulated as such.

Those figures would be subject to comment just as much as the regulations themselves are subject to comment.

Now, it seems to me that that is a much better approach than putting the Congress in the business of administrative rules and regulations review because what you do under that kind of approach is you say to the private sector or nongovernmental sector, this agency is proposing to promulgate certain rules, this is what it says it will cost, and what is your comment on those things.

Then, it seems to me, the proper function of Congress is to make sure that the agency considers, honestly considers, the comments made not on just the substance of the regulations, but on the fiscal and economic impact ramifications of the regulations.

I am inclined to think that when a proposed regulation is open for the comment period, it is only a courtesy extended by the agency and as Senator Moynihan would say, benign neglect is paid to the comments received.

Maybe we should have some mechanism where agencies must respond to the comments, answer the comments. Would you care to comment?

Mr. DUNCOMBE. Well, Congressman Brown, that would make very good sense. When Congressman Long mentioned the task of the Congress taking on this review by itself, I would think the Congress would be swamped by that process.

Requiring the agencies to do it, and opening it up to what the agencies say about costs and benefits, about the alternatives that they have explored, it seems to me would be a very useful way for the Congress to get this information in capsule form, get it distilled and be able to arrive at some judgment on it.

Increasingly, too, the problems are becoming more complex because many of the issues today deal essentially with marginal costs and marginal benefits.

It is a question of if you increase this standard by 10 percent, what will it cost to achieve that and what will be the benefit relative to that cost.

The issues are becoming very complex. I am very certain that the concern of the business community over these issues is so intense today that you would find the business community anxious to participate. From my point of view and I think this would be an entirely General Motors point of view, the opportunity that this would provide us for a more cooperative business-Government analysis in areas of great concern to both, would be welcomed.

I think that we would like to do it and I think you would find a very affirmative response on the part of business.

Representative BROWN of Michigan. Doesn't it seem to you that we have lost sight of what I always thought was a very fundamental thing, for lack of better words, the equationary theory of government.

With FDA, we have aspirin on the market now without any limitations pretty much on its use. Why? Because FDA, with respect to every drug, applies an efficacy-hazard test, that is, what is the level of efficacy versus the level of hazard.

When hazard goes up and efficacy comes down, you get labeling and if hazard gets too great, it comes off the market.

It seems we should do that with respect to Government activities. Look at the cost-benefit equation. The whole thing is that we should look at everything from the equationary standpoint and we don't.

Mr. DUNCOMBE. Sure.

Representative BROWN of Michigan. We have overriding determinations—determinations that override any kind of an evaluation test, it seems to me.

You cited some figures, Mr. Duncombe, earlier in your remarks. You said that 5½ to 8 percent, as I recall, of all capital investment was for pollution and waste abatement capital expenditures.

Mr. DUNCOMBE. Yes, sir.

Representative BROWN of Michigan. Now, I am wondering, if you applied the ratio only to new capital, not replacement capital, but new capital because scrubbers and those kinds of things are new, they are not replacements, I would be surprised if that figure wouldn't be higher than it is.

I think if you could categorize separately new capital expenditures, not replacement, that that figure would have to be a lot higher.

Mr. DUNCOMBE. Well, I would have to——

Representative BROWN of Michigan. As far as new productive facilities, vis-a-vis the cost for pollutant abatement and waste——

Mr. DUNCOMBE. Yes, of course, the capital expenditure figures we get are annual figures.

Presumably, it is all in one sense as new investment. I think I understand what you are referring to here. We could take a look at that and see if we could refine the base figures.

A scrubber that is put on a smokestack is, of course, new investment, just as a new plant is brand new investment.

It might be hard to distinguish this, but I think that if we look at capital expenditures in terms of the priorities that are going on, and I mentioned in my prepared statement the opportunity cost of this investment, we would find it is extraordinarily high.

We will try to do more work on this.

Representative BROWN of Michigan. Thank you. My time has expired, gentlemen. Thank you very much.

Representative BOLLING. Senator McClure.

Senator McCLURE. Thank you, Mr. Chairman.

Just to follow on that latter one for a moment, you have suggested—I think both of you in your statements or at other times—using a faster writeoff of costs by way of investment tax credit.

I think General Motors has in the past, and I think you have, Mr. Walker, talked about depreciation schedules.

Should we be looking at permitting replacement cost depreciation?

Mr. DUNCOMBE. Do you want to answer that?

Mr. WALKER. I will comment on it.

Mr. DUNCOMBE. We both can comment, I suppose.

It is a very intriguing notion. You know, the SEC now requires as an adjunct to our reporting to the SEC to prepare replacement cost analysis and it is surprising the difference in the results that you get.

For example, last year when we reported on our 10-K form, we reported that on an original historic cost basis our plant and equipment had a value of $5 billion, a little over $5 billion, on replacement cost basis it had a value in excess of $11 billion or something over two times.

Now, of course, we are depreciating our equipment on the basis of initial figures, $5 billion.

Senator McCLURE. We all assume that when that equipment wears out, you will replace it with another unit to do the same job in order to stay in business.

Mr. DUNCOMBE. Sure.

Senator McCLURE. But having recovered—written off the capital cost, you have to add to it another amount of capital equivalent to the original investment, that is what your figures tell you.

Mr. DUNCOMBE. That is what these figures would cite.

One of the consequences of this is that, of course, our profit figures and every corporation's profit figures are vastly overstated in terms of rate of return on investment, because just replacing this equipment will cost us twice as much.

I hesitated in my answer because I know how complex it is to measure the replacement cost of capital and I know it is also true that you do not replace all of your capital every year.

So, the problem of interpretation becomes very difficult. I have spoken with a great many accountants who have struggled with this problem and, of course, they bring up all the technical difficulties, but the principle that you are referring to is right.

Now, whether it could be administered and administered effectively, I don't know. I don't know that anyone has it.

Mr. WALKER. I would like to say, first of all, that this adds another important dimension since our depreciation rates—our rates of capi-

tal recovery in business—are so much lower than among our major competitors abroad In this respect, I know that you as well as I are very worried about the $27 billion trade deficit.

To the extent that the deficit results from the energy situation, we don't see signs that we are going to make great progress in the near future. Therefore, we have got to put tremendous effort on making our goods more competitive in world markets.

Now, with respect to capital recovery and depreciation, really the bottom line is the important thing—not bottom line in a profit and loss sense, but bottom line in terms of speeding up capital recovery, getting closer to the rates abroad.

You can do it through replacement cost techniques, but you get into arguments all over the place with accountants and theoreticians and others on that.

You could simplify it through just an indexing technique which would probably be much simpler than the replacement cost technique.

If we admit that our system of taxing business in this country doesn't make a dickens of a lot of sense—as I say, we don't know the incidence of the tax—but the tax purists seem to want to take this overall lousy system and make every moving part within it fit. Then talk about "class lives" being 15 years or 16 years and all this and that.

I say to heck with all that. Let's just simplify and strike through to the bottom of this thing.

There are two approaches, one that is pie-in-the-sky I know we are not going to do it—let business write off whatever rate is wants with a full recapture provision.

Senator McClure. That is the provision of law in other countries?

Mr. Walker. I think United Kingdom has gone to the immediate writeoff. You have a full recapture provision and it would depend on the business time preference as to which direction it would take.

A simple start in this direction, which I believe has been recommended by business groups such as the NAM and the chamber, you could go to immediate writeoff for mandated investment, 5 years for equipment, and 10 years for structures.

You ask what is the logic of that in terms of tax theory. I don't think it has to be logical in that sense.

It moves you toward the bottom line—faster capital recovery—in a simple way.

Senator McClure. You mean it is no more illogical to you than the structure itself?

Mr. Walker. Yes, sir.

Mr. Duncombe. Oh, yes.

Senator McClure. You both have stressed the mandated investments and what they do to return on investment, cost of production, and rates of productivity.

You, Mr. Duncombe, indicated that a high percentage of your future investment, your investment plans, are going to be associated with fuel efficiency standards.

What is the cost of—if we don't go that way—increased imports of foreign oil to our economy and how do we as policymakers weigh that kind of tradeoff?

Mr. DUNCOMBE. Well, I personally think that much of this investment GM is making is required. How we weigh this, I don't know.

I have felt that the problem of reducing our dependence on imported oil was importantly a matter of improving our supply, our domestic capability to furnish energy.

In this connection, I have strongly endorsed a market approach to energy pricing, both because of the incentives it would give on the supply side, which Mr. Walker has mentioned, and because of its conservation capability.

We will make these investments and my only point was that we are convinced that meeting the energy problem is important and we think that consumers will require this.

The point is that it will not improve our productivity and it is going to add substantially to the cost of future vehicles, not only the downsizing of our cars, but also the safety requirements that are now mandated, and the higher emission standards that are mandated.

Senator McCLURE. Thank you.

Mr. DUNCOMBE. That is a good question. It is the sort of a lead question that I think we need to study much more and all I was giving you was GM's evaluation of where the answer came out, that the downsizing that we are going into is essential.

Senator McCLURE. Recently, Mr. Otto Eckstein submitted testimony comparing two ways of stimulating a given amount of investment.

One was a way to cut corporate tax rates or raise the ITC. The other was to speed up the growth in money supply that Mr. Eckstein predicted that the tax cut method would reduce inflation by a percentage point after a few years, but that the money supply method would raise inflation substantially.

Is this a reasonable prediction?

Mr. DUNCOMBE. Yes, sir. I think it is.

Taxes are bound to show up. They are bound to be a part of the price of the product somewhere or other.

Senator McCLURE. Could we generalize from this and say that we can use a carefully designed tax policy by reducion in taxes to stimulate growth in jobs while keeping a moderate monetary policy gradually to bring down the rate of inflation?

Is that the direction we should be taking?

Mr. WALKER. That is the basic thrust of my testimony Senator.

Mr. DUNCOMBE. I would certainly endorse that completely, sir.

Senator McCLURE. Thank you.

Representative BOLLING. We have been in hearings now about a month. I have been at almost all of them. I really set up this panel, which has been very interesting, but we have missed through illness one of the members who was supposed to have a different point of view.

The thing that begins to disturb me is that I may be right in what my intuition told me quite a while ago, that we were no longer talking to each other on the same set of facts, that we needed somehow or another to get back so that we stipulated, after long and agonizing argument, what the facts were.

For example, Mr. Walker talked at length about inflation and how we had seen too much money chasing too few goods, in effect, with a rather loose approach to the money supply, at least implying a very large growth in the money supply over the period that we are discussing now.

I am hesitant to mention dates, but let's just pretend that is was 1972 to 1977.

Now, my reading of the facts, my way of reading them, is that the real money supply from the end of 1972 to the middle of 1977 shrank and that could hardly be described as an excessive growth in the money supply.

I am not suggesting for a minute that you want to mislead me or I want to mislead you but for reasons that are not necessarily bad reasons, we end up behaving as if we were artillery commanders, a little bit behind the lines, shooting over each other's heads to way behind the lines.

Now, I don't know whether there is any hope of finding solutions unless somehow we begin to argue on the same set of facts.

Now, it would be ridiculous of me to suggest that that could happen, given the atmosphere that I think prevails today, if I had not lived through a long period when it did.

When I first went on this committee, which is a very long time ago, the people that ran it were people like Senator Taft, and Senator O'Mahoney, Senator Douglas, Senator Flanders, and usually before we got to our annual report, we would sort of stipulate among ourselves as to what we were talking about instead of shooting over each other's heads.

Now, I have a question to both of you. Is it possible, not for Government as some kind of a disembodied spirit—because Government is, after all, the product of a political process and it is representative of the people and, as such, it has a slightly different set of interests or is the composite of all the interests, which ever way you want to put it—is it possible for Government in this country to encourage, to lead, to do whatever, to get the various interests that are not talking to each other on the same set of facts, together in such a way that we might actually get again the kind of cooperation that we got out of management and labor and agriculture—as well as the associations and organized groups who spoke for them—in the period right after World War II, when they made decisions that were ratified by Government and then served the country rather well?

I am not going to go into any specific detail but, Mr. Walker and I have understood what was going on in the same area on energy today, and there has never been a time when that kind of an approach was taken by the whole community in dealing with the problem.

It has been a series of interest contests in political arenas. Now, I don't know whether I make myself clear or not, but I am just curious as to whether either or both of you think it is possible to get to the kind of situation without even arguing as to whether I am right, that we were there for a while in the late 1940's, in the 1950's, and probably even for a while into the 1960's.

Is it possible for us to get back to that?

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Mr. WALKER. I don't know, Mr. Chairman. You and I have talked about this off and on. You would remember the dates better than I but I think the first minority report of this committee was filed after it had been in existence how many years——

Representative BOLLING. A good many, I forget at the moment.

Mr. WALKER. The committee was established by the Employment Act of 1946 and the tradition was to talk to each other and I presume proceed from the same basis of assumption and fact and come out with, if not unanimous, at least a consensus report.

It is not something in my judgment that is perculiar to this particular committee or this particular problem.

It is broader in the sense that we may have fallen into an assumption that you can make the process of Government work best through a constant adversary relationship.

Once you get into that sort of situation—given the vast body of law that we have, given the point that Congressman Long made, about what the agencies were doing and how do we make sure that they do what Congress wants, and the courts come into the picture with respect to snail darters and things of that type—I tend to come out rather on the pessimistic side. Or rather I tend to come out saying that until there is a recognition that the adversary approach can be highly counterproductive and we move back toward trying to develop in a spirit of good will, a consensus in these areas, that we are going to continue to have trouble.

In terms of a specific which you have seen in the press, I am sure recently, on the energy side, the work that was done under the good offices of the Georgetown Center for Strategic Studies on conferences and discussions with respect to coal. They brought in so-called environmentalists, producers, experts from academia and so forth, and after sort of circling each other warily for a period of time, they are developing a consensus. That's good.

That is not in any means a definitive answer. I can't let pass, though, one specific comment in terms of the growth of the money supply, and I think this is something you will want to talk about within your committee and with your staff. You referred to the real money supply declining over the past decade or so.

I think it is vitally important to talk about the nominal money supply which has grown according to Federal Reserve of St. Louis figures, since 1971, if you include net time deposits, in the general range of 8, 9, 10 percent.

I am not certain that I recall this correctly but I think from reading the classic book on inflation, written many years ago—and I read it many, many years ago—in Germany after World War I, by an Italian economist, that there were times then when you probably had, despite a rate of monetary growth of tremendous dimensions, thousands of percent, velocity was rising so fast—the workers would take the marks in the wheelbarrows down to the store to spend them before their value went down—that the real money supply declined.

I think you have to look at the nominal money supply. Still your basic question is very important.

Representative BOLLING. I think that is very important but I cited that because it is simply an easy way to illustrate—and you have

just done it—the necessary of definition so that there is a common understanding.

We could pursue this in a different area, in energy, and I think we could have sort of an amusing time because we probably both know exactly what is happening and both know how difficult it is to break through once people locked into political positions, and probably each of us or all of us would like very much to get a solution and probably each of us or all of us have had something to do with setting up a situation where we can't.

I am prepared to admit that, having had a good deal to do with the bill in the House.

The dilemma, it seems, I happen to believe that all of these things are urgent enough so that our inability to break through to the best solution or really a good solution without regard to the adversary proceeding may mean that we will fall victim to the old Benjamin Franklin adage, which says in effect if you don't hang together, we are going to hang separately.

That is why I raise this completely general political question at this particular time.

I planned to all along, but I am interested in the reply because I think we have got to do it and I think we have got to do it in a matter of a very, very few years or this whole bloody thing is going to get away from us.

I apologize for the generality of that comment, but I think it is specifically accurate.

Congressman Long.

Representative LONG. I hate to go back to mundane matters after that. [Laughter.]

I have just finished reading, Mr. Walker and Chairman Bolling, something that is very interesting.

I have been reading "The Futurist," which I picked up at an airport somewhere, New Orleans or somewhere recently.

It is edited by the man who wrote "Future Shock," Alvin Toffler, but it is a series of articles or chapters from books relating to this basic question of what's going to happen in the future.

One of the most interesting chapters in the whole book is by Margaret Meade. She is talking about the ability to come to grips with the issues that are facing us and how, over the relatively short period of time in the last few years, that we have moved from dealing in and learning from our elders to finding our own way, to where in her opinion we have got to look for the answers to our children.

She even goes so far as to say, and I am oversimplifying this, that as we find ourselves now living in a time or of a generation which, from the learning process, has no parents and from the process of an ability to teach our children that they are children who themselves have no parents.

The breakoff is right there. It is a very, very interesting article, along the lines of what Chairman Bolling is talking about, but carrying it one step farther with respect to that.

I recommend it for some deep 1 to 4 a.m. reading when you can't sleep. It is very, very interesting, and I think it bears on this point of an ability to come to grips with the issues, and the thrust is that we are really able to get them in the proper context.

Chairman Bolling and I both serve on the Rules Committee on the House side, which gives us perhaps an overview that a lot of people don't have the opportunity with a seat in Congress to operate in.

This continually presents itself. I know I am as concerned about it as he is and a lot of other people.

The one little point, if I may, Mr. Duncombe, I would like to cover, if I remember your figures correctly, approximately three-fourths of GM's cost of compliance with these regulations, the new regulations that have been put in relate back to the auto safety regulations.

Is my recollection of that approximately correct?

Mr. DUNCOMBE. I think we have some figures in the attachment to my prepared statement that bear on that. It is a high percentage, take three-fourths and I will try to confirm that.

Representative LONG. In your extemporaneous brief remarks, you said something that I was not sure I understood but I came out with the conclusion that you had said that in many instances this capital investment from your own personal point of view—and I gathered you were not there necessarily reflecting the view of General Motors—that in most instances these were necessary.

Mr. DUNCOMBE. What I was speaking about there, I think I was talking about the downsizing of the vehicles for energy purposes.

Representative LONG. I am sorry.

Mr. DUNCOMBE. I think I was talking about the downsizing of our vehicles in order to achieve a higher fuel efficiency.

Representative LONG. That has been a substantial part of the cost; has it not?

Mr. DUNCOMBE. It has been a substantial part, and it promises to be a major part.

Looking to the future, we will have a significant part—I don't have the numbers here—but meeting the new passive restraint system on cars will be an additional very large expenditure.

Representative LONG. Let's pursue that point with respect to safety regulations for one moment.

Mr. DUNCOMBE. Yes.

Representative LONG. Putting it in the context of your views with respect to the reduction in the downsizing of the engines——

Mr. DUNCOMBE. Yes.

Representative LONG [continuing]. Do you feel that the Congress and the regulations that have resulted from the congressional acts have been excessive with respect to the auto safety regulations and, if so, what is your general feeling with respect to which ones have been excessive?

Mr. DUNCOMBE. These are all areas I would like to see tested.

I think that the various proposals for the passive restraint system have not been tested in terms of cost-benefit analysis. I would like to see this done prior to the new administration of them. We had proposed this with respect to the passive restraint systems and one of our competitors had agreed to this also, to run an experiment on passive restraint systems involving about 500,000 vehicles so that we could get a feel for the cost effectiveness of passive restraint systems versus the other systems.

That proposal was not put into effect.

Now, what we are going to do in GM is introduce, on a partial basis, a passive restraint system in advance of the mandatory system in the hope that we can get some better data base for judging whether or not these systems will be cost effective. And this gets to my point, I think that a sensible approach in all of these areas is to insist upon some better documentation of what the benefits may be and what the costs may be, and what other side effects that we don't forsee. Because we are starting with something that is out there, we ought to be doing this testing before we say to the American consumer from now on you must pay for a passive restraint system.

This is where I come out. Without judging anything that has been done in the past, I think that with respect to the future we should insist on this because we know very well that the cost of complying with these regulations is just skyrocketing.

Representative LONG. We find ourselves even in this small limited matter that we are discussing back to the same basic problem that Chairman Bolling outlined so eloquently, that until such time as we can find out what the problems are, and what the costs of resolving these problems are, there is basically no way to find an acceptable political solution to those particular problems.

Mr. DUNCOMBE. We simply don't have the data.

Somebody commented that we are making $1 billion decisions on a 25-cent data base, and it is not always a matter of our shooting missiles over each other's heads on the data front; it is simply that we are all coming to the problem without an adequate foundation of fact.

Representative BOLLING. If the gentleman will yield, that answer, I think, is a perfectly valid answer, but one of the dilemmas that Government runs into, particularly in dealing with those who are big enough to plan carefully, is that they resist very violently to Government planning at all, as best I can figure out.

Any suggestion that we approach our task through a degree of planning terrorizes a large number of people in this country with the belief that we are now proceeding to go to something like socialism or communism or what-have-you, when really all those of us who push planning for government are suggesting is that it might be a good idea if we thought about what we did.

Mr. DUNCOMBE. Certainly, I can't oppose that. I think the business community is concerned because so often planning, national economic planning, is viewed as a further intrusion into the private sector of the economy. And if I may add, Mr. Chairman, just one further point, I would like to go back to your philosophical question for a moment and the change that has taken place between the 1940's and today.

We, I think, are asking government today to do a multiple of 10 or 15 times the number of things that we were looking for government to do in the immediate postwar years.

Many of the questions that we are asking ourselves are futuristic. The traditional economics, of which I am a part, had normally responded, the market can resolve these issues, the market can and should be permitted to function.

The allocation of our national resources was based upon the signals that came out of the marketplace. We have been moving increasingly,

and possibly unavoidably, to superimposed signals upon the marketplace—government signals—and these are future looking.

It is very had to get a body of facts upon which we or people can agree in this area because it is future looking and I think that this is the conundrum that the Congress and people in the private sector are wrestling with.

We are asking Government to do so much more and we have superimposed Government upon the marketplace with outcomes that none of us is able to predict.

Representative LONG. Thank you, Mr. Chairman. I have no further questions.

Representative BOLLING. Congressman Brown.

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

Mr. Walker, in your statement you used the classic definition of inflation as being too much money chasing too few goods.

I have always thought that we kind of separated the demand-pull inflation from cost-push inflation.

In this time of full employment, is it the demand for additional workers that is pulling up wage settlements. In this time of our 105-percent utilization of our plant capacity, is it the demand on an already fully utilized plant capacity that is pulling up prices?

I don't think you believe the facts I assumed. I don't think you will say that the classic definition fits all inflationary situations.

Would you care to comment?

Mr. WALKER. Yes; I would like to comment.

All I was stating was a truism, the old-fashioned equation of exchange: Money supply times its velocity equals price level times goods traded or produced.

The tendency in the last couple or three decades has been to talk about demand-pull inflation versus cost-push inflation. In my judgment, that has performed a disservice as far as analyzing the basic roots of the problem are concerned.

I tried to hedge a little bit by talking about the proximate reason for inflation being excessive monetary growth in the nominal terms over the period that I was talking about.

Perhaps I can best make my point clear by assuming a situation similar to the past couple of years where clearly you have had underutilization of the labor force, and also plant and equipment, although I don't think at the present time the 83-percent rate is all that much below the level we want.

If under those circumstances—and, incidentally, thus far, as I understand it, wage increases really haven't gotten way out of line in terms of the cost-push situation at current inflation rates—but if——

Representative BROWN of Michigan. I am talking about those two points you were talking about, the six plus one, plus two, that makes it nine.

Mr. WALKER. And I was on the chapter of Mr. Long's book on futurism—worried about why it has not happened and why it is not sustainable over that period of time as workers strive for the extra points that are not there in real terms.

I don't think we have come to that point at the present time, although we may be very close to it.

Let us just suppose that because of market power—let's just talk about labor now, although we could bring other groups into it—but, because of labor's market power, wage increases are forced considerably beyond the range that can be supported by productivity increases.

A good example for an analytical purpose to show the other side of the coin was the period 1958 to roughly 1966; at least from 1960 after the depth of the recession. We had an increase each year of 4 percentage points or so in wage increases, and we enjoyed about a 4-percent increase in productivity, somewhere in that range, so that unit labor costs were stable over that period.

Economically, it was a very good period. If now we move into a situation where the wage increases are so excessive that unit labor costs constantly go up, 4, 5, or 6 percent a year, unless you have an accommodating monetary policy that creates the wherewithal to finance that higher nominal value of GNP that these higher wages would require, if you keep the money supply under pretty tight rein, the answer is that those people are not going to be able to find jobs.

So, I stick with my basic definition. In our political system, the driving force for inflation can come from the cost-push side in that the pressure is on the Federal Reserve to accommodate and make enough money available so that there will be enough jobs to go around. In our political system, cost-push is inflationary.

If you had a dictator that could control the money supply and didn't care anything about human values or the level of unemployment, et cetera, that increase in cost alone would be deflationary. In fact, any increase in cost is deflationary, but our political system will not let it be deflationary, nor would I in human terms, so we are accommodative to the greater monetary growth necessary to keep unemployment down even though wage increases outrun productivity gains.

I hope that reply is not convoluted.

Representative BROWN of Michigan. No. I understand. You are saying that what may be cost-push forces in our economy result in greater demands on money supply, so there is a demand-pull overall.

Mr. WALKER. The question is: How does cost-push get transmitted into greater monetary growth? It doesn't happen automatically; it is through the political process, the process of spending more, and the sized deficits which we will not finance completely out of savings, but to a large extent of money creation.

We end up in the same place.

Representative BROWN of Michigan. I understand what you are saying.

The tendency is for the cost-push to end up with the demand for greater monetary growth; so it is a demand-pull once again in your statement.

Mr. WALKER. Or demand sustained.

Representative BROWN of Michigan. All right.

I was interested in your kind of academic discussion with the chairman about planning and how it fits into Government.

It just seems to me that today, when we talk about long-range planning, effective planning, we who sit in these marble halls view

it as Government planning dictating a course of action for the private sector instead of the Government attempting to appreciate and accommodate the private sector.

I think that is what some of us worry about. We are all in favor of long-range planning. Our concern is with the role that is played by Government in that planning.

Not necessarily related to that, but a thing that has bothered me, Mr. Duncombe, is that when we talk about these different regulations and the uncertainty in government and the private sector attempting to react timely, it seems to me—that uncertainty causes oftentimes the private sector to get into an activity that almost dictates government policy and it cannot be withdrawn.

Let me be the devil's advocate for a second. I remember back when we were discussing the catalytic converter. I don't think there is much question by what GM got so far down the path in investment and R. & D. in the catalytic converter that it could not very vociferously support Chrysler's opposition to the catalytic converter and the unreal emission standards.

Now, maybe you can say that was a necessary investment but it seems to me such a commitment almost predetermines the result.

Possibly a different result would have obtained had you come in as strong and had worked for a different solution to the emission control offered by the catalytic converter. But, having made the investment you did, you were almost committed to that path.

You don't have to respond specifically to this, but isn't government uncertainty very possibly going to lead to that kind of commitment in the private sector?

Mr. Duncombe. Oh, I think so. This opens up a very interesting area of technology assessment, which is one that intrigues me.

Very often we establish a standard before we know how we are going to be able to reach it.

Now, in the case of the emission controls, standards were set before we really knew the alternative tradeoffs or alternative approaches that we might use. Our research supported the catalytic converter, and we came down and spoke strongly in favor of the catalytic converter.

I think that this is a healthy give and take when you are in an area of uncertainty, provided that you have decided that achieving a certain level of automobile emission control is absolutely essential, then this healthy tension that gets created is a good thing.

The problem arises when we don't know what the standards are going to be on the one hand, what the cost is going to be on the other hand, and what the benefits out of it will be.

It took a great deal of soul-searching, and Tom Murphy, for example, has said, and I think Pete Estes has said the same thing, that we plunged ahead and installed the catalytic converter on our cars across the board, something we had never done with any technology before, because it was required by the law.

Now, normally that catalytic converter would have been put through a series of tests. It might have been put on a test line of cars, and we would have known what some of the tradeoffs were. We would have known whether the sulfate problem was a serious prob-

lem or whether a grassfire problem exists; these would have been analyzed.

I think the problem here was that we pushed ahead in order to meet the requirements of the law and we took gambles that in the normal course of a commercial operation we would not have taken.

We would have tested this just as we are trying now to test the passive restraint systems.

Now, as far as a commitment to the technology is concerned, it is true that we believe that the catalytic converter was the best way, it wasn't simply because we made an investment or because we have to write them off. Our research demonstrated this was the most cost effective tool.

I don't know whether I have answered your question.

Representative BROWN of Michigan. Well, yes and no, I guess.

You made that decision assuming that the standards were going to be adhered to and since you had come up with a partial solution at least, the catalytic converter provided a start in meeting the efficiency standards originally imposed——

Mr. DUNCOMBE. That is right.

Representative BROWN of Michigan. So the question is: Would the efficiency standards have been set back a little more if there had not been a viable alternative such as the catalytic converter?

I think that Chrysler's argument was that we should not go part way at this time because we are not going to be able to achieve the standards until we have that better system.

Certainly, the fact that you had a substantial capital investment in that area may have had some little impact on it.

Mr. Walker, let me get back to you.

It seems to me that one of the areas, when you look at the corporate books, that is a real critical area, is the depreciation reserve or replacement cost, that whole dilemma.

You rather flippantly, I thought, cast aside or only suggested in passing the idea of indexing.

If that is not the route, what is the route to take if you are going to do something to take care of Mr. Duncombe's problem of having to replace a $5 billion capital asset with $11 billion replacement cost?

Mr. WALKER. Well, I didn't mean to be flippant. I said that if you were to agree with the basic point that we need to speed up capital recovery, you could get there in several different ways and indexing is a simpler way, much simpler way than the replacement cost approach.

I would be in favor, however, of—as in my colloquy with Senator McClure—simply saying, "Look, we are going too slow; let's speed it up by a significant amount by saying write off in 1 year the mandated investment, equipment in 5 years, and structures in 10 years."

It is not elegant. It is not pure, but it will help get the job done.

Representative BROWN of Michigan. Then that is your preferred way of doing it?

Mr. WALKER. What, indexing?

Representative BROWN of Michigan. No. Your preferred way——

Mr. WALKER. No. My preferred way is the simple approach.

Represenative BROWN of Michigan. The latter, mandated 1, equipment 5, structures 10.

Mr. WALKER. Given the political concept, my preferred approach is to let everybody depreciate the way he wants to and have full recapture provisions.

Senator MCCLURE. Would you yield?

Representative BROWN of Michigan. My time has expired so it is yours anyway.

Senator MCCLURE. When you say "fully recapture provision," you are alluding to the fact that the depreciation only defers the collection of tax. It doesn't avoid the payment of tax.

Mr. WALKER. Yes, sir.

Senator MCCLURE. And you are just trying to—I think we will need to say for the record that the depreciation schedules do not avoid taxation.

Mr. WALKER. Yes, sir. I would make that point very clear. I am just saying that if the fellow sold the asset shortly after writing it off, you would recapture the difference at the regular rate instead of capital gains rate.

Senator MCCLURE. The President has stated that he is against wage and price controls. I think every administration witness stated their dislike for wage and price controls.

Yet the polls show that businessmen feel there is a good chance that controls will be placed on the economy. From your conversation in the business community, do you feel that the businessmen feel that controls are coming?

Mr. DUNCOMBE. Well, let me say they are always worried about that, whether they feel that the probability is high I would doubt.

I think that the business community feels that the experience with price and wage controls has been such an abysmal failure in the past that it is very unlikely—except in a real crisis—that we would have to revert to them.

Senator MCCLURE. Is that a firm expectation or statement of a wish?

Mr. DUNCOMBE. Well, I think it is—of course, it is a wish, but I think it is a high probability view that we will not get controls.

Senator MCCLURE. Is that shared by other businessmen, generally?

Mr. DUNCOMBE. Those I know of, yes, sir.

Senator MCCLURE. Mr. Walker.

Mr. WALKER. There is a great undertone of concern. I don't want to be flippant, but it is like the piece of doggerel: "Last night I saw upon the stairs, a little man who wasn't there. He wasn't there again today. Oh, how I wish he would go away!"

Many businessmen look at the main thrust of the administration's anti-inflation plan, if you can call it that, and it is in terms of getting cooperation, quote unquote, from labor and business with respect to wage and price decisions.

Second, I think there is a realization on some businessmen's part that memories are pretty short and this very unhappy experience with controls after 1971 might not look all that bad, say, in 1979 and 1980, if you take the worst-case scenario.

I can draw you a worst-case scenario of a peaking out of an inflation expansion, say, in 1979 resulting in stagflation with a vengeance.

The possibility—not the probability; I am taking the worst case—the possibility of double-digit inflation combined with near double-digit unemployment. If something like that were to occur as we move into the year to 15 months preceding a national election—if we were very unlucky, as we were back in 1973 or so—and the consumer in particular was seeing prices go up at the supermarket every week. Well, you gentlemen as politicians know how this sort of thing works itself out within the family. It is not so much that the head of the household picks up the paper and says, "Oh, my goodness, the Consumer Price Index is going up at an annual rate of 11 percent a year."

No, the family is sitting around the dinner table Saturday night and griping about hamburger too many times a week. And the person who spends the money says, "I don't have enough money to go around."

In 1971—I was right in the middle of it as Deputy Secretary of the Treasury—we were under tremendous pressure to put in wage-price controls from all spectrums almost of society, consumer, business, and so on.

If we move into late 1979 and 1980 with very high inflation and very high unemployment, I can see where controls might be reinstituted. There is some fear of that in the business community.

Senator McClure. Is that fear great enough to weigh in their decisions today?

Does it cause businessmen to hesitate in making commitments that they otherwise might make?

Mr. Walker. It is one of a number of factors that causes uncertainty and, therefore, the tendency is to take the safer course.

I serve on the board of directors of a relatively small corporation. When projects come before the board of directors—let me put it the other way around—much of each board meeting is devoted to a grilling of me as to what I think Government is going to do as to inflation, trade, and so on.

Representative Brown of Michigan. Would the gentleman yield?

Senator McClure. I would be happy to.

Representative Brown of Michigan. BLS is coming up with a new system of computing CPI. As I understand it they will run them side by side for 6 months and the new system will take over entirely.

Do you have any comment or opinion with respect to the changed formulation, what it will do if it tilts one way or the other?

Mr. Walker. I don't, Mr. Brown, I don't.

Mr. Duncombe. I am sorry, I don't, either.

Senator McClure. Could you briefly, each of you, give me your assessment about whether or not we are operating at or near full capacity?

There has been a lot of discussion about what the unused capacity is in our economy, and I would like each of you to give your opinion concerning that.

Mr. Duncombe.

Mr. Duncombe. Well, the 83-percent capacity figure, which the Federal Reserve Board publishes, is fairly close to the point where you normally begin to find a trigger for increased capital venture.

In other words, that is generally taken as fairly close; 83 to 85 is a good band for thinking about the response of business on this, but I think that that average overlooks the fact that we have industries such as the aluminum industry, for example, that are operating at well above the average rate.

Senator McClure. If we are operating at a trigger point, and that trigger point calls for either one or two responses, increased capital demand, another trigger point will also indicate that we are running close to supply shortages which will trigger inflation.

Mr. Duncombe. Yes.

Senator McClure. The trigger point for capital band is probably a little lower than the trigger point for shortages.

Mr. Duncombe. Yes.

Senator McClure. Is that right?

Mr. Walker. Probably, as a general proposition. The problems you run into are the bottleneck problems where 83 percent as an average hides what might be close to capacity in certain supply and other areas that you just can't get along without.

It could be misread.

Senator McClure. But you are, both of you, in agreement that we are relatively close to the point to trigger capital investment?

Mr. Duncombe. That will be my conclusion, yes, sir.

Mr. Walker. Yes, if other things remain equal, if we had this resolution of this uncertainty in these crosscurrents that we have been going through, and if taxes on capital formation are cut.

Senator McClure. If that uncertainty, then, says that an economic decision that otherwise would have been made will not be made, then you push us toward that other trigger point I was referring to when supply shortages occur and you begin getting inflation.

Mr. Walker. Exactly.

Mr. Duncombe. I think that the Department of Commerce estimates in the area of real capital investment is on the order of 4½ percent, which is low.

That would suggest that maybe your latter trigger point is more ominous than your former one.

Senator McClure. May I make one comment that refers to earlier discussions, and this will be my last one, Mr. Chairman, and ask for your response if you have one.

This refers back to whether or not we are having a rise or decline in real money supply as compared to nominal money supply.

The Government controls the nominal money supply in one shape or another.

The real money supply is set by the public. If inflation causes the public to want to avoid holding the nominal money, they try to spend it.

Prices rise and the value of the nominal money supply falls. So, the real money supply falls.

The falling real money supply is a sign of a loss of confidence in the currency.

While the Government may control the nominal supply of money directly, it can increase the real supply only by moving the rate of inflation down by slowing the nominal supply.

Would you care to comment?

How does that fit with what you were saying earlier, Mr. Walker?

Mr. Walker. I think it fits hand in glove with what I was saying earlier. I used the extreme example in postwar Germany after World War I. The public was controlling, they didn't want to hold marks—they didn't want to hold it 10 seconds if they had any choice.

This is true of the Central Bank in Germany. It could control the nominal supply. But the public controlled the real supply because the velocity went through the roof.

Representative Brown of Michigan. If I may, just one thing: The economic minister of West Germany was here a little while ago and it was interesting that he commented upon how they were able to hold down their wage settlements without the Government getting intimately involved, and why it is possible for them to be able to do that and we don't begin to have the same success, and he agreed with an observation that I made, that is that their hangups, if we can call them such, or their hangup, is the day when it took a wheelbarrow full of deutschemarks to buy a loaf of bread.

So, they don't want that situation again. Our hangup is a depression and we don't want that again. Therefore, we will suffer inflation and they would be willing to suffer a depression rather than inflation if you have to opt for one.

So, it was very interesting, your comment.

Senator McClure. Thank you, Mr. Chairman.

Representative Bolling. Senator Javits.

Senator Javits. Thank you, Mr. Chairman.

I apologize, Mr. Chairman, to both of these very distinguished witnesses for having been occupied with the Foreign Economic Policy Subcommittee upstairs in the Foreign Relations Committee, of which I am the ranking member.

I am trying very hard to catch up with their views, especially the views of Mr. Walker on productivity, about which I feel very, very deeply, as he knows, and have for years.

That's where we may not agree on many things, but we certainly agree on that one.

I gather that you are recommending that we do a great deal about bringing the American industrial machine up to mark by encouraging the acquisition of the new technologies through much more practical—that is what I recall call it—writeoffs in terms of the equipment and the machinery and the structures which are required; is that the fundamental thrust?

Mr. Walker. Yes, sir.

Senator Javits. I thoroughly agree with that. I have very grave doubts about this personal income tax cut and what it really means and whether or not that is the emphasis that this committee really requires.

In my judgment—speaking as a politician—I think it is a very unusual time when the people are looking to business rather than to Government to really do something about our situation, if Government will not tie it up in knots.

I think it is a very advantageous time to encourage business to move in the public interest toward acquiring greater markets and

toward acquiring greater productivity in order to support the structure which we have.

Is that about the fundamental thrust of your thinking?

Mr. WALKER. Yes, sir, it is.

I think that the longrun salvation in terms of, well, fundamentally, living standards and all the things that go into it, including competitiveness in the world markets, job creation, inflation control, depends, to a considerable extent on our getting our rate of capital formation, specifically capital growth per worker, back up to where we were a couple of decades ago.

Senator JAVITS. One question that affects me, Mr. Walker, and I would love to have your views on it: It is said that one of the sacrifices which is made in that way is that you encourage unemployment until you collect the results of the stimulus which you give to business, because if you cause a tightening and hardening of the industrial machine, for a time until a period when you are collecting the benefits of modernization, the service enterprises that it produces, et cetera, you will suffer greater unemployment.

If you do believe that, first I would like to know what you think about that, and, second, I would like to know what you would do if it is true that you have a temporary bulge in that record; what we should do about it as a social matter?

Mr. WALKER. I am not sure I caught it. There was one word I didn't catch that keeps me from fully understanding the question.

Are you saying that putting inflation efficient machinery would cause more unemployment——

Senator JAVITS. No.

Mr. WALKER. Or are you saying that the policy that resulted in inflation——

Senator JAVITS. No. A hardening of the lines, a contraction of Government expenditures, a bias toward capital investment, as against adding more to demand through governmental means or fiscal policy—you know, I look to have your view on it—may result in an increase in employment, and if it should, what would you do about it?

Mr. WALKER. I would be willing, if you overshoot and it is awfully difficult not to overshoot or undershoot the state of forecasting and so forth being what it is——

Senator JAVITS. Right.

Mr. WALKER [continuing]. I would be willing to support in the short run various safety net type operations not precisely of the type that we have done before. I would be willing to support, as Arthur Burns recommended some time back, I think at a speech in Atlanta——

Senator JAVITS. And here, he recommended it here.

Mr. WALKER. And here, public service employment provided remuneration to public works was such that they had still the stimulus to look for jobs in the private sector.

That is sort of a general thing.

Then I would have to go the micro route and start looking at who was unemployed, and what particular sorts of programs would be best.

Going around the country and talking to groups, I often put out an acronym and get the reaction. Pull out the acronym, WPA, and they frown.

But pull out the acronym, CCC, people start beaming.

Senator JAVITS. They start smiling.

Mr. WALKER. I remember when I was growing up in Texas in the 1930's, what a benefit the Civilian Conservation Corps was in two ways—in terms of the constructive work they did in the newly found devices of terracing and earth dams and all this and that, and, second, getting these young men, I believe it was just male at that time, out into the country and doing constructive work.

So, there has been a lot of talk about a new CCC but I have not seen much results. I have been advocating it since 1973—and we finally got a combined CCC-work-study program.

It makes a lot of sense when you look at the areas in a microsense; one, the young people that are unemployed; two, the lack of training in skills and ability; and three, the things that need to be done so badly in this country and I pull only one, that is rebuilding the railroad beds.

I see a combination there with the right sort of leadership and imagination, approaching on a microbasis, to help deal with that problem and do a lot of good in the process.

You are not just digging holes and filling them up.

Senator JAVITS. And would you also agree that under suitable contractual arrangements this work could be done in the private sector and add to the public interest and to the welfare of the country?

We seem to have a shibboleth about that, that you work for the Government, you can't do anything in the private sector without compromising your virginity.

Mr. WALKER. I would also agree that it should be done basically in the private sector.

Senator JAVITS. No, would you say that such works, for the railroads, for example, could be conceivably done with a contract with the private sector?

Mr. WALKER. Oh, very definitely. The young men that work there, and it might be a combination work and study program, not just work——

Senator JAVITS. Work and job training?

Mr. WALKER. That is correct.

Senator JAVITS. Well, I couldn't agree with you more, Mr. Walker. I really think that this is the place where we are really muddling it. Thank you very much.

I would just like to ask, if I may, one or two questions, if I have a minute, of Mr. Duncombe.

I have got the fundamental thrust of your testimony on regulation, at least the stretchout which is needed.

Mr. DUNCOMBE. Yes.

Senator JAVITS. On the impact, especially, of environmental or, as you say, nonproductive changes.

What I would like to ask you is this, and it is a big question. You are a trained man and you are working for one of the largest companies in the world. Do you feel that the industrial machine of the

developed countries is now capable of outproducing the world's demand so that it is a very key point as to whether we acquire broader markets through an elevation of the standard of living of the peoples of the world, especially those at the bottom of the scale?

It is said that 1 billion people go to bed every night hungry. I had a brother who passed away a few years ago, who was a great thinker in this field, and I remember he used one figure which always astounded me, and that is that if every person in India acquired one more shirt it would exceed the capacity of all the textile mills of the world.

Now, I mean, whatever observations you may have from your study on this thing, whatever reaction you would like to give, I would appreciate it.

You know we are laboring right now under this illusion that foreign aid and the international financial institutions give or take the usual 10 percent for waste, and what business doesn't have it?

But, they are all boondoggling and do-gooding and hands across the sea and all that mawkish stuff, and whatever observations you could make on that, I would appreciate it.

Mr. DUNCOMBE. Well, my general comment probably reflects my economics.

I was always taught that human wants were infinite and I have never been satisfied with that proposition in this country, or in the developed countries. I think we have tremendous needs to be filled in this country.

We don't have to go as far as India to find them, although I am perfectly willing to buy your brother's observation on that.

So, I think that the problem is one of capturing the tremendous vitality of this economy and fulfilling people's need and more fully here at home as well as overseas.

Some of the problems in the developing world, or some of the unrest that we are all very conscious of, I think, we can surely marshall some of our resources to begin to make a dent in that problem.

Senator JAVITS. I would like you to understand my attitude because I may be misleading you.

I am for doing it on a capital basis. In other words, they have got to produce. I am not for doing it on a handout basis.

Mr. DUNCOMBE. By capital basis, you mean investing overseas?

Senator JAVITS. That is right, in productive things and even growing things productively.

Many of these countries don't even supply their own food needs. All you have to do is stick a plow in the ground and drop a seed and you have wheat, but they don't do it.

Mr. DUNCOMBE. Yes, I understand.

I don't know quite how we approach that problem, Senator Javits. How do we approach it?

Senator JAVITS. Well, I think we approach it by two ways now. I will happily answer because I have very deep feelings on this.

One, you approach it through the utilization of the international financial agencies which are hardheaded and have this very gifted concept of conditionality; that is, you get loans on condition that you do certain things, and you keep doing them. That, I think, is one approach.

Two, the element of conditionality is a form of economic and social organization which does not result in thousands of drones and one worker, or, in siphoning it off at the top. I think we have a right to insist on that, and I think we have a right to say to the developing countries, "Look, we would gladly work with you; we will knock ourselves out, give you 50 years credit," et cetera, if you do your part.

Those that won't, OK; go do it your own way and make a deal with the Soviet Union or somebody else if you want to, but don't look to us.

With us, it has got to be reciprocal.

Mr. DUNCOMBE. I certainly agree with that, Senator Javits. I think there are limits on what the private economy can do in some of these higher risk investment areas.

I don't think we can expect very much in the high risk overseas investment areas.

As you know, GM has been deeply committed even before the last war in investments overseas, but generally the test that we have applied there, among other tests, is whether there is a market for our products.

We really would be managing the resources of our investors negligently unless we can make that sort of a test.

So there you are, to the extent that we have a national interest in seeing to it these very underdeveloped countries can sustain themselves, I expect that it has to be done through the international finance organizations.

Senator JAVITS. Would a company like General Motors put out technical assistance and teaching personnel as a long-term investment, that some country in the Sahel might even, 25 years from now, have roads and automobiles? I mean this as a matter of principle.

I will tell you another analogy. I once asked the New York Telephone Co. not so many years ago—one company in one place—how many technicians they could turn loose for the purpose of improving communications in some place in the world if the Government really said we have to have them, but we want you to maintain your New York City system.

How many can you turn loose, say, for a year to do another job? You know what the answer was? 5,000.

Now, we have got 10,000 in the Peace Corps. That's peanuts compared to what American business can do—just American business—if we really set our minds to it and pulled up our socks.

Mr. DUNCOMBE. If this became a high priority national objective, I think a great deal could be done, although I am surprised by the A.T. & T. answer.

Senator JAVITS. It was NYTT, New York Tel.

Mr. DUNCOMBE. Oh, just New York Tel, that is amazing.

Senator JAVITS. It astounded me, not just surprised me.

Mr. DUNCOMBE. Maybe that is the reason it took so long for my telephone to get back into service after the last ice storm.

They are out doing other things. [Laughter.]

Senator JAVITS. Thank you, Mr. Chairman.

Representative BOLLING. Thank you, Senator.

Gentlemen, I thank you both very much.

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You have been not only interesting, but you have been very patient.

With that, the committee stands in recess until Wednesday.

[Whereupon, at 12:31 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, March 1, 1978.]

THE 1978 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, MARCH 1, 1978

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

The committee met, pursuant to recess, at 10 a.m., in room 1202, Dirksen Senate Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling and Brown of Ohio; and Senators Bentsen, Proxmire, and McClure.

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, and Deborah Norelli Matz, 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.

Mr. Fraser, I am very pleased to welcome you to the Joint Economic Committee's annual hearings on the President's economic report and the State of the American economy. You are making your first appearance before us in your relatively new role as president of the United Auto Workers.

Many of the witnesses we have heard have brought us an economic message that parallels the current American story-telling penchant for mixing some good news with a little bad.

The good news focused largely on satisfactory GNP growth, substantial growth in the level of employment and a sharp reduction in the rate of unemployment. The bad news centered mainly on the low levels of business fixed investment, record trade and current account deficits and an increase in the rate of inflation.

Based on a modest stimulus package, the administration remains reasonably confident about both 1978 and 1979 in terms of GNP growth and further reductions in the rate of unemployment. The President's report, however, does not suggest that there will be either a sharp reduction in prices or the size of the American trade and current account deficits. We would welcome your own view on the economic outlook and what policies we may need to assure an adequate economic performance.

The persistence of the coal strike has already threatened to slow GNP growth in the first quarter of this year and could add to the

level of unemployment. With a substantial membership in strike-affected areas of the Midwest, I would appreciate any estimates you might have of the present and future economic impact of the coal strike.

Throughout the course of this year's annual hearings, we have balanced our traditional focus on macroeconomic policy with greater emphasis on specific structural programs designed to reduce inflation and unemployment. In his economic report to the Congress, the President has also stressed the importance of structural programs for groups or areas that suffer from chronically high rates of unemployment. Much of the same emphasis is contained in the President's approach to inflation. He has pointed to improved government regulation and voluntary wage-price restraint rather than restrictive monetary or fiscal policies. I would welcome the benefit of your own experience with structural unemployment and any proposals you might have to directly attack inflation.

Mr. Fraser, if you would prefer to give us an opening summary of your remarks, the full text of your prepared statement will be included in the record. Please proceed.

STATEMENT OF DOUGLAS A. FRASER, PRESIDENT, INTERNATIONAL UNION, UNITED AUTOMOBILE, AEROSPACE AND AGRICULTURAL IMPLEMENT WORKERS OF AMERICA, UAW, ACCOMPANIED BY HOWARD YOUNG, SPECIAL CONSULTANT

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

I am here representing the 1.7 million members of the United Auto Workers. And with me is Howard Young, a special consultant with UAW.

In terms of your question about the coal strike and its impact, Mr. Chairman, the automobile industry has had very little impact thus far. We heard very grave warnings earlier, about 3 or 4 weeks ago, and the Governor of Ohio was saying that in another week we would have to reduce power by 25 percent and the following week by 50 percent. None of those events occurred, and so far the automobile industry has not missed the beat.

My personal view is that if this agreement, hopefully, is ratified then the coal strike alone will have very little impact on the economy.

We have achieved some significant economic gains in the last year, which are reflected in the 1.1 percentage point drop in the unemployment rate. Yet there is still 6.3 percent of the labor force that is jobless. Much more needs to be accomplished to reach our goal of full employment.

At the same time, most of our pressing social needs—such as inadequate housing, deficient health care—require greater effort.

With an administration controlled by the same party we can and must start meeting these challenges now.

Therefore, I urge you to disregard the advice of those who are sounding a note of caution and retrenchment. Pointing to the fact that the current expansion has now lasted as long as the average of the previous upswings of the postwar period, they would cut down the

size of the Federal Government as their attempt to balance the budget and reduce the rate of inflation.

Yet, if there is one lesson to be drawn from the 1970's, it is that those policies did not work. Lack of needed Federal programs would not only mean abandoning the commitment to achieve full employment and solve our pressing social problems, it would also be a sure ticket to another recession and thus fail to achieve its intended purpose.

Rather than putting some predetermined limit on the amount of Federal outlays or the size of the deficit as a yardstick of how much the Government should do, I urge you to look into the unsolved problems, shortcomings and maldistributions in our society, recognize that they never will be corrected without Federal Government direction and intervention and get on with the job. The tasks will not be completed in a year or two; accordingly, I will comment briefly on the fiscal year 1979 budget proposals and then go on to the UAW's longer term view of the role of the Federal Government.

One important outcome of the partnership between the administration and Congress will be the budgetary program for fiscal year 1979. President Carter has presented budget proposals which go far toward meeting the Nation's needs; that is reflected both in his spending and his tax proposals. Many of the proposals do not go far enough and Congress should improve upon them.

On the revenue side, we generally support the administration's proposed changes in the taxation of personal income. The President's commitment to reject a tax reduction package unless it is tied to significant reform is particularly encouraging. So is the fact that the President chose not to follow the advice of those who urged him to abandon tax reform efforts on grounds of political expediency.

The UAW does not support every aspect of the administration's tax program: For example, we flatly disapprove of granting tax relief to the corporate sector which will further undercut its share of Federal income taxes. I will have more to say on that later in this testimony.

On the spending side, the administration's proposals for fiscal year 1979 are not sufficiently expansive. The administration's own economic forecast makes this abundantly clear: By the end of 1979, its policies anticipate an unemployment rate of 5.8 percent and a loss in output as measured by the GNP gap as high as $200 billion. After 3 years of the Carter administration, the cumulative loss in output would therefore reach almost $600 billion. These are not adequate goals. More detailed comments are included in my prepared statement, which I am submitting for the record.

The budget message and the economic report of the President also raise serious questions about the longer term; particularly the role and importance of the public sector in our economy. Decisions and concepts adopted now will set the framework within which priority programs—such as national health security, welfare reform, and many others—will have to operate.

The UAW does not agree that Federal expenditures have taken too large a share of GNP, nor that they should be limited to a smaller share in the future.

First of all, cyclical variations must be allowed for when reviewing what has happened. While budget outlays increased in relation to GNP during the past 10 years, that is supposed to happen when the economy is below full employment. A comparison of the budget outlays with potential GNP—at 4 percent unemployment—shows very little variations from the 20 percent level during the seventies.

Second, a distinction must be drawn between those Federal expenditures which are used to purchase goods and services—and are in true competition with the private sector for labor and other resources—and those which simply transfer purchasing power and decisionmaking from one group in the private sector to another. These transfer payments have been the largest cause of growth in Federal expenditures.

Furthermore, they are relatively uncontrollable in the sense that they are determined by demographic and other factors, rather than by a decision to spend some fixed amount. Thus, in 1977, transfer payments were three times higher than in 1970, but GNP was only two times higher.

Those who are concerned about the size of Government should recognize that when the Federal Government collects social security taxes and pays benefits, it does not reduce the size of the private sector. Aside from the small amounts used to administer the program, that Government transfer does not hire anyone, nor does it use up any energy or raw materials. In short, Government activity cannot be measured by the size of the budget.

The real issue is how much Federal expenditures are used to help meet the Nation's needs for goods and services—including investments for the future—that are not adequately provided by the private sector. Within the budget itself, those expenditures are estimated to decrease from 50 percent in 1970 to 35 percent in 1979. In relation to GNP, those expenditures decrease from 9.9 percent in 1970 to 7.4 percent in 1979.

Furthermore, the bulk of those Federal expenditures are military related. Although a trend away from military spending took place from 1970 through 1975, the trend has since been reversed. Proposed defense purchases in 1979 would take 63 percent of total Federal Government purchases.

Therefore, current proposals mean that in 1979, the Federal Government's ability to finance all types of civilian activity—including space exploration, research in medical and energy fields, outlays for veterans' hospitals, construction of highways and sewers, and the wages of Government nonmilitary personnel—would be only 2.7 percent of our Nation's total output. That is the share that Government will have at its command for the acquisition of labor, capital, and land. It also measures how much direct action the Federal Government can take to initiate developments in areas such as nondefense technology, supply and price of fuels, investments, and land utilization, to supplement the indirect effects of regulation and incentives.

Thus, the President's intention to limit the budget to 21 percent of GNP by 1983 through tax cuts and other measures, and to put increasing reliance on the private sector would unduly limit the Gov-

ernment's ability to meet social needs. We believe that budget decisions should start with a consideration of social needs, especially in those areas which will not be met by private action, and let that determine the required level of public expenditures rather than the other way around.

In response to the massive unemployment at the time he took office, President Carter's first major economic action was to propose a substantial expansion of the public service employment, PSE, program. The program is expected to average about 680,000 person-years in fiscal year 1978 in regular PSE, plus 400,000, mainly youths, in work experience categories. I commend the administration and Congress for the speed with which these programs were enacted.

The rate at which workers have been getting on the PSE rolls is proof that such programs also can be speedily implemented. Naturally, problems have occurred; for example, we have been concerned about the program's ability to reach the unskilled, the minorities, and the poor. We were therefore encouraged by recent testimony of Labor Secretary Marshall to the effect that significant advances have been made during the past few months in focusing the program on the neediest.

Current and expected levels of unemployment fully justify higher funding for PSE. Rather than follow the administration's proposal to cap the program at the 725,000 level, I recommend to Congress funding up to 675,000 additional jobs for regular PSE in fiscal year 1979 and a total of 250,000 jobs for youths in work experience programs.

Two questions tell why the case for public service employment is not based simply on the Government's obligation to provide jobs for everybody willing and able to work. First, are there services in our society which need doing and are not being done? Second, are these needs unmet because the private sector cannot find available workers?

To the first question, the answer is unequivocably "Yes." For example, The Labor Department release on the job components of welfare reform identified 13 major categories of needed services to local communities, involving a total of 1.4 million jobs—for example: 200,000 jobs aiding the elderly and the sick; 200,000 jobs building and repairing local recreation facilities; and 150,000 jobs improving public safety.

The second question has to be answered in the negative. While many useful productive services go unperformed, there always remains a sizable contingent of people who want to work but who are at the end of the employment queue due to lack of skills or work experience, age, geographical location, or discriminatory practices. This is borne out by the labor force statistics. The American economy has been providing jobs, including government jobs, at a pretty fast clip for the last quarter of a century, yet the unemployment rate shows an upward trend. Indeed, it has been 8 years since the unemployment rate was at 4 percent.

Cyclical fluctuations in the economy obviously increase the role of public employment. To allow for that, a reservoir of additional public employment projects must be available to take up the slack. Enactment of the Humphrey-Hawkins bill will provide for those.

The point we want to stress here is not the need for countercyclical public service jobs; that has obviously been acknowledged. There is also an ongoing need to match important and otherwise unavailable services with the permanent public employment programs. They should be flexible enough to accommodate some of the cyclical variations.

This concept of public employment also implies that the limitation of tenure in public service jobs should be relaxed. If the premise that there is productive work to be done and there are people eager to do it is accepted, constraining the length of employment to 1 year does not bear close inspection; all it does is invite reshuffling and recycling of the unemployed, and perpetuate a sense of insecurity and instability among those in public employment.

Advocating longer or indefinite tenure in public service jobs should not be construed as our acceptance of a second-class labor market to which workers would be confined indefinitely at poverty wages. On the contrary, we see one function of public employment as affording an opportunity otherwise unavailable to gain work experience and job training at wages comparable to the private sector, as does the current countercyclical public service employment program, which pays an average of about 60 percent above the minimum.

We urge this traditionally forward-looking committee to give careful consideration to the importance of the public sector meeting public needs with public jobs. In so doing you will get few insights from the analysis put forth by the Council of Economic Advisers in their annual report. In the two and a half pages they devote to PSE, there is not a single reference to what these jobs actually accomplish; that is, what kinds of services are actually performed.

Given that the focus of the CEA's attention is the so-called inflation-unemployment tradeoff, it stands to reason that particular attention should be paid to the results those jobs produce. Putting people on productive jobs that turn out needed goods and services is less inflationary than leaving them unemployed. A job that turns out a needed good or service should help reduce inflation.

We are as concerned as the administration about slow investment growth, because of its effect on employment and eventually on productivity. In our opinion, much of that sluggishness would vanish if more expansionary policies were to push up the rate of capacity utilization, which has remained relatively low throughout the recovery.

The CEA has analyzed the impact of that factor and others on investment spending, in an effort to pinpoint the reasons for the drift. However, the report admits that "conclusions about the performance of investment remain uncertain."

Unable to establish a cause and effect relationship, the report still goes on to recommend the enactment of tax measures; i.e., tax breaks, specifically directed to enhance investment incentives. This approach is much too narrow.

We must move away from the "carrot without stick" proposals of the Council. These policies entail giving taxpayers' dollars, an estimated $15 billion in the coming fiscal year, in the futile pursuit of

business confidence and a measure of investment spending which more often than not would have been forthcoming anyhow.

At the same time, Government policymakers should recognize that while the match of sectors and locations which attract private capital with people's needs for jobs, services and output has been far from perfect, there is no evidence that we can expect it to improve without a change in public policy.

As a consequence of this mismatch, sectoral and locational imbalances have developed. Low- and moderate-income housing is a good example of a sector which could use more funds. Most of the central cities have experienced capital flight for almost two decades. The Federal Government has on occasion worsened the chances for balanced growth; for example, by granting investment incentives which act as relocation incentives. In many instances, it has been guilty of inaction on matters that affect private decisions, as in the case of its failure to federalize the unemployment compensation system.

The Federal Government must change its role with respect to investment decisionmaking. There should be more publicly owned investments; there should be greater public regulation with respect to those private decisions that have great impact on workers and communities; and there should be national economic planning in order to improve the results of other private investments.

There are a variety of social needs involving investment funds which will not be satisfied even at a higher level of private economic activity. We believe that the Federal Government should play a direct role in satisfying these needs, rather than continue to leave investment almost entirely to the private sector. Government action would remain overwhelmingly in the area of services, but here, too, direct investment by the Government follows naturally from a commitment to full employment. Most of the types of jobs listed earlier, to provide services in high demand, require capital equipment if they are to be as productive as they should. In fact, one of the reasons for low productivity in PSE has been the unwillingness to provide sufficient capital for those workers.

Public investment to meet social needs can be illustrated by considering energy, housing, and railroads. Not only would many jobs be immediately generated in the process, many more—mostly in the private sector—would be created as the ripple effects of stepped up economic activity move through the system.

In energy, the public sector should involve itself more in conservation, research, development, and production. Conservation goals would be well served by weatherization of public buildings and low-income housing. This provides a natural focus for the use of public funds; a small-scale program to match Comprehensive Employment Training Act workers with weatherization grants is already underway. More should be done in this area.

The Government must actively engage in research and development across the full range of alternative energy sources; but this should not result in the private sector always profiting from publicly financed technologies. Instead those technologies should produce publicly owned industry.

The Nation needs greater direct Federal involvement in actual fuel production. For example, in the fossil fuel area, the fiscal year 1979 budget reflects the Government's continued refusal to expand its role on the supply side. Research and development must be supplemented by direct activity in exploration and production on public lands, and in the importation process. There is simply no way to determine true costs, and no way to have a truly national energy policy, except by the Government being one of the active participants in sourcing of fuels.

In housing, the last 2 years have witnessed a resurgence of building, which will probably continue some months into the current year. Nevertheless, this welcome expansion has left the housing needs of a large sector of our society untouched. Average prices for new housing are so high that only about one-fourth of households can afford a new home.

Housing is too critical a need for continued neglect; ways must be sought to make decent housing a reality for families at low- and middle-income levels.

Any public program for more new and rehabilitated housing will provide jobs for many skilled and unskilled workers. Many of the latter could be drawn through CETA from the community being built or rehabilitated, to supplement construction union workers who must not become unemployed as a consequence of the program.

Railroads clearly need a substantial commitment of public funds. So far, the wrong type of commitment has been chosen. The Regional Reorganization Act of 1973, which created Conrail, was in effect a corporation bailout with Federal financing. Conrail has demanded ever larger subsidies to remain in operation at very unsatisfactory levels. This is periodically taken up by the conservative press, and makes a good story for those who criticize public interference in the private sphere, even if this is one case where that interference provided a way out to unprofitable enterprises.

One of the obstacles faced by Conrail in its operation is the disastrous state of the railbeds; these are still in the hands of the individual companies, which are not about to invest in improving them. The resulting safety hazard is outrageous. As a first step toward complete nationalization, the railbeds should be taken over by the Federal Government. Putting the beds in good running condition is not only one of the keys to an improved railroad system, it would also be a source of demand for thousands of workers at various degrees of skills. Indeed, it would put back to work some of the displaced workers in steel mills as well.

The UAW has repeatedly urged Congress, and this committee as well, to stop the windfall to corporations which results from tax gimmicks such as the investment tax credit. We are frankly disappointed that the administration has not only proposed to make the credit permanent at 10 percent, but to liberalize it so that it could offset up to 90 percent, rather than the current 50 percent, of tax liabilities. Most disturbingly, the credit would apply not only to investment in equipment but to investment in structures as well.

Our objections to the investment tax credit rest on several grounds:

(i) It is not an efficient expenditure of Federal moneys. Although the academicians' evidence is mixed, the evidence from listening to

corporate spokesmen is not. Especially in the case of the large and very large corporations, investment plans are drawn independently from any tax credit considerations.

(ii) It constitutes an incentive to plant relocation; as such it is bound to accelerate the flight of establishments from the central cities to the suburbs and from older industrial areas to regions with low wages, few unions, and low State and local taxes.

In reference to the cities, extending the credit to structures could almost be labeled an urban devitalization program. President Carter will propose a plan to aid the cities later this month. We certainly hope that will be effective and are concerned the problems will be made even more difficult by the investment tax credit.

(iii) The investment tax credit is not tied to previous levels of investment; in fact, the only condition for receiving the credit is that investment be made, even if at lower levels than the previous year. By contrast, the employment tax credit at least has some strings attached, in that it requires an increase in employment over previous year levels.

The liberalization of the investment tax credit is a step in the wrong direction. The IRS should stop giving business blank checks which are often used to bring havoc to the lives of workers and communities, and always cashed with no other consideration than the maximization of profit. At a minimum, the tax credit must be tied to incremental levels of investment; more importantly, it must be targeted to new investment which will generate jobs and economic activity in areas of high unemployment. A credit must not provide incentive for relocation of production; it does not make sense for the Government to in effect subsidize a corporation to leave a community, only to have to turn around and prop up the community with Federal dollars from a different kitty.

Going beyond investment tax incentives, the entire question of investment decisions needs to be examined. Some mechanism, such as an investment funds system, should be adopted to direct investment to areas or sectors of activity which are starved for funds and jobs. In particular, corporations should not be allowed to consider plant location or relocation as a matter which only calls for consideration of private benefits and costs.

We urge Congress to give particular attention to the issue of economic dislocation. Whether due to public policy—as in the case of military spending cutbacks, energy or environmental requirements, imports, et cetera—or strictly to private preferences, the potential disaster that often faces affected workers and communities must be prevented or alleviated.

Another facet of the same problem is the rivalry which is displayed by State and local governments in their efforts to attract commerce and industry, a rivalry which is exploited by companies as they play off each community against the others. This is not confined to the sunbelt against the snowbelt. As a union with members all across the country, the UAW is painfully aware that, while the only net gains from this competition accrue to business, State social welfare programs are starved for funds, and workers are pitted against each other just because they live on opposite sides of a

State border. I urge you to correct this problem. Individual States have great difficulty resisting the temptation to undercut each other's standards and tax base. Only the Federal Government can prevent the effect of that.

I want to impress upon you that I clearly understand the implications of the agenda for Federal Government action that I have submitted to you this morning. None of it is "business as usual." In effect, it would give the public greater control over the investment process; that is, some of the power to generate economic development and to create jobs. This will not be easy. However, the real concern of the administration and Congress should not be that the Federal Government is doing too much, but that it is doing too little.

[The prepared statement of Mr. Fraser, together with an article entitled "UAW Comments on FY 1979 Budget Proposal," follows:]

PREPARED STATEMENT OF DOUGLAS A. FRASER

I am Douglas Fraser, President of the International Union, UAW. It is a pleasure and a privilege to have the opportunity of speaking before this Committee on behalf of 1.7 million members of the UAW.

We achieved some significant economic gains in the last year, which are reflected in the 1.1 percentage point drop in the unemployment rate. Yet, with 6.3 percent of the labor force still jobless, there is much more that needs to be accomplished in order to reach our goal of full employment. At the same time, most of our pressing social needs—such as inadequate housing, deficient health care—require greater effort.

With an Administration and Congress controlled by the same party we can and must start meeting these challenges now. Therefore, I urge you to disregard the advice of those who are sounding a note of caution and retrenchment. Pointing to the fact that the current expansion has now lasted as long as the average of the previous upswings of the postwar period,[1] they would cut down the size of the federal government as their attempt to balance the budget and reduce the rate of inflation.

Yet, if there is one lesson to be drawn from the 1970s, it is that those policies did not work. Lack of needed federal programs would not only mean abandoning the commitment to achieve full employment and solve our pressing social problems, it would also be a sure ticket to another recession and thus fail to achieve its intended purpose.

Rather than putting some predetermined limit on the amount of federal outlays or the size of the deficit as a yardstick of how much the government should do, I urge you to look into the unsolved problems, shortcomings and maldistributions in our society, recognize that they never will be corrected without federal government direction and intervention and get on with the job. The tasks will not be completed in a year or two; accordingly, I will comment briefly on the FY 1979 budget proposals and then go on to the UAW's longer term view of the role of the federal government.

THE FY 1979 BUDGET

One important outcome of the partnership between the Administration and Congress will be the budgetary program for FY 1979. President Carter has presented budget proposals which go far towards meeting the nation's needs; that is reflected both in his spending and his tax proposals. Many of the proposals do not go far enough and Congress should improve upon them.

On the revenue side, we generally support the Administration's proposed changes in the taxation of personal income. The President's commitment to reject a tax reduction package unless it is tied to significant reform is particularly encouraging. So is the fact that the President chose not to follow the advice of those who urged him to abandon tax reform efforts on grounds of political expediency.

[1] Except for the 1961–69 expansion, which was prolonged by the Vietnam War.

The UAW does not support every aspect of the Administration's tax program: for example, we flatly disapprove of granting tax relief to the corporate sector which will further undercut its share of federal income taxes. I will have more to say on that later in this testimony.

On the spending side, the Administration's proposals for FY 1979 are not sufficiently expansive. The Administration's own economic forecast makes this abundantly clear: by the end of 1979, its policies anticipate an unemployment rate of 5.8 percent and a loss in output as measured by the GNP gap as high as $200 billion. After three years of the Carter Administration, the cumulative loss in output would therefore reach almost $600 billion. These are not adequate goals. More detailed comments are attached and I am submitting them for the record.

LEVEL OF FEDERAL EXPENDITURES

The Budget message and the Economic Report of the President also raise serious questions about the longer term: particularly the role and importance of the public sector in our economy. Decisions and concepts adopted now will set the framework within which priority programs—such as national health security, welfare reform, and many others—will have to operate.

The UAW does not agree that federal expenditures have taken too large a share of GNP, nor that they should be limited to a smaller share in the future.

First of all, cyclical variations must be allowed for when reviewing what has happened. While budget outlays increased in relation to GNP during the past ten years, that is supposed to happen when the economy is below full employment. A comparison of the budget outlays with potential GNP (at 4 percent unemployment) shows very little variation from the 20 percent level during the 1970s.[2]

Secondly, a distinction must be drawn between those federal expenditures which are used to purchase goods and services—and are in true competition with the private sector for labor and other resources—and those which simply transfer purchasing power and decision-making from one group in the private sector to another. These transfer payments have been the largest cause of growth in federal expenditures. Furthermore, they are relatively "uncontrollable" in the sense that they are determined by demographic and other factors, rather than by a decision to spend some fixed amount. Thus, in 1977 transfer payments were three times higher than in 1970, but GNP was only two times higher.

Those who are concerned about the size of government should recognize that when the federal government collects Social Security taxes and pays benefits, it does not reduce the size of the private sector. Aside from the small amounts used to administer the program, that government transfer does not hire anyone, nor does it use up any energy or raw materials. In short, government activity cannot be measured by the size of the budget.

The real issue is how much federal expenditures are used to help meet the nation's needs for goods and services—including investments for the future—

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[2] See the following table:

	Budget outlays as a percent of gross national product, raw data	Budget outlays as a percent of gross national product at 4-pct unemployment
Fiscal years:		
1968	21.5	21.5
1970	20.4	20.5
1972	20.9	19.8
1973	20.0	19.9
1974	19.8	19.2
1975	22.4	20.0
1976	22.5	20.1
1977	21.9	19.7
1978[1]	22.6	20.6
1979[1]	22.0	20.2

[1] Estimate.

Source: U.S. Department of Commerce, Department of the Treasury, UAW calculations.

that are not adequately provided by the private sector. Within the budget itself, those expenditures are estimated to decrease from 50 percent in 1970 to 34 percent in 1970 to 7.4 percent in 1979.

Furthermore, the bulk of those federal expenditures are military-related. Although a trend away from military spending took place from 1970 through 1975, the trend has since been reversed. Proposed defense purchases in 1979 would take 63 percent of total federal government purchases.

Therefore, current proposals mean that in 1979, the federal government's ability to finance all types of civilian activity—including space exploration, research in the medical and energy fields, outlays for veterans' hospitals, construction of highways and sewers, and the wages of government nonmilitary personnel—would be only 2.7 percent of our nation's total output. This is the share that government will have at its command for the acquisition of labor, capital and land. It also measures how much direct action the federal government can take to initiate developments in areas such as nondefense technology, supply and price of fuels, investments, and land utilization, to supplement the indirect effects of regulation and incentives.

Thus, the President's intention to limit the budget to 21 percent of GNP by 1983 through tax cuts and other measures, and to put increasing reliance on the private sector would unduly limit the government's ability to meet social needs. We believe that budget decisions should start with a consideration of social needs, especially in those areas which will not be met by private action, and let that determine the required level of public expenditures rather than the other way around.

THE FEDERAL GOVERNMENT AND JOB CREATION

In response to the massive unemployment at the time he took office, President Carter's first major economic action was to propose a substantial expansion of the Public Service Employment (PSE) program. The program is expected to average about 680,000 person-years in FY 1978 in regular PSE, plus 400,000, mainly youths, in work experience categories. I commend the Administration and Congress for the speed with which these programs were enacted.

The rate at which workers have been getting on the PSE rolls is proof that such programs also can be speedily implemented. Naturally, problems have occurred; for example, we have been concerned about the program's ability to reach the unskilled, the minorities and the poor. We were therefore encouraged by recent testimony of Labor Secretary Marshall to the effect that significant advances have been made during the last few months in focusing the program on the neediest.

Current and expected levels of unemployment fully justify higher funding for PSE. Rather than follow the Administration's proposal to cap the program at the 725,000 level, I recommend to Congress funding up to 675,000 additional jobs for regular PSE in FY 1979 and a total of 250,000 jobs for youths in work experience programs.

Two questions tell why the case for public service employment is not based simply on the government's obligation to provide jobs for everybody willing and able to work. First, are there services in our society which need doing and are not being done? Second, are these needs unmet because the private sector cannot find available workers?

To the first question, the answer is unequivocably yes. For example, the Labor Department release on the Job Components of Welfare Reform identified thirteen major categories of needed services to local communities, involving a total of 1.4 million jobs:

200,000 jobs aiding the elderly and the sick.
200,000 jobs building and repairing local recreation facilities.
150,000 jobs improving public safety.
150,000 jobs providing child care.
150,000 jobs for paraprofessionals in the schools.
125,000 jobs running local recreation programs.
100,000 jobs improving school facilities.
100,000 jobs cleaning up neighborhoods and controlling insects and rodents.
75,000 jobs involving cultural activities.
50,000 jobs monitoring environmental quality.
50,000 jobs weatherizing homes to save energy.

25,000 jobs providing facilities for the handicapped.
25,000 jobs aiding in waste treatment and recycling.

The second question has to be answered in the negative. While many useful productive services go unperformed, there always remains a sizable contingent of people who want to work but who are at the end of the employment queue due to lack of skills or work experience, age, geographical location, or discriminatory practices. This is borne out by the labor force statistics. The American economy has been providing jobs (including government jobs) at a pretty fast clip for the last quarter of a century, yet the unemployment rate shows an upward trend.[3] Indeed, it has been eight years since the unemployment rate was 4.0 percent.

Cyclical fluctuations in the economy obviously increase the role of public employment. To allow for that, a reservoir of additional public employment projects must be available to take up the slack. Enactment of the Humphrey-Hawkins bill will provide for those.

The point we want to stress here is not the need for countercyclical public service jobs; that has obviously been acknowledged. There is also an ongoing need to match important and otherwise unavailable services with permanent public employment programs. They should be flexible enough to accommodate some of the cyclical variations.

This concept of public employment also implies that the limitation of tenure in public service jobs should be relaxed. If the premise that there is productive work to be done and there are people eager to do it is accepted, constraining the length of employment to one year does not bear close inspection; all it does is invite reshuffling and recycling of the unemployed, and perpetuate a sense of insecurity and instability among those in public employment.

Advocating longer or indefinite tenure in public service jobs should not be construed as our acceptance of a second-class labor market to which workers would be confined indefinitely at poverty wages. On the contrary, we see one function of public employment as affording an opportunity otherwise unavailable to gain work experience and job training at wages comparable to the private sector (as does the current countercyclical public service employment program, which pays an average of about 60 percent above the minimum).

We urge this traditionally forward-looking Committee to give careful consideration to the importance of the public sector meeting public needs with public jobs. In so doing you will get few insights from the analysis put forth by the Council of Economic Advisers in their annual report. In the 2½ pages they devote to PSE, there is not a single reference to what these jobs actually accomplish, i.e. what kinds of services are actually performed.

Given that the focus of the CEA's attention is the so-called inflation-unemployment trade-off, it stands to reason that particular attention should be paid to the results those jobs produce. Putting people on productive jobs that turn out needed goods and services is less inflationary than leaving them unemployed. A job that turns out a needed good or service should help reduce inflation.

THE FEDERAL GOVERNMENT AND INVESTMENT

We are as concerned as the Administration about slow investment growth, because of its effect on employment and eventually on productivity. In our opinion, much of that sluggishness would vanish if more expansionary policies were to push up the rate of capacity utilization, which has remained relatively low throughout the recovery.

[3] See the following table:

	Average annual increase in civilian jobs (in thousands)	Average unemployment rate (percent)
1952 to 1957	764	4.2
1957 to 1962	526	6.0
1962 to 1967	1,534	4.6
1967 to 1972	1,466	4.7
1972 to 1977	1,768	7.7

The CEA has analyzed the impact of that factor and others on investment spending, in an effort to pinpoint the reasons for the drift. However, the Report admits that "conclusions about the performance of investment remain uncertain."

Unable to establish a cause and effect relationship, the Report still goes on to recommend the enactment of tax measures (i.e., tax breaks) specifically directed to enhance investment incentives. This approach is much too narrow.

We must move away from the "carrot without stick" proposals of the Council. These policies entail giving away taxpayers' dollars (an estimated $15 billion in the coming fiscal year) in the futile pursuit of business confidence and a measure of investment spending which more often than not would have been forthcoming anyhow.

At the same time, government policy-makers should recognize that while the match of sectors and locations which attract private capital with people's needs for jobs, services and output has been far from perfect, there is no evidence that we can expect it to improve without a change in public policy.

As a consequence of this mismatch, sectoral and locational imbalances have developed. Low- and moderate-income housing is a good example of a sector which could use more funds. Most of the central cities have experienced capital flight for almost two decades. The federal government has on occasion worsened the chances for balanced growth, e.g., by granting investment incentives which act as relocation incentives. In many instances, it has been guilty of inaction on matters that affect private decisions, as in the case of its failure to federalize the unemployment compensation system.

The federal government must change its role with respect to investment decision-making. There should more publicly-owned investments; there should be greater public regulation with respect to those private decisions that have great impact on workers and communities; and there should be national economic planning in order to improve the results of other private investments.

PUBLIC INVESTMENT

There are a variety of social needs involving investment funds which will not be satisfied even at a higher level of private economic activity. We believe that the federal government should play a direct role in satisfying these needs, rather than continue to leave investment almost entirely to the private sector. Government action would remain overwhelmingly in the area of services; but here, too, direct investment by the government follows naturally from a commitment to full employment. Most of the types of jobs listed earlier, to provide services in high demand, require capital equipment if they are to be as productive as they should. In fact, one of the reasons for low productivity in PSE has been the unwillingness to provide sufficient capital for those workers.

Public investment to meet social needs can be illustrated by considering energy, housing and railroads. Not only would many jobs be immediately generated in the process, many more—mostly in the private sector—would be created as the ripple effects of stepped up economic activity move through the system.

In energy, the public sector should involve itself more in conservation, research, development, and production. Conservation goals would be well served by weatherization of public buildings and low-income housing. This provides a natural focus for the use of public funds; a small-scale program to match CETA workers with weatherization grants is already underway. More should be done in this area.

The government must actively engage in research and development across the full range of alternative energy sources; but this should not result in the private sector always profiting from publicly financed technologies. Instead those technologies should produce publicly owned industry.

The nation needs greater direct federal involvement in actual fuel production. For example, in the fossil fuel area, the FY 1979 budget reflects the government's continued refusal to expand its role on the supply side. Research and development must be supplemented by direct activity in exploration and production on public lands, and in the importation process. There is simply no way to determine true costs, and no way to have a truly national energy policy, except by the government being one of the active participants in sourcing of fuels.

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Railroads clearly need a substantial commitment of public funds.

So far, the wrong type of commitment has been chosen. The Regional Reorganization Act of 1973, which created CONRAIL, was in effect a corporate bail-out with federal financing. CONRAIL has demanded ever larger subsidies to remain in operation at very unsatisfactory levels. This is periodically taken up by the conservative press, and makes a good story for those who criticize public interference in the private sphere, even if this is one case where that interference provided a way out to unprofitable enterprises.

One of the obstacles faced by CONRAIL in its operation is the disastrous state of the railbeds; these are still in the hands of the individual companies, which are not about to invest in improving them. The resulting safety hazard is outrageous. As a first step towards complete nationalization, the railbeds should be taken over by the federal government. Putting the beds in good running condition is not only one of the keys to an improved railroad system, it would also be a source of demand for thousands of workers at various degrees of skills. Indeed, it would put back to work some of the displaced workers in steel mills as well.

TARGETING PRIVATE INVESTMENT

The UAW has repeatedly urged Congress, and this Committee as well, to stop the windfall to corporations which results from tax gimmicks such as the investment tax credit. We are frankly disappointed that the Administration has not only proposed to make the credit permanent at 10 percent, but to liberalize it so that it could offset up to 90 percent (rather than the current 50 percent) of tax liabilities. Most disturbingly, the credit would apply not only to investment in equipment but to investment in structures as well.

Our objections to the investment tax credit rest on several grounds:

(i) It is not an efficient expenditure of federal monies. Although the academicians' evidence is mixed, the evidence from listening to corporate spokesmen is not. Especially in the case of the large and very large corporations, investment plans are drawn independently from any tax credit considerations.[4]

(ii) It constitutes an incentive to plant relocation; as such it is bound to accelerate the flight of establishments from the central cities to the suburbs and from older industrial areas to regions with low wages, few unions, and low state and local taxes.

In reference to the cities, extending the credit to structures could almost be labeled an urban devitalization program. President Carter will propose a plan to aid the cities later this month. We certainly hope that will be effective and are concerned the problems will be made even more difficult by the investment tax credit.

(iii) The investment tax credit is not tied to previous levels of investment; in fact, the only condition for receiving the credit is that investment be made, even if at lower levels than the previous year. By contrast, the employment tax credit at least has some strings attached, in that it requires an increase in employment over previous year levels.

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[4] A UAW economist has illustrated the situation as follows: from 1959 to 1960 (a period when there was no investment tax credit and comparable to 1976–77 in the timing of the cycle), real business fixed investment in equipment rose 3.05 percent. Assuming the same growth rate from 1976 to 1977 implies hypothetical investment in equipment of $114.8 billion. Actual investment was $9.2 billion higher. The credit cost the Treasury about $11 billion in FY 1977, which were given up to induce $9.2 billion in additional investment. These are admittedly very rough estimates which assume all other things are equal between these two periods, but they give some perspective as to the trade-offs involved in the credit.

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The liberalization of the investment tax credit is a step in the wrong direction. The IRS should stop giving business blank checks which are often used to bring havoc to the lives of workers and communities, and always cashed with no other consideration than the maximization of profit. At a minimum, the tax credit must be tied to incremental levels of investment; more importantly, it must be targeted to new investment which will generate jobs and economic activity in areas of high unemployment. A credit must not provide incentive for relocation of production; it does not make sense for the government to in effect subsidize a corporation to leave a community. only to have to turn around and prop up the community with federal dollars from a different kitty.

Going beyond investment tax incentives, the entire question of investment decisions needs to be examined. Some mechanism, such as an investment funds system, should be adopted to direct investment to areas or sectors of activity which are starved for funds and jobs. In particular, corporations should not be allowed to consider plant location or relocation as a matter which only calls for consideration of private benefits and costs.

We urge Congress to give particular attention to the issue of economic dislocation. Whether due to public policy—as in the case of military spending cut-backs, energy or environmental requirements, imports, etc.—or strictly to private preferences, the potential disaster that often faces affected workers and communities must be prevented or alleviated.

Another facet of the same problem is the rivalry that is displayed by state and local governments in their efforts to attract commerce and industry, a rivalry which is exploited by companies as they play-off each community against the others. This is not confined to the sunbelt against the snowbelt. As a union with members all across the country, the UAW is painfully aware that, while the only net gains from this competition accrue to business, state social welfare programs are starved for funds, and workers are pitted against each other just because they live on opposite sides of a state border. I urge you to correct this problem. Individual states have great difficulty resisting the temptation to undercut each other's standards and tax base. Only the federal government can prevent the effect of that.

I want to impress upon you that I clearly understand the implications of the agenda for federal government action that I have submitted to you this morning. None of it is "business as usual." In effect, it would give the public greater control over the investment process, i.e., some of the power to generate economic development and to create jobs. This will not be easy. However, the real concern of the Administration and Congress should not be that the federal government is doing too much, but that it is doing too little.

UAW Comments on FY 1979 Budget Proposal

The federal budget, one of the most powerful instruments of economic policy, reveals the Administration's perception of what the government's role should be in the economic and social system. Thus, the budget is always an important document; the FY 1979 budget is additionally important because it affords the Carter Administration the first opportunity to lay out in quantitative detail its goals and priorities. As such, it deserves both praise and criticism. The focus of our praise is the magnitude, direction, and character of most of the proposed changes in revenues. The focus of our criticism is the inadequacy of the funds allocated to some of our most pressing problems, coupled with the continuing overemphasis on defense spending.

THE SIZE OF THE FY 1979 BUDGET

Much has been made, by fiscal conservatives, of the increase in the FY 1979 budget, and of the fact that it is proposed to exceed the half trillion dollar mark for the first time in history. Yet in comparison to FY 1978 estimates, FY 1979 outlays as a portion of our gross national product (GNP) are proposed to decline from 22.6 percent to 22.0 percent. Measured in real terms, outlays would experience an increase of 1.2 percent, substantially lower than the annual 5 percent rise estimated to take place from FY 1976 to FY 1978.

Moreover, it is misleading to compare federal outlays and GNP historically without allowing for cyclical fluctuations. When the economy is below full

employment, government expenditures are not expected to be cut back—quite the contrary. Put in the proper perspective, the relative role of the federal government does not appear to have experienced steady growth during the last 10 years (note that budget outlays as a percent of full employment GNP overstate the corresponding level of government spending because they include recession-induced expenditures):

	Budget outlays as a percent of gross national product, raw data	Budget outlays as a percent of gross national product at 4-pct unemployment
Fiscal years:		
1968	21.5	21.5
1970	20.4	20.5
1972	20.9	19.8
1973	20.0	19.9
1974	19.8	19.2
1975	22.4	20.0
1976	22.5	20.1
1977	21.9	19.7
1978[1]	22.6	20.6
1979[1]	22.0	20.2

[1] Estimate.

Source: U.S. Department of Commerce, Department of the Treasury, UAW calculations.

Basically, the size of the budget concerns the social decision as to how much of our national resources should be devoted to needs that have to be met with public means—such as decent and universal health care, adequate housing, defense—rather than to private needs. In the Administration's projections, outlays as a percent of GNP are estimated to continue to fall behind FY 1979 to under 21 percent in FY 1983. However, revenues as a percent of GNP will go in the opposite direction. Rather than use these increases to solve some of these public needs, the budget document states:

"The President will carefully consider proposing further (tax) reductions between now and 1983 in keeping with his stated policy of holding the Federal budget to not more than 21 percent of the gross national product, and letting our citizens share the benefits of *expenditure restraint* in the form of reduced tax burdens."[1] (emphasis added)

Economic decision-making should proceed in precisely the opposite fashion—it should appraise the social needs that the private sector has been unable or unwilling to solve, and allocate government funds to meet them. Other industrialized economies are not afraid of channeling a much larger slice of their national output through the government; by at least one measure—the unemployment rate—it is clear that those societies have chosen to impose less of a hardship on workers and their families than we have, even at a time of general recession in the Western World:

[In percent]

	Ratio of current government outlays to gross domestic product[1]—1975	Unemployment Rate[2]—1976
Canada	37.1	7.1
France	38.9	4.6
Germany	41.7	3.6
Italy	39.8	3.6
Sweden	46.8	1.6
United Kingdom	39.5	6.4
United States	33.9	7.7

[1] The "OECD Observer", May 1977. Current government outlays include Federal, State, and local outlays.
[2] Bureau of Labor Statistics, U.S. Department of Labor. Rates adjusted to U.S. concepts.

[1] "The Budget of the U.S. Government, FY 1979", p. 11.

THE "SHORTFALLS"

As a $500 billion budget is put forward by the Administration for FY 1979, the experience of the last two fiscal years suggests this level of spending might not be reached. The "shortfalls", or differences between projected and effective levels of government spending, do not appear to be under control.

The amounts and proportions involved in these "shortfalls" are far from trivial. In FY 1977, the shortfall of $12.35 billion amounted to 3 percent of total budget outlays projected for FY 1977 as late into that fiscal year as February 1977, and to 18 percent of the projected deficit. About $3.8 billion of the $12.35 billion total were traced back to economic stimulus and construction programs, as follows:

	Shortfall	
	Amount (billions)	As a proportion of effective spending (percent)
Economic stimulus program:		
Employment and training	$1.1	16
Antirecession financial assistance	.5	29
Local public works	.4	68
Construction program:		
EPA construction grants	.7	19
Major water and power programs	.6	14
Community development grants and urban renewal	.5	17
Total	3.8	

Source: 5-yr Budget Projections: fiscal year 1979–83, Congressional Budget Office, December 1977; fiscal year budget.

Thus, a very substantial proportion of federal funds specifically intended to stimulate employment and assist communities in distress remained unspent. Translated into jobs, eliminating the shortfall in these programs could have produced decent employment for about 280,000 workers.[2]

According to the Congressional Budget Office (CBO), spending for the current fiscal year may again fall $6 billion to $8 billion below scorekeeping estimates as of last December. The President has stated that special efforts have been made to turn out more accurate estimates of projected outlays for FY 1979, but that will not be sufficient. Procedures are needed to assure that targeted spending levels will be achieved where that is within the government's control. In addition, some budget items are for spending triggered by events beyond the government control; for example, disaster relief. Many people would be quick to show concern if such spending exceeded budgeted amounts, and would call for cutbacks elsewhere; it must be understood that any spending below those budgeted amounts are even more a concern in an underemployed economy. The anticipated spending levels are part of the overall budget deficit designed to stimulate economic growth.

Therefore, Congress should mandate standby projects which could be quickly phased-in during the fiscal year if spending shortfalls are indicated by updated estimates. Until the nation can achieve a full employment economy, it is better to err on the side of going over—rather than falling short of budget goals. "The FY 1979 Budget Deficit and the Public Debt."

We are not disquieted by the gap between expenditures and revenues in the FY 1979 budget except insofar as it may prove too narrow. The Administration projects a deficit of $60.6 billion. There are indications that this will not provide enough of an offset to the deflationary pull expected to come from a continuing net outflow of funds to foreign countries, high savings by state and local governments, and a limited demand of investment funds from business,

[2] In the second year, the employment impact could have reached as many as 70,000 additional workers. (Sources: Congressional Budget Office; Bureau of Labor Statistics)

probably coupled with higher savings by individuals than in 1977. The 1978 Report of the President to Congress states that, for 1977 the federal deficit was just enough to offset the drag that the first two of these factors imposed on the economy. However, budgetary analysis in one recent CBO study estimates that a deficit of $67 billion will be needed in FY 1979 in order to offset the fiscal drag that otherwise would exert recessionary pressures on the economy.[3] That is $6 billion higher than the deficit proposed by the President.

That CBO study also underscores the need for new stimulative policies, since it estimates that if only present policies were continued during FY 1979, the deficit would be only $38 billion. The President's proposals are on the right track, they simply don't go far enough.

The size of the federal debt is another well-worn conservative bugaboo. Statistics show that the amount of federal debt held by the public is now about 30 percent of GNP, as compared with over 100 percent at the time of World War II and about 50 percent in the late 1950s:

FEDERAL GOVERNMENT DEBT HELD BY THE PUBLIC AS A PERCENTAGE OF GROSS NATIONAL PRODUCT, SELECTED YEARS, 1940-77

	(1) Federal Government debt	(2) Gross national product	Percentage of (1) over (2)
1940	$44.8	$100.0	44.8
1945	252.5	212.3	118.9
1950	217.4	286.2	76.0
1955	229.6	399.3	57.5
1960	239.8	506.0	47.4
1965	266.4	688.1	38.7
1970	301.1	982.4	30.6
1971	325.9	1,063.4	30.6
1972	341.2	1,171.1	29.1
1973	349.1	1,306.6	26.7
1974	360.8	1,412.9	25.5
1975	446.3	1,528.8	29.2
1976	515.8	1,706.5	30.2
1977 (preliminary)	572.0	1,890.4	30.3

Source: Economic Report of the President, 1978; U.S. Department of Commerce, Bureau of Economic Analysis; U.S. Department of Treasury, Office of Debt Analysis.

The recent rise in the percentage is obviously due to the catastrophic 1974–75 recession. From 1974 to 1977, the federal debt climbed 60 percent. This is not excessive when put in perspective: during the only recession in memory deeper than the last one—the Great Depression—the federal debt doubled in 5 years, from 1930 to 1935. Yet in hindsight, it would be difficult to question that, had the debt increased even more substantially, the economy would have fared better and working people would have faced less hardship.

The service on the debt is expected to take 8 percent of federal outlays in FY 1979. The only problem that we see with the service is the income redistribution accruing from the tax-paying to the bond-holding members of our society. Aside from the fact that the public debt has become much more widely held (e.g., miscellaneous investors such as savings and loan institutions, pension trust funds, and nonprofit institutions have tripled their holdings in the last 10 years), the redistribution problem can be justly perceived as an argument for a more progressive federal tax system.

Our concern that the Carter budget may not be expansionary enough is reinforced by the results of the policies embodied in the budget as indicated by the

[3] "Five-Year Budget Projections: Fiscal Years 1979–1983." Congressional Budget Office, December 1977.

Administration's economic forecast. It is informative to compare the current one with a previous forecast as recent as July 1977:

[In percent]

	Forecast			
	1978		1979	
	July 1, 1977	Jan. 23, 1978	July 1, 1977	Jan. 23, 1978
Real gross national product rate of growth from previous year	5.3	4.7	5.0	4.8
Unemployment rate:				
Yearly average	6.3	6.3	5.7	5.9
Fourth quarter	6.1	6.2	5.5	5.8

Source: Office of Management and Budget.

If these forecasts are realized our society will be experiencing, almost 5 years after the depth of the recession, a rate of unemployment as high as in the midst of the 1969–70 recession, and a full percentage point higher than the prerecessionary rate that prevailed in 1973.

The long-range economic assumptions in the budget are "projections that assume progress in moving toward the Administration's goals of a more fully employed economy and greater price level stability." In agreement with the President's endorsement of the Humphrey-Hawkins Full Employment and Balanced Growth Act, the unemployment rate is targeted to reach 4.0 percent at the end of 1983.

We in the UAW feel that the goal is a modest one; 1983 is a long time to wait for unemployment to come back down to 4 percent. We have accepted the decision to adopt so modest a legal standard as part of legislation that will be binding on the actions of the Administration and the Congress. Our moral and political standard for this Administration and this Congress is much higher. We fully expect them to continue and to accelerate their actions to reduce the rate of unemployment much faster than would be legally required under this bill.

The bill does not describe any path for the reduction of unemployment between 1977 and 1983. As we told subcommittees in both the House and the Senate, we are concerned that some may conclude that it would be acceptable under the bill simply to draw a straight line between the 7 percent unemployment realized during 1977 and the 4 percent goal for 1983 in order to describe a path for reducing unemployment—to 6½ percent by 1978, to 6 percent by 1979, to 5½ percent by 1980, and to 5 percent by 1981, with each year showing a reduction of only one-half of a percent in the unemployment rate. This is precisely what the Administration has done in its long-range economic assumptions.

All students of the problem of unemployment would agree that such a path would not be feasible: the earlier gains on the problem are the easier ones. When 6 percent or 6½ percent of the labor force is unemployed there are large numbers of workers available for a wide number of tasks, and also any shotgun action to stimulate demand will be able to provide productive jobs for some of those workers. As the unemployment rate falls closer to 4 percent, and as some of the slack in the economy is taken up, the danger arises that scattershot increases in aggregate demand will miss the target, that instead of providing jobs for those who are actually unemployed they will bump up against bottlenecks or shortages of particular kinds of labor in particular parts of the economy.

It is not only puzzling but indeed dismaying to realize that, while the Administration has endorsed the goal of a 4 percent unemployment rate embodied in the Humphrey-Hawkins legislation, it uses significantly higher rates as its own measure of full employment:

"The unemployment rate at high employment is estimated to be 4.9% by 1983. These rates are consistent with a 4.0% rate in 1955, adjusted for changes in the composition of the labor force toward groups that typically experience higher rates of unemployment."[4]

[4] The FY 1979 Budget, p. 41.

We totally reject this characterization of "full employment," and would not accept a 4.7 percent rate in 1983 as fulfillment of the Humphrey-Hawkins commitment.

At one level, the argument is no more than a statistical artifact: as a demographic group's share of the labor force increases, that group will have more of an impact on the aggregate unemployment rate. As women and teenagers have suffered higher unemployment rates and over the last two decades have increased their "share" of the labor force, average unemployment rates have been higher—for any given set of economic conditions. That explains what happened, but does not justify their higher rates.

At another, more politically important, level, the argument is that the unemployment of women and young people need not be treated as seriously as that of adult males—society should not strive to meet the need of the former for a job with the same energy and resources as it commands to meet the need of the latter.

Yet it is morally and economically indefensible to use descriptive categories as explanatory or causal categories. As one economist has noted:

"Unlike the analysis of 15 years ago, the current argument does not claim that it is lack of experience or marketable skills or of potential productivity that plagues today's unemployed. Instead these are identified simply as women and young people—as if such categories as sex and age indicated direct causation rather than mere identification." [5]

THE FY 1979 BUDGET RECEIPTS

The Administration is proposing substantial changes in the area of budget receipts; both the magnitude of federal revenues and the way in which those revenues are raised would be affected. We believe the tax cuts for individuals are justified; without them, inflation and higher payroll taxes will depress the purchasing power of workers' paychecks. Translated into lower consumer spending, a drop in disposable incomes would ring the death knell for the current expansion; the prospect of a job for those who have been standing in the unemployment lines for very long would dim further, with the newly laid off joining them in their fruitless search.

We believe that the President has proposed an estimable tax reform package as well. The UAW has long advocated a drastic overhaul of our personal income tax laws in favor of a fairer, more efficient, and simpler tax code. We are encouraged to see a large area of overlap between the Administration's and our own program. Our comments on the details of the proposal will be presented in testimony before the pertinent Senate and House committees. At this time, suffice it to say that we stand in support of the President's tax reform initiatives and will work strenuously in Congress to have them implemented and expanded.

A crucial feature of the proposed changes in personal taxation is that they must be considered as one indivisible package. This is the way the Administration has presented them, making abundantly clear that changes in this quid pro quo approach will not be acceptable. We believe that the constituency for tax reform is a majority in our country. The experience of the last few years, when attempts by progressive-minded groups to reform the tax laws ended lamely in tax relief, must not be repeated.

In setting budget levels, allowance should be made for additional tax relief to those low wage earners who would not benefit from the President's proposals, but who would be hit by higher Social Security (FICA) taxes in 1979. Although clearly a progressive proposal in that it would ease the tax load on most lower-income taxpayers and increase it on the higher brackets, the tax cut does result in some unfair twists. For example, the working poor now exempt from paying income taxes would miss any benefits from the relief package, even though they will be assessed higher (payroll) taxes. In 1979, the FICA tax will be $14 more than in 1977 for 4-person households with one worked earning $5,000. The earned income credit should be increased enough to not only offset that increase, but to permit the very poor to share in the general program of tax reduction through a higher negative tax.

This anomaly underscores the tremendous drain that the Social Security tax is now imposing upon earnings, as well as its regressive nature. As the new tax

[5] Carolyn Shaw Bell "Age, Sex, Marriage and Jobs," *Public Interest*, Winter 1973, p. 77.

rate becomes effective next year, the drain will become even heavier. The higher ceiling on taxed earnings will not diminish the regressivity sufficiently. The best way of dealing with the increased burden of Social Security is to do it with transfers from the general fund. Indeed, this is what is being done now through the back door, i.e., relieving workers from the weight of the payroll tax through the income tax. This indirect approach is bound to be plagued with inequities and peculiarities.

We do not agree that the budget should allow for as much reduction in business taxes as the President proposes.

Substantial tax relief has been provided to business in recent years, and its share of total federal taxes on income decreased from 29.4 percent in FY 1968 to 24.8 percent in FY 1978. If the President's proposed tax legislation—which includes changes through 1980—is enacted, the business share of total federal income tax is estimated to drop even further—to 23.6 percent. That is despite the estimate that, from 1978 to 1980, corporate profits will rise faster than wages and salaries.

In fact, the situation would be even more favorable to business than indicated by those estimates, because the expected rebates of oil wellhead taxes have been treated as a reduction of personal income taxes but the wellhead tax itself has been counted as an excise tax. Since those two are intended to offset each other, they should not be counted in comparing business and personal income taxes. If that adjustment is made, the business share of total federal income tax is expected to be 22.9 percent in FY 1980; that is almost two full percentage points—or almost $6 billion—lower than for FY 1978.

We see no reason why business should end up paying a smaller portion of total taxes, and urge that the President's proposals be changed to prevent that from happening.

We strenuously oppose the liberalization of the investment tax credit. Although again we prefer to postpone our detailed criticism for the proper opportunity, we take special issue with that aspect of the liberalization which would grant the credit for new structures. This will tend to compound the problem of plant relocations, and might prove deadly to some cities and other older communities. At a minimum, the credit should be tied to some restriction, for example to an examination of the employment situation in both the areas where the structure would be built and where the company would close down.

The proposed reforms in corporate tax laws—business deductions for entertainment expenses, phase-out of DISC, and ending of the deferral of foreign income taxation—are long overdue and deserve our full approval.

THE FY 1979 BUDGET EXPENDITURES

While the size of the budget measures how much of our resources should be allocated to public needs, and the difference between revenues and expenditures provides government with a rudder to steer the economy, the composition of the budget reflects government's perception of the needs of society as a whole, as well as the often-conflicting needs of the many social groups which make it up. The process of putting a budget together involves decisions about which of those needs will be taken care of, in what order, and to what extent—in turn revealing what government's priorities are.

EMPLOYMENT

We are gratified by the favorable trends in both employment and unemployment during 1977, which were partly due to the economic stimulus programs enacted in the first half of last year. As we noted before more could have possibly been accomplished had all the scheduled outlays been spent.

Although encouraged by the direction taken by the labor force statistics, we are keenly aware of the human waste and frustrations embodied in the current 6.3 percent rate of unemployment. By that measure, proposed funding for employment programs falls short of needs. Outlays in FY 1979 for employment and training are requested to increase by $1.9 billion, but this would only suffice to keep the FY 1978 level of 725,000 public service employment job slots, achieve a previously authorized build-up of programs, and provide for the increase in the minimum wage.

We urge you to allocate substantially more funds to employment and training programs than is proposed in the FY 1979 budget.

Some guidance as to the number of jobs which should be provided under the Comprehensive Employment and Training Act (CETA) is given by the Administration's background paper on the jobs component of Welfare Reform. The proposal details the need for creation of 1.4 million jobs, ranging from child care services to weatherizing homes to save energy. We believe that level is a realistic target to shoot for in FY 1979.

Most of these jobs would be allocated through Titles II and VI of CETA, the Public Service Employment titles. At the assumed cost per slot in the FY 1979 budget—which includes funds to raise the average cost from $8,900 to $9,200—the additional outlays would be about $6 billion.

In urging this Committee to allow for a significant increase in outlays for employment programs, we are convinced that the difficulties and shortcomings associated with public employment programs do not stem from the lack of potentially productive public sector work opportunities. In a time of rising energy costs, thousands could be employed weatherizing public buildings, and the homes of the poor and the elderly. Many of our schools are severely understaffed and could advantageously employ paraprofessionals to improve the educational environment. Adequate child care services, if they are ever to become a reality for low-income parents, will need substantial nonprofessional labor input. The long-advertised deterioration of the railroad beds is another source of demand for labor.

One of the most significant questions with CETA has been who the program should serve. According to the law, the scope of its clientele can go beyond the (officially designated) poor to include the unemployed and underemployed. However, we are concerned that has detracted from the program's impact on the unskilled, the minorities, and the poor. In FY 1977, about 65 percent of the participants in training and employment programs were poor, the same proportion as in FY 1976. A lower proportion of minorities participated in FY 1977 than in FY 1976 (36 vs. 43 percent). In both years, the proportion of participants with less than high school education was around 40 percent. CETA Title VI slots must now be filled with economically disadvantaged Americans who have been out of work for at least 15 weeks. A tighter definition of key terms such as economically disadvantaged, unemployed, and underemployed would be of help to sponsors in targeting their CETA efforts.

I think that we should subscribe to a concept of public service employment which recognizes that in any society, no matter how good the services are, there are many things that need doing and are not being done. As we indicated above, our society is no exception. This concept also implies that the limitation of tenure in public service jobs should be relaxed. That is, we ought to start with the premise that, on the one hand, there are many useful services that go unperformed; on the other hand, there may be a ceiling above which private employment cannot be expanded, leaving out a sizable contingent of people who are willing and able to work. The ceiling is not always at the same level. But should it drop, a reservoir of public employment and private nonprofit employment projects must be available to take up the slack. As you know, the creation of a shelf of public projects is part of the Humphrey-Hawkins legislation now before Congress.

The Comprehensive Employment and Training Act expires at the end of the current fiscal year and must be reauthorized. This presents a good opportunity to enact the type of changes that we are advocating in the programs.

The FY 1979 budget places richly deserved emphasis on federal programs to combat youth unemployment. The youth unemployment problem has acquired enormous magnitude in our society. As our overall unemployment rate continues to recede, the problem of those 16 to 24 will acquire increasing proportions and, we hope, attract the attention and the public funds it properly merits.

In 1977, about half of all the people who were officially unemployed were in the 16 to 24 age bracket. Their unemployment rate was 13.6 percent; 3.2 million youths. Another 300,000 would have been job hunting if they thought any jobs were available.

A specially troublesome problem are the 750,000 minority youths who had essentially disappeared from the system: they were not unemployed, not employed, not in school. They were basically on the street. Counting them, the resulting overall unemployment rate for minority youth last year was over 43 percent.

Among all young people, if we add to the unemployed the 1.4 million who are employed part time but are looking for more hours of work, we end up with

close to 5.7 million young people who are either unemployed or looking for significantly more work.

We are deeply concerned about the line of thinking that goes, "It is regrettable that all these youths are unemployed, but it is not the serious welfare issue that it would be if adults were unemployed." We are even more concerned to see a hint of that type of thinking behind the Administration's definition of 4.9 percent as high employment quoted earlier in this testimony.

A look into the characteristics of the youth unemployment problem clearly shows that unemployment is fed by, and feeds into, the gross disparities and inequities that plague the rest of society. For example, while about 80 percent of white unemployed youths have families with resources that they can fall back on, over 50 percent of the unemployed minority youth come from poverty families.

What about young people attending school? An increasing number of them are also a part of the labor force. Statistics tell us that the in-school labor participation rate for males rose from 36 percent in 1960 to 48 percent in 1977. For college students, this is probably due to the increasing cost of tuition, which has gone up faster than family income, and to the fact that more students now come from low-income families. Thus, a shortage of jobs for youths contributes to undermine the tenet of equal opportunity.

The attribution of less significance to the unemployment of youth vs. that of adults implies passing a judgment not only on young people's current plight but also on their prospects of success later in life. It may also ignore real threats to the whole society. For instance, we may be sitting on some kind of economic time bomb due to the fact that when today's people turn into adults and finally break into the job market, their contribution might be diminished by their lack of previous work experience.

Besides reaching mammoth proportions, the youth unemployment problem will not go away easily. It has been estimated that the unemployment rate for those aged 16 to 24 comes down by about a percent and a half for each one percent point drop in the national rate. This looks like a close relationship, but the national rate and the youth rate are so far apart that even if the national rate would come down to 5.9 percent in 1979 as the Administration forecasts, the unemployment rate for youth would drop to 12 percent.

This points to the need to find special solutions for a special problem. We commend the Carter Administration for addressing itself much more forcefully to this problem than was ever the case. We are referring to the Youth Employment and Demonstration Projects Act of 1977 (YEDPA), the main vehicle for increased outlays in this area. Indeed, federal expenditures for FY 1978 are estimated to come in at twice the level of FY 1977. However, the expansion stops there. The FY 1979 proposals, although up by $740 million—47 percent—over the previous year, do not represent any actual increase beyond the expected build-up of programs under YEDPA.

We are advocating 50 percent higher funding—or an additional $600 million—particularly for the Youth Employment and Training Programs within YEDPA. There are many innovative and creative programs that could be tried. For example, a program of rehabilitation of low-income housing (much of which is now owned by the cities) which could combine funds allocated through the Department of Labor as well as HUD. The proper safeguards, so that union skilled workers in certain areas do not become unemployed as a consequence of the program, should, of course, be taken. There may be many other problems to be solved; but ultimately, we have a situation in almost every inner city where there are countless deteriorating and abandoned buildings, while people —mostly young people—just stand on street corners with no chance of becoming employed. It seems to us that there must be ways of bringing these two together.

One of the youth programs which seems to have met with the greatest success is the Job Corps. Several studies have found it to be a very effective device in terms of graduates getting well-paying, permanent jobs. Not all those programs are residential at present, and that has reduced the per capita cost of the program. The connection between trade unions and the Job Corps has been strengthened, which will benefit both trainees and instructors. For example, the UAW has just signed a contract with the Department of Labor to run a Job Corps program in Utah where disadvantaged youths will be trained to become auto mechanics. Some people get disturbed at the high cost of Job Corps pro-

grams—I submit to you that those are among the best invested dollars in our society.

The Administration's projections show an increase in both outlays and participants (up to 45,000 youths) in FY 1979 but, again, this is only a result of this program not having reached its expected maximum level in FY 1978. We urge you to budget funds for a doubling of this program in FY 1979—an additional 45,000 slots for an additional cost of roughly $.4 billion.

In summary, we are advocating an increase of about $7 billion to fund an additional 800,000 jobs and training slots in the programs for training and employment in the FY 1979 budget, as follows:

	Fiscal year 1979 Budget outlays	Additional funds (billions)	Total
CETA (additional unds to go mostly to titles II and VI)	$6.2	$6.0	$12.2
Job corps	.4	.4	.8
YEDPA (additional funds to go mostly to YETP-employment and training)	1.2	.6	1.8
		Jobs (thousands)	
CETA (titles II and VI)	725	675	1,400
Job corps	45	45	90
YEDPA	167	83	250

ENERGY

The UAW is in agreement with the proposed increase in the U.S. energy budget from $7.8 billion in FY 1978 to nearly $9.6 billion in FY 1979. Much of that increase would arise from enactment of the President's energy program, which we generally support.

The energy budget is weakest on the supply side of the energy equation. First, net outlays for energy supply are expected to drop from $4.2 billion in FY 1978 to $4.1 billion or less in FY 1979. Second, fully $3.0 billion of this $4.1 billion is research and development (R&D) money. We support public R&D efforts but it is disturbing that they often result in a subsidy to the U.S. energy industry, which adopts publicly-financed technologies and then turns around and calls for an end to public sector regulation.

What the nation needs is greater direct federal involvement in actual fuel production. For example, in the fossil fuels area, the proposed budget reflects the government's continued refusal to expand its role on the supply side. The UAW supports R&D in coal gasification and liquefaction, oil from shale, and "alternative surface mining techniques" but that must be supplemented by direct activity in exploration and production on public lands, and in the importation process. There is simply no way to determine true costs, and no way to have a truly national energy policy, except by the government being one of the active participants in sourcing of fuels.

We agree that nuclear breeder reactor R&D funds should be reduced from FY 1978 levels. The UAW has long called for a redirection of the U.S. nuclear program away from plutonium-based fast breeder reactors. The difficulties that have occurred with that type of reactor emphasizes the need to fully evaluate all aspects of nuclear fission projects more carefully.

The UAW supports the proposed budget increases in funding for research, development, and demonstration (RD&D) in renewable resources, such as solar, geothermal, and biomass. It is particularly encouraging that much of the year-to-year increase is earmarked for solar photovoltaics (P/V), which show growing promise. On the negative side, the RD&D approach to renewable does not guarantee small manufacturers a market for their new offerings; the Department of Energy (DOE) could learn much from the Department of Defense (DOD) Federal Photovoltaics Utilization Program (FPUP), which strives to create predictability in the emerging P/V market.

We believe additional funds could be allocated to renewable resources RD&D, especially as part of defense facility conversion projects described elsewhere. For example $1.0 billion could easily be utilized for additional solar equipment production and installation.

HEALTH

A review of the Administration's projected increases in the cost of health-related programs poignantly demonstrates the need for a program which will slow this increase. This is one reason for the need for speedy implementation of a Health Security program, along the lines of the Kennedy-Corman Bill, which has cost controls built into it.

The central cost control feature of such a Health Security program is a health care system which would be anchored to a budget established in advance. Under the budgetary procedures, hospitals and doctors would both be paid negotiated amounts based on predetermined annual budgets. The cost of each kind of service and the overall costs of the program would be allowed to increase on a controlled and predictable basis. Participating providers would be required to accept payment from the program as payment in full; they could not charge patients additional amounts. Physicians would be entitled to reasonable fees for their services, or be paid by other acceptable methods; but the amounts would be negotiated between the public program at the local level and representatives of the physicians. Hospitals would present prospective budgets relating both to their own internal and external services, and to other hospitals in the same area so that duplication of expensive and underutilized services would be controlled. Needed but presently unavailable services, such as hospital-based home care, could be rapidly developed.

In addition to controlling costs, the budgetary process will strengthen local, state, and regional planning, stimulate more efficient institutional administration; and gradually reverse the current undesirable emphasis on in-patient hospital and other institutional services. This would be done by stressing preventive alternative levels and forms of care available outside of institutions.

A National Health Security program will sharply reduce the runaway inflation that is plaguing the health care systems, while at the same time provide access to quality care for all Americans in a way consistent with the self-respect and dignity of the individual.

Health Security will be the establishment of a broad system for health care in the United States. It means that, along with cost controls, there will be:

payment for nearly the entire range of personal health care services, including catastrophic coverage;

administration at four levels—national, regional, area, and local—with some important functions carried out by states;

financing by combination of payroll and general revenue taxes;

national standards for providers;

consumer participation in policy, development, and administration;

encouragement of more efficient organization of existing health person-power, funds for special training of physicians, dentists and other health personnel, and financial incentives to stimulate the movement of health person-power to medically deprived areas;

funds to increase the resources for services and to bring new organized programs of health service into being and to expand existing ones; and

financial, professional and other incentives to move the health care delivery system toward organized arrangements for patient care, such as health maintenance organizations and other prepaid group practice plans or professional foundations, and toward the establishment programs for preventive care, early diagnosis of illness and medical rehabilitation.

In its FY 1979 budget the Administration reiterates its commitment to submit legislation on national health insurance this coming year. There is no funding proposed for the program because federal outlays in 1979 or 1980 will not be affected.

WELFARE

Welfare budget projections are based upon the President's welfare reform proposals which he made last August. As the Administration and responsible groups within both the public and private sector recognize, it is time for major restructuring of the country's welfare programs.

As recently stated in UAW testimony before the Welfare Reform Subcommittee, the Administration's welfare program included many positive concepts, but requires modification if reform is to accomplish its objectives and provide equitable treatment of those in need.

The public jobs component of the reform package contains serious limitations. The targeted number of public service jobs is based upon an assumption about the expansion of private employment which will lessen the need for subsidized public service jobs. If the private economy does not expand as fast as the Administration is predicting, the jobs program will prove insufficient.

Even though newly created jobs would be replacing CETA jobs which pay the prevailing wage, current proposals call for pay at the minimum wage. Workers who would be required to accept public employment must receive the greater of the minimum or prevailing wage. Anything less would be a step backwards and would result in the creation of a pool of second-class workers who could become an undermining force threatening the job security and wage scales of America's workers.

An expansion of the Earned Income Tax Credit is proposed. However, only those fortunate enough to find private sector jobs would be eligible for the credit. Those who must accept subsidized public service employment would be denied the tax credit. The difference in the tax treatment was designed to encourage the seeking of private sector employment. However, unless there is a great expansion in the number of private sector jobs available, tens of thousands of Americans will have to take subsidized public sector jobs. Denying them the tax credit would create a sharp disadvantage to large numbers of those who would rather work than receive welfare.

Benefits for those unable to work are too low. Administration proposals would set federal minimum income levels—a national income floor—at two-thirds of the poverty threshold. It is essential that benefit levels be phased upwards in the first few years until they reach the minimum poverty levels. Payments should be indexed to cost-of-living changes as they are at present for the aged, blind and disabled under the Supplemental Security Income Program.

Furthermore, uniform national eligibility criteria should realistically reflect immediate family needs; the Food Stamp Program should be continued at least until the cash benefit payments are comparable to the poverty level; fiscal relief for states and localities should result from increased federal expenditures rather than any reduction in income support payments; and Medicaid eligibility criteria and benefits should be maintained until those eligible for assistance are covered by an operating health insurance program.

NATIONAL DEFENSE

The post-Vietnam war years saw a decline in real spending for national defense which was halted in 1976. The Administration has chosen to continue the reversal of that downward trends by proposing a real increase in spending authority for FY 1979 amounting to 3.4 percent over FY 1978 levels—9.4 percent in current dollar terms. Further real increases in military spending are projected for each of the next five years, through 1983.

The "theme" for this year's DOD request is the need to strengthen the NATO forces on the basis of the belief that a Soviet land attack is a more likely possibility than a nuclear war. This attack, the argument goes, could quickly defeat NATO forces and result in the Soviet occupation of Western Europe.

However, this assessment has been questioned in the Hoopes-Scoville Report,[6] which UAW President Douglas Fraser endorsed along with several other union leaders, and the Presidents of the U.S. Conference of Mayors and the National Urban League. The questions arise on both military and political levels. From a purely military point of view, it appears that there is a stable overall military balance in Europe—and that while the present logistical support structure of Soviet forces in Eastern Europe is insufficient for launching an immediate attack, large-scale preparations could not escape Western detection. From a political viewpoint, detente continues to be a reality—there is little indication in Soviet policy of any aggressive intention to invade, occupy or rule Western Europe.

Along with this shift of emphasis on the one hand proportionately smaller increases in the strategic programs are proposed—they are scheduled for no real increases. On the other hand, operations and maintenance is proposed to increase 12 percent, and general purpose forces, about 13 percent.

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[6] Townsend Hoopes and Herbert Scoville, "Military Policy and Budget Priorities Fiscal Years 1979–82", (Council on National Priorities and Resources, 1977.)

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As a general statement, there can be no denying that recent levels of military spending have far exceeded the real security needs of the nation. One need not be an expert in international relations to see that further increases in such spending carry the risk of heightened world tension and a renewed arms race spiral. Indeed as Hoopes and Scoville argue so persuasively, further increases in military spending could well lead to a reduction of our national security by any reasonable definition of that term.

The UAW has long been concerned with the need to reduce unnecessary military spending, and to redirect those resources toward badly needed and historically underfunded social programs. Conversion—by which we mean the orderly and planned shift to civilian production of facilities and workers affected by military spending cutbacks—is an indispensible part of any such reordering of national priorities. Indeed, we are convinced that conversion has broader applicability, as part of a comprehensive federal policy on economic dislocation.

We are also concerned about the consequences of excessive military spending for our domestic economy and society. An enormous proportion of our total research and development effort over the past 30 years has been devoted to the military. While this provides knowledge and by-products that often can be used to meet civilian needs—in fact, that is why conversion is such a logical procedure—the overriding effect of this military orientation has been detrimental to the nation's technological vitality and economic growth.

The relationship between military spending and inflation is another cause for serious concern. Military spending increases the purchasing power of individuals and corporations, while diverting resources away from production of goods and services on which this additional purchasing power could be spent. As a result, military spending is the most inflationary kind of federal outlay.

The availability of military spending as a convenient mechanism for stimulating the economy has also doubtless inhibited development of other necessary approaches for achieving a high and stable level of employment. It is time the nation addressed the challenge of creating full employment without leaning unduly on the crutch of military spending. As it stands, the military budget is the most expensive public service jobs program in existence. DOD purchases from industry will increase by $7 billion between FY 1978 and FY 1979. During the same period, 120,000 new jobs in defense-related industries will reportedly be created.[7] While some of the $7 billion is due to inflation, even after allowing for that, the cost to the public of one single job in defense-related industry is over $30,000—more than three times the cost per slot of CETA programs, which is criticized by many as wasteful and inflationary.

Although by comparison the FY 1979 Defense Budget is leaner than what Ford had put forward for the same fiscal year (at a time when it was logical to put pressure on the incoming President on behalf of the military establishment), there is no escaping the fact that in an absolute sense the Administration's proposal is far from austere, calls for substantial real growth, and projects further significant increases into the future.

We urge this Committee to set a budget ceiling lower by at least $5 billion—possibly more—than was proposed in the DOD budget. We refer you to the Hoopes-Scoville Report list of alternatives for reductions, which according to their analysis would amount to $10.5 billion (in FY 1978 dollars) in FY 1979.

While we want these funds cut off the defense budget, we do not want them cut off the overall budget outlays. Rather, we want them reallocated to areas of federal government spending which meet our country's basic human needs.

The transfer concept is a strategy for doing precisely that: shifting federal spending away from specific defense categories into similarly specific areas of human need. Congress can use the concept to shift funds within the budget (as opposed to changing the total size of the budget) as part of its statement of national priorities. Thus, it is fully consistent with the still relatively new congressional process for dealing with the budget as a whole, rather than piecemeal. The introduction of a transfer amendment on the floor of the House last year was an innovative move which the UAW was proud to support. Although the amendment was defeated, it doubtless contributed to a climate where the Budget Committee's Resolution was sent back to committee and only

[7] Office of the Assistant Secretary of Defense (Public Affairs) New Release, No. 17-78, January 23, 1978.

approved when it came back with a $3.7 billion lower ceiling on military spending authority. I urge this Budget Committee to make the introduction of an amendment necessary this year by accomplishing the transfer in your own report.

There are numerous areas of human need that would benefit from additional funding, aside from those energy and employment programs covered earlier in this testimony. Higher outlays for urban fiscal assistance and the creation of an urban development bank for a $1 billion total would ameliorate the plight of our troubled cities and their residents; so would $1 billion additional spending authority for housing, or urban community development. Forward looking programs for weatherization and energy conservation could easily absorb about $2 billion in FY 1979; improvement of mass transit facilities, another $800 million.

Thus, the desirability and indeed the need of a shift away from military spending cannot seriously be questioned. What can be questioned is implementing such cutbacks without sufficient attention to the problems which will be faced by employees adversely affected, and by the communities in which affected facilities are located. Indeed, it is our view that any acceptable budget transfer plan must necessarily include adequate conversion provisions.

These provisions would redirect federal spending toward putting people to work on projects of priority social concern such as improving health care, revitalizing the cities, etc.

The rationale for conversion goes beyond the inequity of forcing employees and communities hurt by military (or space-related) spending cuts to bear the entire burden of adjustment. These employees, and the facilities at which they work, comprise an enormous potential resource; if a program to reduce unnecessary military spending failed to tap this potential, that would be wasteful in the extreme.

We recognize that the Budget Committee does not determine the details of new programs. Nevertheless, we believe it would be appropriate for the committee to specify—in its report or otherwise—the need to implement any transfer in a manner which minimizes economic dislocation.

The immediate need is to develop a short-run approach that could be implemented in connection with any cutback in defense-related activity during the next year or two.

A federally coordinated planning effort should begin as soon as any "official" proposal is made which would affect military or space-related work at a prime or subcontractor facility.[8]

The goal of the planning effort would be to develop a conversion plan that will provide satisfactory and useful employment for, and output from, the affected workers and facilities, and to coordinate that with the cutback in military or space-related activity at the facility.

The federal agency responsible for the planning activity could be EDA in the Department of Commerce. Planning should be done in cooperation with management and labor at the facility, but without their cooperation if necessary. Community representatives should be involved as appropriate. If a conversion plan is approved by the President or his designee, then it must be implemented as an integral part of the cutback in military-related activity.

The conversion plan should include provision, if necessary, for federal procurement of goods and services, oriented toward civilian needs, produced by the workers and facilities of military or space contractors and subcontractors affected by cutbacks. It is clear that the nation's economy will not achieve full employment during the next few years. In that context, thrusting "converted" military-related facilities into competition for a share of the private market could—even if successful—simply displace other output, thereby shifting the burden of economic dislocation to the source of that displaced output.

A further reason why conversion must encompass direct federal procurement is that military contractors presumably have a different kind of managerial knack—the ability to achieve new goals and accomplish difficult missions. Performance is stressed instead of lower price. Conversion centered around federal

[8] A cutback proposal could be considered "official" if it is announced by the Administration, or is approved by either house of Congress; such a proposal may never become effective, but the action described provides sufficient probability of a cutback to justify formal planning for conversion.

civilian procurement offers the opportunity to apply that kind of effectiveness to the solution of pressing social problems. Illustrations such as solar energy, or urban and intercity public transit are often cited and are appropriate.

In addition to direct government procurement, other aspects of the conversion assistance effort should include loans, loan guarantees, in-plant retaining programs, and technical and marketing assistance.

If conversion is found not to be feasible, adjustment assistance must be provided to displaced workers and affected communities as a backstop measure. This assistance must encompass cash payments, fringe benefit continuation, and retraining and relocation allowances in the case of affected workers, and special payments in lieu of tax revenues lost in the case of communities.

It must be stressed, however, that conversion to alternative useful activity, providing continuity of employment at satisfactory rates of pay, is the desired result.

In summary, the UAW supports the concept of shifting federal expenditures from unneeded military output to dealing with the unmet civilian needs of our society. The transfer concept provides a procedure Congress can use to implement that goal. As stated earlier, the FY 1979 transfer should in no case fall under $5 billion; we urge this Committee to increase the authority of the Economic Development Administration (EDA) (Title IX) by a minimum of $1.5 billion to implement an interim conversion program such as I have just outlined. This could be accomplished partly by fully funding EDA at the $2 billion level now authorized. Conversion plans developed for specific facilities could involve additional amounts—from the appropriate budget category—to purchase output from those facilities.

That $1.5 billion should not be restricted to defense-related conversion, but should also be available to finance pilot projects aimed at increasing the government's effectiveness in dealing with the more general problem of plant closings and relocations. This is an increasingly important problem, frequently—but not exclusively—related to public policy decisions, such as in the areas of energy, environment, imports, etc. Recent efforts in connection with steel plant closings have again emphasized the need to develop effective procedures. Financing of pilot projects during FY 1979 could provide benefits for those directly involved in those projects, as well as knowledge that would help us to develop more comprehensive solutions.

OTHER FUNCTIONS IN THE 1979 BUDGET

We support the Administration's proposed increase in the level of funding for education. Proposed outlays would increase by 13 percent over FY 1978, and by 32 percent over FY 1977. We especially welcome the stepped up allocation of monies to school districts serving disadvantaged children and the enlarged federal share of expenditures for the education of the handicapped.

We also support the Administration's concept of relieving families of the increased cost of higher education and equalizing educational opportunities through a grants program, whereby grants would be given directly to undergraduate students. We find this approach superior to the tax credit mechanism that seems to be gaining support in Congress, and which would add one more blanket incentive to a system already overburdened by inefficient tax expenditures.

There are no new initiatives in urban assistance, but the President has promised to deliver a specific proposal to cope with the problem of the cities in early spring. We will withhold our comments until that opportunity. We hope that proposal will be more positive than indicated by the tone of the Administration's remarks on urban revitalization, suggesting a lesser role for the federal government in the cities, with the slack taken up by private enterprise. There is no evidence that the private sector is about to fill the vacuum that it created in its exodus to the suburbs and smaller communities. What has been said many times must be repeated; fresh initiatives are needed in this area, and no institution is better situated than the federal government to produce them.

The Administration will propose new transportation legislation this year to reauthorize highway and public transportation programs through FY 1982. In doing that, some programs will be consolidated, others added, and more flexibility will be provided at the local level.

We are concerned that not enough new funds are allocated to urban mass transportation. Although outlays are expected to increase from FY 1978 to FY

1979, obligational authority has declined; this may hurt public transportation in the next two or three years. We advocate an increment of $800 million to the FY 1979 budget proposals in the capital facilities category to accommodate the acquisition of additional buses, the replacement of rail vehicles, and the financing of new starts in several people-mover systems.

The housing assistance budget for FY 1979 is commendable; we especially welcome its emphasis on rehabilitation as a strategy for providing housing assistance in urban areas. The new Targeted Tandem program, budgeted at $50 million, should facilitate the goal of an economically-minded central city housing market. Still, about $1 billion in new funding for public housing should be added to the President's proposals, which does not expand beyond the 400,000 unit total housing goals, and for new funding for Section 235, which provides homeownership opportunities for moderate-income persons.

CONCLUSION

President Carter's budget proposals, although going in the right direction, may not provide enough stimulus to reach the relatively modest goals that in terms of output growth and the unemployment rate the Administration has set for itself. For FY 1979, the CBO has estimated a deficit of $67 billion resulting from the need to offset the fiscal drag in order to achieve an average unemployment rate even higher than the Administration's forcast (6.2 vs. 5.9 percent). The CBO deficit is thus $6 billion larger than the Administration's.

We urge this Committee to adopt a ceiling for outlays higher than the Administration's by at least that amount. We want to underscore that the increase in the deficit should stem not from deeper tax cuts but from an increase in targeted expenditures. We are indeed disturbed that the President is implicitly placing so much reliance on the private sector to achieve increased economic growth. For example, the FY 1979 budget proposes tax cuts three times larger than the amount scheduled for new expenditure programs. Yet a CBO analysis shows that many more jobs are generated by outlays for public employment and public works programs than by tax reductions.

This Committee undoubtedly knows of the UAW's emphatic support of the Humphrey-Hawkins bill. In broad traits, we see in that bill the embodiment of this targeted approach towards fiscal policies. That is, after establishing a goal of full employment, the bill provides a set of programs to achieve that goal. These programs would substitute a rifle for the shotgun of aggregate demand by carefully aiming job-creating efforts on those groups and areas in the economy that continue to show high rates of unemployment.

In addition, one of the most important features of the bill is the process it establishes for integrating the programs needed to achieve its goals into the overall economic policies of the federal government. Multi-year budgetary planning clearly becomes an issue at that point. We welcome the Administration's decision to ask each agency to prepare future budget requests extending for three years beyond the budget year. This will facilitate and allow for longer-range planning where we now only have projections, and will provide a better structure for review and analysis of spending and tax policy choices. More informed decision-making will be afforded to the private sector as well as to state and local governments.

The achievement of full employment and other major new initiatives satisfying human needs will require a high degree of coordination among all institutions of government. We urge this Committee to carry on a very important part of the process by providing long-term budgetary planning in a framework of socially-oriented and forward-looking national priorities.

Representative BOLLING. Mr. Fraser, throughout your prepared statement you have spoken against the investment tax credit. Now, previous witnesses that we have had before this committee said, in those things that were added to costs of a plant such as pollution control, that we ought to have a first year writeoff for business. How would you react to that kind of proposal?

Mr. FRASER. Well, I want to make the distinction between that and tax credits for normal investment. If I might just take a minute, and we didn't bother reciting it in the testimony, but in terms of

an overall tax incentive principle, I dredge up the statements by General Motors and Ford, which say that they don't base their decisions on expansion on whatever tax incentive happens to be in place at a particular time; that they are guided by the demand of the marketplace.

In terms of the pollution offset, I would like to take a look at that, because one of my concerns is we are bearing down too heavily on American industry in terms of cost for environmental protection.

Representative BOLLING. That concerns me, too. That removes the competitive position and it takes us a long time to adjust for it. One, the writeoff of that would take care of that burden after the 1-year period. We ought to remain competitive, it would seem to me.

I have been concerned about this from a competitive point. One argument, as you know, in the steel industry, is whether or not there is fair competition between U.S. steel, Japanese steel, and the steel of the Common Market countries and so forth, and whether or not we are placing too big a burden of environmental controls on American industry. And I have no tax solution, but certainly I would not be opposed to scrutinizing that possibility.

Senator Bentsen.

Senator BENTSEN. We are pleased to see you again, Mr. Fraser.

Mr. FRASER. Nice seeing you again, sir.

Senator BENTSEN. I recognize the leadership that you have exercised and the study that you give to these issues. Thinking about the arguments that investment tax credit if used on structures can result in moving of businesses, I can see some legitimacy to that argument. What if the investment tax credit was a credit limited in size, structured to rehabilitative and modernization of the structure?

Mr. FRASER. That would be much more attractive to me. You know as well as I do what is happening to many of our urban areas, and one of my concerns is that the tax investment extended to structures will accelerate that process. If we could structure a tax credit to give industry an incentive to stay where they are, we would be attracted to that proposal.

The fact of the matter is we have supported such a proposal in the State of Michigan.

Senator BENTSEN. I have been moving to support more and more of those things that result in rehabilitative and modernization, whether it be housing or factories. I am speaking from a sun belt State, but we are going to have some of these same problems. I want to look down the road at the inner cities, although most of them are in pretty good shape now. We have to show these concerns and address ourselves to them now. But it seems to me that we create more jobs through rehabilitation than I think new housing from some of the studies that I have seen.

In addition, you don't have some of the displacement of the people and the great human cost.

Mr. FRASER. I think you are absolutely right, Senator. I wish there was more emphasis on rehabilitation. And I think obviously what we need is a mix but, you know, it is one thing to theorize and another to look at the practical results of a rehabilitation effort. I

served on the Michigan State Housing Authority. We put a considerable amount of money in rehabilitating older homes with substantial foundations, many that were built in the 1930's and the early 1940's—basically in the 1930's. And those programs have been tremendously successful. I am committed to the process of rehabilitating housing provided you have the correct structure in the first place. You can do just wonderful things if you have a sound structure in which to rehabilitate.

Senator BENTSEN. I am intrigued by the proposal. I have not seen it before. The public sector is spending some funds in trying to develop some real conservation in all of these Federal bills. I have got an office back there. And if I ask for a change in the temperature somewhere deep down in the bowels of these structures, someone begins to turn some valves and about 28 hours later I get the results. But the temperature changes at that time.

I think right here in the Capitol is one of the places that we might do that. We can probably put on a lot of storm windows and additional caulking that we have not put on before.

Mr. FRASER. I might say, Senator, that it is not theorizing. When you look at the energy used in this country vis-a-vis other industrial countries, there must be a horrible waste in our system in many, many areas.

Senator BENTSEN. One of the other points you make is in the proposed budget research for renewal of resources. There are no guarantees for the small amount of factories—we have noted the demise or reduction in small business ventures. I don't know how you can get the competition for big business and the small business can survive or starve. What can be done to correct the specific situation? What can we do in trying to open up opportunities for small businesses, to bring about further competition?

Mr. FRASER. I don't have any immediate comments. It is a very difficult problem you pose because there is a greater and greater concentration, and conglomerates in our country are growing and keep absorbing the small businesses.

I have a deep belief that our society, our economy is better off if there is a proliferation of smaller business. I truly believe that the more competition that we have the better off our country is. Consider our union; a lot of people view us only as GM, Ford, and Chrysler. We have literally hundreds and hundreds of contracts with small employers. They are always of a deep concern because you are not dealing with General Motors but marginal employers, and you are always worried about their survival.

I am for encouraging the small employer, and anything that we can do to enhance their survival and even their growth.

Senator BENTSEN. The President proposed a wage and price restraint. What do you think are the prospects of that and how would you deal with that kind of problem?

Mr. FRASER. I don't think that we would be as negative as our friends in the AFL–CIO. We would have an open mind on that. As you know, the so-called deceleration program is pretty general.

We are willing to sit down with the administration to get more details as to what they have in mind. As you know, they said it

would vary from industry to industry. Conceptually, I suppose if you can have general deceleration, hardly anyone can oppose that. But what I want to do is to sit down and to learn about what they have in mind. For example, how can we as a union in the auto industry make an intelligent decision about cost impacts if we don't know the rate of productivity in the industry.

We are willing to sit down with the administration and explore with them specifically what they have in mind.

Senator BENTSEN. I have a lot more questions I want to ask but Senator Proxmire I am sure is chomping at the bit to ask you some questions.

Senator PROXMIRE. Thank you very much, Senator Bentsen.

Mr. Fraser, I congratulate you on the quality of your prepared statement. It is exactly what we would expect from the head of the UAW. We have had, of course, over the years, I can recall when I first came on the committee a long, long time ago—Walter Reuther coming in with a series of statements over the years and followed by Mr. Woodcock. And you are certainly right in that great tradition.

Also, I don't want to overlook the fact that yours is a very unusual union. It is a union of great moral strength. It is a union that has emphasized honesty, a union that looks far beyond the interest, the broad public interest. And I think you indicated that in your responses to Chairman Bentsen's last question.

So I think it is a most unusual union. It is certainly a great force in my State in all kinds of ways. You are one of the first unions certainly that had your own kind of an affirmative action program, for example, with respect to minorities and there is just a myriad of ways in which you contributed greatly to a better country and a fairer country.

I say all of that because I mean it, but I don't want you to feel that I am being contentious if I quarrel on a few things.

You say that the President's limits of the Federal budget to 21 percent of GNP by 1983 would unduly limit the Government's ability to meet social needs. I can quarrel with you on several bases on that. I think 21 percent is too big rather than too small. In the second place, it makes all kinds of assumptions as to the kinds of economy we will have in 1983. He assumes 4 percent unemployment. In other words, a very high level of activity. He assumes considerable growth before we have achieved that level. The GNP would be at a relatively high rate and, therefore, 21 percent would still present a substantial amount for the Federal Government to spend.

Furthermore, you can assume for 1983 the social needs that would be somewhat less because there would be less unemployment compensation, less welfare, because there would be more people working.

How big do you feel the Federal budget share of the GNP should be under conditions of reasonable full employment?

Mr. FRASER. I don't know if I am ready to recite a specific figure, Senator, because of transfer payments, and, second, when I look at what is happening in other countries of the world I don't see any immediate danger.

Senator PROXMIRE. It is not so. If you just look at the Federal share in isolation it is one thing. But look at the State and local

governments. There is a great deal of State and local spending because Federal programs require it.

Environmental programs and other programs. I voted for those, but nevertheless we do have a local, State, and Federal government which constituted 10 percent of our GNP roughly in 1930 and now constitutes almost 40 percent. And the main growth in recent years, you are right, has not been in the Federal Government but at the State and local government. And overall it is a burden. It is a burden on the productivity of the country. It means that we are more likely to have inflation. It means, of course, heavy taxes for the people, including the members of your union.

Mr. FRASER. Let me answer your question by raising a question with you, Senator. How is it, for example, our outlay as percent of gross domestic product was 33.9 percent, while Canada is 37.1, and Germany is 41.7 percent. And I halt at Germany because you know in Germany——

Senator PROXMIRE. What are you comparing?

Mr. FRASER. Total government expenditures.

Senator PROXMIRE. What level did you put us at? What is your percentage?

Mr. FRASER. Ours is 33.9.

Senator PROXMIRE. Those figures, I am not sure of what is excluded. My figures are closer to 38 percent than 33 percent.

Mr. FRASER. This is in 1975, Senator.

Senator PROXMIRE. All right. Let me concede it then. You may well be right. I haven't checked the figures out in the last couple of years. Countries have attempted to impose too much of a burden and inflation is worldwide, a worldwide phenomenon and we are doing better than most.

Mr. FRASER. I stopped at Germany, which is 41.7 against our 33.9. The inflation rate is below 4 now and the employment rate is maybe 4½ percent. They are doing quite well there. I don't know if there is an absolute answer to your question, except based upon the transfer payment, and based upon what is going on in other places in the world I am not fearful of going beyond 22 percent.

Senator PROXMIRE. I want to make the point that it is great to have you come in and make a strong case as you do here, because we need to be challenged on this. We have not been with your viewpoint as much as we should have been. We had a few other people that represented similar views, but you give it a vigor and breath of support.

Mr. YOUNG. What concerns us on the point that was made is that the discussion should be on two levels. There should be a real distinction between the discussion of those Federal and, for that matter, State and local expenditures that merely move money around but let private decisions be made, and those expenditures where the Federal Government really decides how resources get used.

And while we don't have an exact target figure for either of those and while we have problems, for example, in the transfer payment area——

Senator PROXMIRE. I would interpret it as just moving money around, period. I agree with you on social security. I am all for it,

and I think that it is one of the greatest programs we have had. But I do think it is not just a matter of moving money around. The fact is that people who work are paying taxes and people who retire are getting better benefits. It is a good policy, but it is a policy decision made by Government which shifts funds in an enormous amount from productive work into those that have retired.

I think it is right, but it is a program that I think—that can't be ignored and say let's forget that.

Mr. YOUNG. No. But there the issues should be how are the taxes raised. As you know, we have great concern about the form of taxation, but that issue is a different one from the Government using too large a share of the country's productive capacity. When the Government funds the social security system, which we support, it is not using up any of the productivity capacity of industry, and it is not meeting needs for goods and services.

Senator PROXMIRE. I am delighted to have your statement on housing. I agree with you wholeheartedly. We can get a real improvement of the economy with a minimum expenditure by the Federal Government. I think your emphasis on energy, on conservation makes sense, is wise. I am also happy to see your proposal, although I disagree with you, on nationalizing the railroads. We have to do something about it. We have not done enough things. I think that this should be considered.

By and large, I think Government doesn't do well in the private sector, even in the area of railroad operation. And I am also concerned about—I should say I am concerned about your negative position on business tax relief, particularly with respect to corporate income tax. I think it is a proposed reduction by President Carter, that I also favor the investment credit, but the reduction in corporate income tax is important for a whole series of reasons.

In the first place, the instant corporate income tax—on the basis of everything that I have seen—is on the consumer rather than on the stockholder in many sectors. No. 2, it is extremely hard for a small corporation to grow, especially a profitable organization, an efficient corporation to grow when you have that kind of a very big tax.

Also, you have—you encourage featherbedding. The New York Times has had quite an enlightned editorial policy—has proposed the abolition of the corporate income tax. I think the very moderate steps that President Carter proposes of reducing it over a period of years to provide a greater cash flow and provide an opportunity for greater investment is a reasonable proposal.

Mr. FRASER. One item I would like to point out. Over a span of time, the corporate share of the total taxes on income has been declining. In 1968 it was 28.9 percent. In 1978 it was 24.8 percent. And I think a rational prediction would be that it would continue to go down.

Senator PROXMIRE. Right. It is so inequitable. Some corporations and some industries are paying 40 to 48 percent and others pay very little. Banks pay something like 14 percent. Other industries pay even less than that. We have so many exceptions and loopholes, we are trying to achieve so much in terms of social policies with these

incentives that I think they are very discriminatory and I think that the whole operation is unfair.

Mr. FRASER. One matter that we would wish the committee to look at—but I don't have an easy answer. This isn't the sun belt vis-a-vis the snow belt. There are some States competing with one another for plant location which causes great, great dislocation in terms of the people involved. I just think it ought to be controlled.

Let me give you a couple of examples. We had this competition between Ohio and Pennsylvania bidding for Volkswagen. Pennsylvania won out at the expense of about $400 million. Recently we had competition between Ohio and Michigan for the location of a new Ford plant. Governor Rhodes came up, and certainly has a right to, and tried to attract from the State of Michigan an industrial plant. It would do great harm to the State of Michigan if that plant left and relocated in Ohio. I think there is a meeting today of the council of the city of Trenton in downriver Michigan. In order for them to meet the bids of the State of Ohio, they have to vote themselves a tremendous increase in taxes, and we think that that proposal is unfair. I wish you would look at this.

Senator PROXMIRE. I have one more question. I would like to ask this. I would very much welcome—it is so typical of UAW, so for you to take that cooperative and thoughtful position on inflation is extremely welcome. Would you give us your economic analysis of the labor-reform bill? We are about to vote on it in the Senate in the next couple of weeks, and I hope to pass it. I think it is essential but I have gotten a tremendous amount of lobbying against it, and my mail is running about 3 or 4 to 1 against it. And it seems to me that the possible economic adverse effect on small business has been, and others have been, enormously exaggerated.

I would like to get your view of what the economic consequences are likely to be, in terms of unemployment which has been charged to it, in terms of inflation and so on.

Mr. FRASER. First off, Senator, I am at a complete loss. I don't think there are any economic arguments.

Senator PROXMIRE. You don't think it will have any economic inflation impact?

Mr. FRASER. Let me tell you what I think; what it means to me as the leader of a union.

Senator PROXMIRE. To structure this so that the basis for the economic argument is that unions would get 6 or 7 million additional members and they will negotiate for higher wages and it would have a rippling effect on the economy and the wages would go up and the prices would go up.

Mr. FRASER. First off, let me tell you what I believe the bill means from our respect. Perhaps the best way to make the case is to give you an actual example of what I experienced within the last few months. We were trying to organize Rockwell International, 6,000 engineers. We have the production workers organized. They are the ones building the B-1. We embarked upon an organizational campaign in May of 1976. We filed in May of 1976, did not get an election until August of 1977.

During that time the company kept eroding our majority. So the bill provides that we would have an election within a reasonable

period of time. It couldn't be just deliberately delayed. They could not hire a firm of lawyers and then contrive to delay the democratic process. After all, what we are saying is when a group of workers indicate that they want to join the union, give them a secret ballot election conducted by the Government. You still have to win that election.

Second, and perhaps more importantly, from our point of view, under the current law this is what happened at Rockwell. I went out to three meetings there. And we called a meeting of all 6,000 engineers in the halls near the plant. Some of them were in the back of a beer garden.

So here you are talking to the engineers after work where they have to expose themselves, where there are partisans to the union. After the three meetings, I talked to no more than 1,000 engineers, 900 engineers I would say. In the meantime the company, on company time, on company property, at the citizens' expense because it is all defense contracts, they were talking to all 6,000 engineers in small groups—groups of 2 and 3. So there was no free debate and there is no equality in the opportunity to present your point of view.

These are the cornerstones of the labor law reform. I won't get into it unless you wish to ask about it; there are other features of labor law reforms. The fact of the matter is in organizing we have to get the workers that are attempting to organize. We have to have over 6 percent of the workers agree by secret ballot that they wish to join the union, and if labor law reforms were enacted tomorrow, there would still be a struggle out of there.

We have organized all of the easy ones and left the ones that are tougher. Workers have to be motivated. If the employer is smart enough to avoid the grief and strife, we are not going to organize it. So, No. 1, the workers have to be motivated to join the union. No. 2, we have to convince the majority to cast their secret ballot in favor of the unions. So, you know, the enonomic argument is an abstraction.

If we can go in there and negotiate a wage increase, maybe the wages are depressed—maybe they should be increased. If that causes an increase in price, maybe society will have to assume that cost.

Senator PROXMIRE. Thank you very much.

Senator BENTSEN [presiding]. Representative Brown.

Representative BROWN of Ohio. I apologize for not being here earlier. As you know probably from your experience around these halls, one committee session at a time would be wonderful. I have not had a chance to go through your prepared statement but I have scanned it, and if I am being repetitious, I apologize.

If you would run through the things that caused you to conclude that public service jobs and those kinds of things rather than through appropriation processes in government spending is better than the approach that the President is taking. Is that tax package providing greater incentive for greater increased jobs in the private sector?

Mr. FRASER. I am all for that. I wish in our economy that it was not necessary to advance the program of public employment. Let me

start out near your home base, and what worries me is that there is a point of view in this country that the only people that are unemployed are people that don't have the incentive to go to work. But this is about the third contrary experience that we have had in and around Detroit.

The Ford Motor Co. made an announcement that they are renovating the plant out in River Rouge, the assembly plant, and they are going to be hiring 1,300 people. They are going to expand the Mustang production, although there are signs of a slowdown in the automobile industry in terms of sales. And 3,000 people literally battered down the doors to get an application. And this was the day before yesterday.

They started to line up at midnight in subfreezing weather in order just to get an application, an opportunity to go to work. You have probably heard of similar situations at the Cadillac plant in Detroit sometime ago. They just passed the word that they were going to take applications to fill attritional programs. Ten thousand people by word of mouth lined up outside of the Cadillac plant. I wish there were the private sector jobs that could absorb these people and give them an opportunity to get employment in the private sector. And the more private sector jobs that we can generate, the more pleased I would be.

Representative BROWN of Ohio. But I think you would agree that the contention of management is—really they could do more in the way of expanding their facilities—creating more jobs if they were able to have a better chance for capital formulation and retention. That is what the pitch is in the President's tax program and others who have had even greater tax cuts.

Mr. YOUNG. But Congressman, I think in the Council of Economic Advisers' reports, in their comments they say what they are concerned about is a down-the-road shortage of capacity when the economy expands, as we hope it will. It seems that we are putting the cart before the horse. The problem that we hear from companies is not that they can't get enough return on capital. It is that they are worried about whether if they make the expansion that the demand will be there to use the facility. If the economy expanded and people were closer to their capacity limits, there would be greater incentive to expand. There is no inability to develop money for investment. And it is the marginal situation where the investment tax credit makes the difference.

The real issue, as we understand it, and also the writing that we look at, indicates the decision of whether or not to expand the plant—the decision of whether or not to invest—is, if somebody is convinced that that market is going to be there and they are going to be able to sell the goods. What everybody is hearing is 1979 is going to be a bad year and that is what is holding them up, not the question of whether or not they would get some immediate tax break.

Representative BROWN of Ohio. I was at a meeting yesterday where we heard that one of the greatest difficulties in terms of what should be government policies, is the inability to agree on facts.

Mr. FRASER. I have figures that I have seen, Congressman, in terms of industrial sector. The last figures I can recall seeing were 81 to 82 percent of capacity. It is not a lack of capacity.

Representative BROWN of Ohio. Let me stop you there.

Mr. FRASER. Yes.

Representative BROWN of Ohio. What is full utilization, 100 percent?

Mr. FRASER. No. I think if we are utilizing 100 percent we would be in real trouble. We would have tremendous inflationary pressures.

Representative BROWN of Ohio. You can't achieve 100 percent utilization for all kinds of reasons and you are bound to have some structural lack of capacity.

Mr. FRASER. Right.

Representative BROWN of Ohio. What is your estimate of full optimum—what is the effect, practical rate of full utilization of plant capacity?

Mr. FRASER. Let me put it in this way. It is more than 81 percent. I don't know if it is above 90, but certainly we have a conclusive argument. I believe we have a convincing argument that it is above where it is now at 81 percent.

Mr. YOUNG. It fluctuates.

Representative BROWN of Ohio. I think it is 82.9.

Mr. FRASER. There are industries, you know, Mr. Brown—the auto industry is one of them, that are expanding. Particularly General Motors and Ford. And there is need for greater capacity there, but I don't think you are concerned. GM made $3.3 billion last year and Ford made $1.6 billion last year. I mean they have the wherewithal to make the expansion that is necessary and are doing it. I am glad they are doing it.

Representative BROWN of Ohio. Mr. Fraser, you have probably looked at the President's tax program, the reform, and followed his discussion about the three-martini lunch. And I think by and large you probably endorse the recommendation in that regard.

Mr. FRASER. Yes.

Representative BROWN of Ohio. How do you take that view on that issue when I think you presently have before the IRS a request for a favorable rule, your so-called legal services plan, which I understand would cover all personal legal services. Basically it would be a negotiated contract. It would cover many things.

In any case, that would not be taxable deductions. In other words, you are asking IRS to receive a tremendous revenue loss by making that program a nontaxable item to the employers; right? How do you reconcile that with the rather, I would think, less significant revenue loss impact of not permitting deductions for half of a lunch?

Mr. FRASER. I don't know how much the abolishment of the three martini lunch will yield to the Government, as compared with the legal services.

Representative BROWN of Ohio. What kind of price do you put on this as a fringe benefit? What is anticipated to be the average legal cost per individual to be covered by the program?

Mr. FRASER. One of the reasons why we thought of the exemption—this is a purely experimental program. In 1961, Chrysler Corp. was in great difficulty financially and their reserve funds, their SUB funds were on the brink of bankruptcy. So the workers agreed in 1961—this is just Chrysler, not Ford or GM, they didn't have the

same economic problem—they put aside 1 cent per hour in 1962, 2 additional cents in 1963, and 2 additional cents in 1964. So at the end of 3 years the workers were putting 5 cents an hour of their own money in the SUB fund. That accumulated amount of money amounted to $11 million. We dissolved the funds; put it in a reserve fund. It wasn't necessary to use the money. It was put in the bank and over a span of years that money grew and grew until it is now $20 million.

So that is the money that is being used. It is the workers' money, not negotiated money. It didn't cost Chrysler a mill. That is money we are using to introduce legal service programs. We are not going to apply it to all of the Chrysler workers. We don't want the experiment on such a broad basis. We don't want to stumble along the way and will take it one step at a time. There are obviously some pitfalls in terms of a program—it is an experimentation. It is not a full-fledged program.

Hopefully, frankly, we will be able, when we have the money to do it, to apply it to all of the 100,000 workers in the United States. In one area where we have large numbers of workers we will deliver the service one way, and where there is a smaller group of workers we will deliver it another way.

Now, in terms of your question on taxes, and I will be very blunt with you on this. I suppose if you are living in a perfect world and were starting from scratch where you could close all loopholes—for example, I will give you a tough one—deductions on taxation, on insurance loans, on surgical, medical, and drug programs, and on mortgage interest. If you lived in a perfect world, I suppose you could see all of those as loopholes. And if we want to go after legal services, there are several other services that we can go after and make the same case. So I am not going to argue philosophically with you, because if we can start writing the tax code over again and everybody could buy a percentage of their income in services, I would agree with you.

Representative BROWN of Ohio. You are asking to basically approve the nontaxable benefit derived from your legal program. Are you concluding that only individuals include their deductions?

Mr. FRASER. That is not what we are asking IRS. This Congress passed legislation providing for a tax exemption for legal services. All we are getting—all we are asking of the IRS is the approval to use those funds for legal services. The tax exemption is already there. Congress enacted the tax exemption.

Representative BROWN of Ohio. If this was a negotiated item in your contract—I just wondered why that was applied just to your situation and not across the board.

Mr. FRASER. It is not a negotiated item.

Representative BROWN of Ohio. Are you saying that you would not attempt in the future to have a legal services package be part of your negotiating efforts?

Mr. FRASER. No.

Representative BROWN of Ohio. I think that your answer is absolutely irrelevant as to what it is going to look like in the future.

Mr. FRASER. You are saying we couldn't—didn't petition IRS. All we are asking of IRS is permission to use the funds because it was, in the purview of IRS——

Mr. YOUNG. What we applied to the IRS for was a ruling, that what we wanted to do was in conformity with the law. Now, the law provides for certain tax—approved legal services plans. And also, my understanding is that that particular provision of the law—it is an experimental item which is open for automatic review. It has a sunset provision. So it is very different from the kind of business entertainment deduction which you are describing.

Representative BROWN of Ohio. I agree with Mr. Fraser that what is a loophole for me is not one for you, and what is a proper tax treatment for me is a loophole for you. And what is a proper tax treatment to you would be a loophole for me.

Mr. Fraser, I have one last thing on loopholes. Again, in the perfect world, Mr. Fraser, you run into all of these things.

Mr. FRASER. I would be willing to say that. There are obviously inconsistencies—let me give you a couple of figures. I will put in a little plug for national health insurance here. In Michigan, the Blue Cross-Blue Shield premium in the State of Michigan, the January 1st adjustment brought it up to $167.02 a month. That is 96 cents an hour. That is $2,002 a year. General Motors in Michigan for Blue Cross-Blue Shield family plans with no dental or vision care—it is hospital, surgical, medical, and drug programs—premium is $141. The last adjustment was back last October, October 1977. October 1978 there will be another upward adjustment. It will go to around $160. You can see variation in each private enterprise, for example, if the corner grocery store owner wants the same coverage, he would be paying tax on this.

So I would have no difficulty if we were starting all over again writing tax codes and everybody had to pay for these services, then you would get some equity.

Again, I repeat on the legal services there was an act of Congress and we were petitioning IRS to use that money.

Representative BROWN of Ohio. I forget when it was passed.

Senator BENTSEN. In 1976.

Representative BROWN of Ohio. I don't remember that. The full taxation—the ramifications of that were probably discussed in the House.

Senator BENTSEN. They were discussed at length in the Senate. There was quite a bit of debate over the issue.

Mr. FRASER. I think they went into it rather cautiously. I think they provided for a review periodically, just wanted to see what the impact would be. I don't know, but in any event that is the story of the Chrysler legal services.

Representative BROWN of Ohio. Thank you, Senator Bentsen. Thank you, Mr. Fraser.

Senator BENTSEN. Senator McClure.

Senator MCCLURE. Thank you very much. I appreciate your testimony. I appreciate the fact that the UAW has gone to the trouble, as they usually do, to analyze the President's budget and alternatives to give us some advice. I think that kind of input is helpful to us.

One concern that I have is that at various places in your testimony you advocate increases for revitalization of the nation's cities: $1 billion more for mass transit; $1 million and a half for EDA; $1 billion in urban development; and $2 billion for something else; $1 billion for lower energy equipment production of insulation, $7 billion more for unemployment compensation. In the 1979 budget, for example, there are several places you have sudden increases.

Do you suggest that that would simply be an increase in the proposed deficit?

Mr. FRASER. What we would propose is several things, Congressman. No. 1, we are atracted to the argument of the CBO, which recommends $6 billion increase in the President's proposed deficit. And we would adopt that as a proper figure.

In addition to that, we would get money from shifting over from defense to other projects, and we come up with a figure of $5 billion shifted from defense to civilian projects.

Senator MCCLURE. You want to cut the fancy expenditures by $5 billion or on the man-hours side?

Mr. FRASER. On both. It is a fair question to ask. It is easy to say we want a $5 billion cut, and it is a fair question to put the burden on us: OK, where are you going to get the $5 billion?

Senator MCCLURE. I ask for cuts, and people ask me the same thing.

Mr. FRASER. We have corroboration with Townsend Hoopes and Mr. Peter Scovil. They came forward with a list of items where we think there are alternative choices of making cuts that we do believe are rational—and I underscore "believe"—in having a solid defense posture.

I am not for cutting defense budgets recklessly, but we think we can justify the $5 billion shift in both materials and manpower.

Senator MCCLURE. Do you have the faith in SALT I agreements, maintaining adequate parity between the United States and the Soviet Union?

Mr. FRASER. I am really not too sure. I don't know if absolute parity or superiority is a viable objective. They have to stop their race someplace.

Senator MCCLURE. We can stop it by surrendering.

Mr. FRASER. I am for keeping the capability. And I know these are all cliches, this is the world in which we live and we have to maintain the capability of massive retaliation so the Soviet Union, or anyone else, would not dare make the first strike with immunity.

No. 1, I don't believe we have to have superiority. I don't think we will get the end of this arms race unless we have some limits, unless we have some control. I fear the impact it is going to have on our country and the economy in general.

Senator MCCLURE. I agree with your statement that we need to have limitations, that we need to be concerned about the size of the growth of the establishment and the defense expenditures. My concern is that we do not undertake that reduction unilaterally.

Mr. FRASER. I am not suggesting that.

Senator MCCLURE. And all of the evidence indicates that the Soviet Union is continuing its buildup in every item of defense

expenditures, with increased manpower, increased strategic weapons, and aircraft. They have increased their submarine capacity. They have modernized all of their forces. Can we safely reduce the expenditures in this country?

Our argument is that we can, but that presumes that there won't be an acceleration of the Soviet's buildup.

Just let me say this: If we look ahead to the new strategies that have come about, I think great emphasis—in fact, I am sure the United States is going to insist upon it by some reasonable means of verification. That we have to be assured that the defense of this Nation is protected. We would be foolhardy otherwise.

I would invite your attention—you say you are not an expert, and I don't pose as one—to look at what they have done, what they are doing and what they can do in the SALT I agreements that are in violation of the spirit of the agreement as explained to and ratified by the U.S. Senate. In view of their violation of the space treaty, their continued violations of the spirit of that treaty as well, we must ask ourselves the sobering question, can we assume that we can reduce defense expenditures until we have achieved some kind of a reversal of policy between the Soviet Union?

Mr. Fraser. I assume it is a fair question. Then must we spend more to have combatability? If we have to spend more, how much more and where do you stop? To me, Senator, it is such a vicious circle. I suppose the real answer is you hope that the people in the Soviet Union possess some sanity because it really takes a rather insane act to invoke the first strike, and you would think that they would be concerned about what it going on in their country.

I don't think that we should accept that as an overall, you know, umbrella for our protection. But hopefully, people will be rational and act in a sane manner. In the meantime I am for keeping our defenses up.

Senator Proxmire. Will you yield briefly?

We had testimony from the CIA and the Defense Department, testimony that there is not one area which the Soviet Union is equal to us in military technology. With respect to numbers, it is true that they do have some superiority in some respect. But its difference to us is that there is no area where we don't have at least equality or superiority with respect to the efficiency of our military operations.

Senator Bentsen. I don't agree with that statement at all.

Senator McClure. There has been testimony before our committee.

Mr. Fraser. In any event, when we advocate a $5 billion shift, it seems to me the burden is upon us to tell you where we would make it, and we are willing to do that. I think that too often in the past people said we want a $10 billion cut or $15 billion cut, and I think an absolutely fair question is, all right, but where? We are prepared to say that.

We are prepared to put forward some alternatives as to where the possibilities are to make that shift.

Senator McClure. Again, I think that debate on military preparedness will take place, and I would invite your attention to it in a critical sense: Where we stand, how we do achieve that essential military balance by which we can guarantee that the Soviet Union will act rationally, and why assume that they will.

I sat down across the table from them in the Kremlin and listened to them tell us that they were spending only 17 million rubles a year on defense establishment, and that is an absolute and total distortion of facts.

Mr. FRASER. I think all of the American people are concerned about their behavior.

Senator McCLURE. I wonder if the people of this country realize that, or have really focused on the fact that Soviet pilots are flying Soviet aircraft out of Cuba today.

Mr. FRASER. I saw those reports.

Senator McCLURE. And as a matter of fact, we may have a power skeet shoot down over Key West.

Mr. FRASER. I am not one to suggest to let down our guard. I am for being alert and vigilant, but also I want to end the insanity of just making these expenditures to have the competition. I think the key is not really how many tanks we have vis-a-vis Russia. It is of less relevant importance. But getting back to my original statement, we have to maintain the ability to prove to Russians that they can't survive if they engage in the first strike. I think that is the principle.

Senator McCLURE. Without prolong——

Mr. FRASER. You can do that without equality.

Senator McCLURE. I understand that. Without prolonging the debate, I want to touch on one issue as well. First of all, they believe they can fight a nuclear war and survive it. That is their belief. Now whether or not it is right or wrong, it is their belief.

Mr. FRASER. I don't know how we can determine that fact.

Senator McCLURE. Let me state my opinion on the basis of my conversations with them and the review of the record. It is my opinion that they believe that——

Mr. FRASER. Why should you believe them in that situation when you don't in the other situation?

Senator McCLURE. I am not talking about what they have said to me solely in terms of that they think they can fight. I am looking at what they have done, the actions they have done and the interpretation of the data to come to that conclusion.

Mr. FRASER. Unfortunately, I suppose we will not find out the answer to that question until it is too late.

Senator McCLURE. It is simply strategic. I think we focus on nuclear weapons or exchange to determine whether there is a nuclear strike. It is in that area that I think we have fallen critically on hard times.

Let me shift for a moment. You have in your prepared statement a section on energy, what you think we ought to do and where we ought to be headed. What do you think that we can do, in terms of reducing the rate of growth of energy consumption in this country in a full-employment economy, if our goals are to find useful work for other people? How much energy will we be consuming next year and in 1985? Will we be growing? Can we reduce the amount of energy? What must we plan for?

Mr. FRASER. You can do a lot more with the same amount of energy. I mentioned before you came in—and you know I think we

are comparing apples and apples—if you look at Germany and Sweden, Japan and France, countries all over the world, and try to figure out their industrial capacity and ours and their standard of living: We use so much more energy than do the rest of the world. There has to be a lot of waste there. And I am talking about countries that have generally the same standard of living as we, countries that have almost the same, relatively speaking, concentration of industrial capacity as we.

And so I am confident that we can have economic growth in this country without a great expansion of energy utilization.

Mr. YOUNG. If I may add, Senator, the other issue is not only how much energy but what kind of fuels are used to generate it.

Senator MCCLURE. I understand that.

Mr. YOUNG. That is an important part because we can have great growth in the use of energy, as much as we need if we can generate the energy from nonshortage sources, and that is where we see money being put to develop the sources.

Senator MCCLURE. I understand that, but I would like to return for just a minute to the question of whether or not we have to increase energy supplies. Do we have to increase energy supplies? We will be consuming less energy in 1985 than today.

Mr. FRASER. I think it is beyond that realm, any reasonable possibility.

Senator MCCLURE. How many, how much growth would you estimate would be required? There are those who say it has to be as high as 6 or 7 percent a year, and those who say it has to be equal to the rate of growth of the GNP; those say it could be slightly less and those who say there could be a slight reduction.

Where do you fall in that range of tradition?

Mr. FRASER. I don't know if we have made that calculation—off the top of my head I think we can do a great deal more with the same energy consumption that we have today, with the shift in the type of energy.

Senator MCCLURE. The administration's official position, as stated upstairs just a few minutes ago by Mr. Schlesinger, is that we can reduce energy growth rate below 2 percent a year. I think that is a preposterous statement; it is only my opinion, I can't prove it.

The second question is if we don't substantially increase our domestic production in the short term, we are going to increase our dependency upon oversea sources of oil and natural gas. We have already done the remarkable feat of curbing our import in this country in just 4 years, since they have cut off their support to us. We have gone from 30 percent dependency to 36 percent on foreign oil in just 4 years. At that time when we should have reversed that trend. Against that background we don't have yet the sense of urgency.

I had understood that perhaps we were making a national commitment to solving the problem. I understand we are only getting our attitude adjusted toward the problem. But if we had responded in the same way when the Japanese attacked Pearl Harbor, they would have been in Virginia while we were still deciding, as a matter of fact, whether they had attacked us out there.

It doesn't seem to me we have attacked the problem with a great deal of urgency or a great deal of national commitment.

Mr. FRASER. I agree with you. The last figure I saw the import of oil cost range is $40 to $46 billion in the calendar year. I think it is a frightening figure. I don't think we have addressed the energy problem at all. It is hard on occasion to get the American people to feel a sense of urgency. I suppose it is a part of the educational process that you have to go through in a democracy.

The Soviet Union can handle that very quickly. They have tripled the price of gas unilaterally and arbitrarily. I don't think we have addressed the foreign oil problem.

Senator McCLURE. The means are certainly under the bait, because if you have correctly pointed it out in your statement, it is an essentially negative side, except for the conversion of coal and increased use of coal. It doesn't really concentrate on the productivity of alternatives in this country.

Mr. FRASER. I think this is what is happening in the United States. All of the heads of government, Federal Government, State government, union leaders, have to take the responsibility when the American people get confusing signs.

Three weeks ago, Governor Rhodes was saying that unless the coal strike was settled that week he had to cut down the energy supply by 25 percent, and the following week by 50 percent. Let me show you what would happen in the automotive industry. Let's take Chrysler as an example. Chrysler Corp. would shut down completely, 110,000 workers, because of one plant in Ohio.

Governor Rhodes told us it was going to go down the next week. That is 4 weeks ago. I am sure the people of Ohio and the auto workers in Michigan are saying what about this, we are getting false signals all the time. I think that is the problem. During the oil crisis, during the embargo you probably have heard the story as well as I did, people said: there is no problem; there are thousands of ships laying out there off the coast of New Jersey and they are loaded with oil.

Senator McCLURE. Were those ships there off the coast of New Jersey?

Mr. FRASER. I will tell you this. The way the American people perceived this there was no shortage. I suppose there is no shortage if the price is high. Maybe that is the answer. In any event, it is difficult in a democracy—you know Pearl Harbor which was an immediate, visible crisis in a time of war—it takes more persuasion I believe to persuade the American people that they were not given too many false signals. The coal incident is the latest of many.

Senator McCLURE. A democracy is never a very tidy process, and there are differences of opinion. As long as they exist, there will be these so-called false signals.

Mr. FRASER. Bad information, not false signals.

Senator McCLURE. Sometimes it is lousy information, sometimes it is rumors. I did my best to find the ships off the coast of New Jersey: there were a few, 5 or 10 that were backed up, and they were backed up because suppliers anticipated the embargo. They had accelerated their orders and were on the high seas at the time the embargo was ordered, and the overloading capacity was not sufficient to temporarily accommodate all of the large construction at that

particular time, and we didn't know how long the embargo was going to last.

So Government policy said, spread it out, rather than ship it out, as rapidly as possible. There is no shortage, and there will be none if we are willing to continue to increase our dependence on foreign supplies of oil, if they are willing to produce it and willing to sell it to us, and if we are able to pay for it.

Now, if all of those things are met and there is no shortage between now and 1985, but if they are willing to produce it and willing to sell it, if we are unwilling to pay if there is a shortage, and if there will be one before 1985 at various places within the next decade, it is already too late to meet our requirement; the time lag of technology and investment and development is simply that great.

Mr. FRASER. I don't disagree with that. I think that is why the call for conservation and these other measures should be dealt with a much greater degree of urgency.

Senator McCLURE. In the face of that great degree of urgency and the fact that one of the problems is Government regulation, we can't drill offshore as fast as we might otherwise. We cannot dig coal as fast as we might otherwise. We cannot increase transportation lines as fast as otherwise. We cannot burn the coal as quickly as we might otherwise. We can't build nuclear plants as quickly as we might otherwise.

The obstruction of Government will be a major reason why we are short of energy over the next decade.

Mr. FRASER. There is a rational middle ground where conservation is given some weight without being able to hamper production. But I have seen stripmining in Pennsylvania that devastated the terrain.

Senator McCLURE. I saw factories that absolutely polluted the atmosphere around them, but we have stopped doing that.

Mr. FRASER. I think we are smart enough to do both.

Senator McCLURE. I agree with you.

Senator BENTSEN. Thank you very much, Senator.

Mr. Fraser, a comment was made by your associate that business looks to the markets and the demand for this product, and that is what determines their capital investment. I think that is too simple a statement. I don't think that really covers it. Business looks to two things, and they are completely interrelated. One direction is to markets, and demand for their products, and a reasonable rate of return on investment to make it competitive for the other source of investment. In addition to that, the statement as to 83-percent utilization of available capacity, does not reflect all of the story. The capacity that is laid aside often is the least efficient, the least moderate, the least competitive. I don't have the last few years' figures. Business has not put back in what they should have put back in, in investment capital or modernization to keep us competitive, and that is a major concern for me.

I don't see how we can stay competitive unless they do that. That is one of the reasons that I support the investment tax credit. I think there may have to be some kind of limitation on it as we discussed earlier. And why I support a lowering of the corporate tax rate.

Let me show you what has happened to new ventures in this country of ours, to the starting of new technology, you just don't have

the new issues today. Ten years ago you had all kinds of new issues being floated for investment capital, but that market has dried up. You have seen a change in the tax structure that has mitigated the start of small businesses. And you have seen the regulations that have been added, government regulations today cost us $62 billion a year and another $3 billion for enforcing it. Most of that is passed on to the consumer. Those are some of the things that concern me, really, in trying to see that we were competitive, for those big companies. That we have the Xerox's and the General Motors of tomorrow, that somebody can take them on and provide the competition and innovative ideas and creative ideas. We would like a comment on that in 3 minutes.

We have a vote before the Senate.

Mr. FRASER. Briefly, we provide in our statement basically that we are against the increase in the tax incentive. If we are going to do it at all, let's try to target it. Let's try to give it to the smaller companies. Let's try to give it to those companies who wouldn't otherwise expand. I suppose, if we must have such a tax relief, let's direct it in the right places. As you know, General Motors is not going to make a decision for expansion based upon tax incentive programs. They are going to do it upon expansion in the marketplace.

Mr. YOUNG. Senator, you are absolutely right. We tend to talk in extremes.

I was responding to the idea that putting money in investment tax credits will generate a lot of investment. We recognize that all of it is for mixed reasons. What disturbs us about the investment tax credit as it is proposed, much of the money, it seems to us that the great bulk of it will go to investment that would be made anyhow. The issue is to direct that to the kind of investment that you are talking about. It is not so much an objection to the tax credit in principle, as to the practical effect of the kinds of very generalized credit, that we have.

Senator BENTSEN. Some of it will go to some of the people that have made the investment otherwise. My problem is trying to figure out how to draw the line.

Mr. YOUNG. Yes.

Senator BENTSEN. Gentlemen, do you have any further questions?

Senator McCLURE. Aside from the comments you made in your prepared statement, you don't go into very great detail about the policies to counter inflation. Just how do you view the inflation? Is it a problem?

Mr. FRASER. It is a very serious problem.

Senator McCLURE. It is a very serious problem, what would you do to counter it?

Mr. FRASER. First off, I think the inflation that we are now experiencing is an external force. A great deal is due to, frankly, the grain deal with the Soviet Union that filtered its way, that affected the food prices. I think energy prices were obviously affected by the embargo. People in Government were projecting 6 percent. It is a continuing inflation. It is much too high. And I would suggest that one of the ways that you can reduce inflation is having higher levels of employment than you now have. We are wasting billions and bil-

lions of dollars. I have heard and read various statements. I am sure you read the statement for each 1-percent unemployment it costs us in the range of $19 and $20 billion in this country in terms of the various compensation and in terms of loss of income tax. If we could just reduce unemployment by about 2 percent, for example, it seems to me that would be fighting inflation.

Senator McClure. Do you support the President's voluntary program of keeping wage and price increases below the recent historical level?

Mr. Fraser. I commented on that earlier. We are willing to sit down with the administration and get more details of what the thrust of the program is. There is one question that we wish to ask; for example, I don't know how we can make an intelligent judgment on what effect our negotiations would have on prices unless we know the productivity in the auto industry. And if we can get this information, we can make an intelligent judgment. Certainly we would then be more receptive to the proposal, but we are willing to talk about it.

Senator McClure. Right now there is the American agricultural movement, the so-called farm strike. Does your union support or oppose the efforts?

Mr. Fraser. We haven't taken a position either way. What concerns us is this demand for 100-percent parity. I suppose the response to that would be don't you go in the negotiations with a demand that might be a bit exaggerated, but we have done nothing except to say that we believe that farmers are entitled to parity and equity, whatever that is.

Senator McClure. You mentioned earlier—the reason I asked that question about the grain sale was that it was one of the causes of inflation. If the wheat price moved up from an average of a little less than $2 a bushel to an average of a little better than $3 a bushel during that period of time, that increase of about $1 a bushel adds up to less than one penny——

Mr. Fraser. We had a shortage of fertilizer. We had a shortage of grain. The consequences of that grain deal was much greater than the price of bread.

Senator McClure. It just wasn't the price of wheat that we are concerned about?

Mr. Fraser. Of course not.

Senator McClure. I might indicate that I don't believe that that grain deal was other than the fact that some speculator got a hold of it, and the Russians were the greatest of the speculators because they were able to manipulate the price. We have tried to stop that, and, of course, we shouldn't have been surprised that they did it. They have done it to us twice before, but I don't believe that, for instance, if the farmers' strike is successful and they get the price of food up, you will see a similar effect on the market at this time. And I would assume that if you didn't like the grain deal, you would be opposed to the farmer getting more money for the price of the food now.

Mr. Fraser. I don't think so, the farmers are suffering from the economic distress. We have to find a way to accommodate their problem. You can't turn your back on the farmers.

Senator McClure. That was true when the grain sale to Russia went on. They had distressed levels then.

Mr. Fraser. We would have been better off to keep the grain in this country and figured out another way to do it.

Senator McClure. I would like to debate with you on that point further, as to why I agree with that point. But it is always fair to say that I am going to miss that vote if I don't run.

Representative Brown of Ohio. Mr. Fraser, I guess you will have to be content to let me maintain the dialog. I want to go back to your criticism of "crying wolf," I guess, the false warnings.

Many people criticized us for not having properly alerted them to the concern about energy and some of those things before when people saw there was a problem. So I guess that which is "crying wolf" to one person is an appropriate warning to others. I am wondering if there hasn't been some of this wolf crying about the coal situation. How much longer the President would have waited before he would have become actively involved in the negotiations.

Mr. Fraser. Well, I believe this is sort of a process that the bargaining took. I happen to believe, unlike some other people, that the President's timing about getting involved was correct. He should not have intervened earlier on because if he would have, first of all, I don't think it would have done any good.

Representative Brown of Ohio. If your people in the automobile industry generally—happened to start talking about layoffs that started to occur and if they would have kept quiet, would the President have gotten involved there at that exact moment? It was those concerns that were being expressed that were going far beyond the coal industry.

Mr. Fraser. Let me suggest this. Somehow they alerted the Nation. They thought they were alerting the Nation. I don't think they had to convince the President, as I understand it. He had an overview of the whole country as to what the energy problems were. But my suggestion is, Congressman, that if someone tells you something on one day that predicts the dire event and it doesn't come to pass, you have to lose your credibility. You can't expect the American people to feel a sense of urgency about the energy situation when they keep getting misleading information.

In our own State, you know, the Governor went on TV and alerted the State that we had to do certain things. That we were becoming desperately low in terms of supplies, and 2 days later the utilities said they had 37 days. I am not blaming the Governor. He got his information from the utilities. The whole point is no matter who is responsible for false information the fact of the matter is you can't expect the American people to feel a sense of urgency when they don't believe there is a crisis.

Representative Brown of Ohio. I don't dispute with you, except the energy situation that we are anticipating now. And in 1985—this situation was predicted many, many years ago.

Mr. Fraser. Certainly.

Representative Brown of Ohio. But if they had come down and fixed a day, certainly since it was many, many years ago, then maybe you are quite correct.

Let's go back to the prior utilization.

Mr. FRASER. If I could just add one thing about the President's intervention. I think he intervened at the right time, and I think like in any collective bargaining situation the process develops and there is a certain time to move in. There is a certain time not to move in, and I would suggest to you it wasn't what Rhodes was saying in Ohio or Milliken was saying in Michigan. The President moved in at a time when the prospect for settlement was realistically there, that is an agreement with Pittsburgh and Midway, with the independent coal producers. That was the element that I think made a settlement possible. Without that, it is hard for me to visualize, having some experience in collective bargaining, whether or not there could be a settlement. I think the President picked the correct time to move in and intervene in the negotiations.

Representative BROWN of Ohio. Going back over the figures on the plant utilization the highest figure at peacetime since World War II has been 87.5. If that is full, total utilization, if we are at 83 percent now, we are up around 94–95 percent of nonplant utilization within a peacetime period, is that correct? It is my figure.

Mr. FRASER. 91.1 in 1966; 98 in 1965; 87.6 as a peak in 1973.

Representative BROWN of Ohio. Yes. I am saying if we use that as being what we can expect it to be, full plant utilization at peacetime, then we are up to 97 percent, 90 something percent.

Mr. FRASER. I would argue that we are almost, in automotive we are almost in capacity. In steel we can double the plant and equipment in the steel industry and you still operate at 70 percent of present capacity because the market doesn't demand anymore. Japan is operating at that. The consumer markets simply aren't there. So you can have all the expansion in the world and still it has no impact on that.

Representative BROWN of Ohio. The overall figures, that 83 percent takes into consideration that many of these activities are way down in the utilization period.

Mr. FRASER. 83 percent.

Representative BROWN of Ohio. In what industry do you restrain? Automotive certainly has the money to make an investment through plant expansion and is doing so, but I don't know if any other industries are restraining

According to those who testified in the energy crisis we are short in the insulation area and related industries.

Mr. YOUNG. Those are being expanded and that is exactly the point. The point that we are trying to make is that one of the key issues and Senator Bentsen is correct that it is not the only one, but one of the key issues is the investment decisionmakers' perception of the risk involved and whether the need is immediately there. And as long as you have margin, if we use 7 percent as the margin or 5 percent, he does not have to invest in those industries where there is excess capacity. He doesn't have to risk investment to meet some expansion of demand. He has got the margin already there. It is only when he sees that the expansion will really take them beyond the margin that he has that—that it would be well to move ahead.

In industries where there is shortage, there is great investment. We know in automotive there is great expansion going on and plans

to expand plant and modernize plants. But those are the critical determinants of whether or not people invest, not whether or not they are going to get a few more dollars in taxes.

Representative BROWN of Ohio. I think you have frankly disregarded what Senator Bentsen has said. What about others that can't in effect, prevent that return without some incentive to move ahead? Are you saying that basically there are no industries, no activities today that have the demand which would justify the expansion when the expansion is to be made?

Mr. YOUNG. No, sir. We are not saying that at all. There are industries where there is a demand. There are industries where there should be expansion. The question that we are facing—we agree there should be more investment in the economy. The question is that if the Government wants to use $15 billion to stimulate investment in the economy, is the most effective way to do that by giving everybody who makes an investment, an investment tax credit. That is the issue we raise. Or is there a more efficient way for the Government to use $15 billion to stimulate investment. And we believe there is.

Representative BROWN of Ohio. I don't recall, no doubt you have it in your prepared statement. I skipped over it. What was your position on the reduction of corporate taxes?

Mr. YOUNG. We are putting together a total comment on the tax proposal. What concerns us about the overall tax proposal is that the net result of it will be to shift the corporate share of taxes. We don't see that there is justification for that. Depending on how the pieces come out, obviously there can be some reduction. It depends really on how the Congress decides to utilize the various alternatives.

Representative BROWN of Ohio. Who pays the corporate taxes, for instance, in the automobile industry?

Mr. YOUNG. As you know, the economists debate that enormously. It is not only a question of does the corporation pay it or does the consumer pay or the stockholder pay it, but if it does get passed through, who does it get passed through, who does it get passed through to? What is clear at this point is that the dollars come directly from the corporations and anything beyond that is very iffy.

Representative BROWN of Ohio. Do you have a position on who pays corporate tax?

Mr. YOUNG. The corporation.

Representative BROWN of Ohio. I am not saying who delivers the money to the Federal Government. Who is the real party in interest in the payment of the corporate taxes? The stockholder or the consumer?

Mr. YOUNG. We think that the overall result—I am going to have to answer your question indirectly. I think as you know that any analysis of this is very iffy. We think what is clear is, that the overall result is, that the corporate taxpayments if they were somehow shifted simply by doing away with the corporate rate, the way the present structure is we would have less progressive structure. Now, exactly how the flowthrough is to be traced——

Representative BROWN of Ohio. Correct me—if you eliminated the corporate tax, you would have a less progressive structure?

Mr. YOUNG. Yes.

Representative BROWN of Ohio. Very interesting.

Mr. FRASER. Frankly, the whole question of passthrough, I think, depends upon the time, the place, and the product, the state of the competition, and the particular industry. If the corporation can pass it on through, they will. But when the competition prevents it from doing so, they have to be absorbed. The tax lands on capital or is passed along to the consumer. I think it depends upon the time and circumstances and the product.

Senator PROXMIRE. I have a couple of questions. Let me follow up on that point. I think you are dead right. It depends on the state of the competition in the industry, and in the short run you have no monopoly if you have a utility that is allowed a certain return after taxes, they would pass on every nickel of the corporate income tax to consumers in higher rates. In the long run if you have reasonable entries, you are going to have a situation in which investors are going to demand certain returns and, therefore, you are probably going to pass the tax on to the consumer in that event in the long run.

But let me get to something else: I never cease to marvel at the UAW position. You have how many defense workers as members of the UAW, several thousand?

Mr. FRASER. I would say 40,000.

Senator PROXMIRE. That is amazing. I think there you are asking for a $5 billion reduction in defense spending. I think that certainly speaks for the integrity of your position. Nobody can say you are doing it to serve your own purpose. I might also point out that the testimony before this committee from the CIA and the Defense Department indicated that it is true the Russians are spending more money than we are but that they are far less efficient, that the ships they are constructing aren't as capable as ours, that the planes aren't as good as ours. They are using brute force to achieve greater numbers.

But in the important areas of military technology, which is crucial, of course, crucial to the development of effective weapons systems, the CIA testified before my committee a few months ago that they cannot find one single area where the United States wasn't ahead of the Soviet Union. We can't be smug about it. The Russians are bright people and work hard in their area, but that is the situation at the present time.

I think that your position is sound, although this is a much better defense budget this year than before. I think it is a sounder budget in a lot of ways.

Now, one of the reasons that I have stayed throughout the testimony, principally because I wanted to hear what you had to say, but I wanted the opportunity to ask you a question that I think is very crucial. You didn't mention it in the course of your abbreviated testimony, but you have a great interest in the Humphrey-Hawkins bill. I presume you support it.

Mr. FRASER. Yes.

Senator PROXMIRE. I think the Humphrey-Hawkins bill in its present form is a good bill. I am very much in favor of the goal for unemployment, a goal of 4 percent. However, there is no goal here for inflation at any point. I think in the annual numerical goals for 5

years that the President calls upon to pronounce is said for unemployment, production, productivity, and nothing for prices. The Humphrey-Hawkins bill says we ought to hold down inflation, but there is no equal treatment. And I cannot understand why perhaps a long-term goal of 3 percent inflation by 1982–83 might not be as reasonable as a long-term goal for unemployment.

You have virtually every other important economic element here, unemployment, production, real income, and productivity, requiring the President to make a report. Why not have also that kind of requirement for prices?

Mr. FRASER. I will address the Humphrey-Hawkins bill in a minute.

It is difficult for us to talk about defense cuts when we have workers employed on those very items that we are suggesting could be eliminated or reduced, and also it becomes increasingly difficult for us to keep making pronouncements on the principle of free trade.

In 1977, there were 2,100,000 imported automobiles sold in the United States. And we believe in the principle of reciprocal trade, and we have never waivered from that. And we take the position on defense contracts because we think it is right.

But we also suggest, Senator, that we should again address the problem of what happens to the workers. What happens to the workers when the B-1 is eliminated? What are the plans for conversion in using the facilities and tremendous talent in the work force? It seems to me the burden should not be borne just by those workers that suffer from that decision. It should be shared by society generally, I think, both in terms of conversion of the defense industry and in terms of free trade and trade in other areas where standards and energy requirements result in workers being laid off. And all of those actions that represent not just a group of workers who aren't—now, in the Humphrey-Hawkins bill—I suppose the reason is we think that there is sufficient language in the Humphrey-Hawkins bill that addresses the problems with inflation; that alert the executive branch so that they focus their attention on the problem of inflation.

Other difficulties with the specific number at 3 percent is that would be used as a tradeoff. This how you would feel if you had knowledge but no specific control over unemployment. It wouldn't be worth anything.

I happen to think that we have a bit more control over unemployment than we do inflation, because inflation is impacted by external events.

Senator PROXMIRE. I am not asking that inflation be put on the same basis as unemployment. That is a long-term 5-year utilization goal, but I am saying each year when the President comes forward I am talking about the section of the report that is under the economic report of the President, section 103, section 3 subtitle (2), where it says annual goals. And then it goes on, for unemployment, production, real income, at that point. Now, some of these other things are hard to estimate, productivity, for example. There are all kinds of elements, as you know, that go in there. It is certainly hard to estimate what productivity will be, but the important point I want

to make is this is exactly where any tradeoff ought to be discussed, ought to be debated, ought to be understood.

We ought to go into it with our eyes open. You can put a goal in and not come within a mile of achieving it. The 1968 Proxmire amendment was adopted by the Senate providing for a goal of 26 million in housing to start in 10 years. We haven't come close to that goal in any of those years.

So that you are not going to get it achieved by just putting it in and each year you are going to get the alibi, you are going to get is that it is inflationary. What we have to do is work hard on developing policies that will, No. 1, put people to work and do so without inflationary effects.

I think you would agree that there are policies that will enable us to do that.

Mr. FRASER. The only quarrel I have, Senator, and I suppose this is a bit theoretical generally speaking. I agree with specific goals.

I think it is good for all of us to be challenged in seeking new goals. We are very, very fearful that if we have a specific 3 or 4 percent inflation goal, we will begin to get tradeoffs. I believe that we have less control over inflation than we do unemployment.

Senator PROXMIRE. I have a couple of more questions I would like to ask you. Is it the trend toward American manufacturing facilities who are foreign based likely to continue and to bring any management problems from the union point of view?

Mr. FRASER. In terms of the trend of American manufacturers, I think the Ford Motor Co. has done the best job of internationalizing. I expect GM to continue to be producing more cars in foreign countries. I frankly don't know if Chrysler Corp. will have the capital to do so, although I think they would like to do so.

In terms of foreign manufacturers coming here, we had some opposition to that within our own union. I explained to the members that, you know, if the Volkswagen plant is in Pennsylvania, they are not going to pay with marks but dollars. And it will be, I think, a very profitable situation in terms of some capital coming from abroad into this country, No. 1; and providing jobs that we wouldn't otherwise have. So we welcome relocation of the foreign manufacturers with open arms.

Senator PROXMIRE. Do they raise any kind of a labor union problem?

Mr. FRASER. We haven't come to that yet. We are in the process of organizing a plant in Ephrata, Pa.

Senator PROXMIRE. That is the Honda plant, or Volkswagen?

Mr. FRASER. That is the Volkswagen plant. Honda really hasn't started in yet. It is just a prospect. The fact of the matter is we had discussions this week on the state of the organization of that plant. We have about 85 percent of the members organized. We do not expect Volkswagen to behave in a manner as some of the employers in the United States have. I don't think you will see the fears and resistance on the part of Volkswagen as you do in some other companies who are domestically based.

Senator PROXMIRE. Do you have any reaction like that with respect to Peugeot?

Mr. FRASER. No. I think Peugeot would be roughly like Michelin. Generally in France it is really not a strong trade union movement in our sense. But, you know, if some unfriendly employer located in the United States, I suppose it would be a challenge for us and that we would try to help and win the majority of the workers.

Senator PROXMIRE. Now, there has been repeated speculation that the UAW is about to rejoin the AFL–CIO. Are there any short-term prospects for that kind of merger?

Mr. FRASER. No short-term prospects.

Senator PROXMIRE. Any long-term prospects?

Mr. FRASER. It might be different. It depends upon the events in the immediate future. I might say I have said this before that there is a fierce resistance, particularly in our local union leadership. The proposition of reaffiliation we broached with them, and we had a convention in May of 1977. I suppose if the vote was taken there with 3,000 delegates, it may be 40 to 50 against reaffiliation, but I don't think we are going to approach that subject in the foreseeable future.

Senator PROXMIRE. Almost 20 years ago Walter Reuther testified before this committee about the importance of productivity and how the UAW welcomed technology improvements and recognized that as the only real way you can improve the standard of living in the long run. Is there room here for improvement in productivity in the UAW, in the automobile industry—for example, through changes in work rules—or are the work rules in the industry reasonable and in accordance with the market productivity?

Mr. FRASER. The provisions that Walter Reuther negotiated—I haven't read that part of the contract in years. I challenge anyone to go into an assembly plant or any one of the plants and point out where a work rule prohibits the productivity progress. The American automobile plants are very, very efficient. I am not suggesting others aren't, but the American automobile plants are, I think, extremely efficient.

Senator PROXMIRE. Management hasn't raised that issue. They don't claim they could improve productivity by changing the rule.

Mr. FRASER. No. We agree the companies' improved productivity comes through new methods of doing things. It is amazing some of the things going on in the industry today. We are making tremendous progress.

This is just off the top of my head, but in 1957 we produced cars and trucks in the United States in the range of 7.2 million. The last year, in 1977, it was in the range of 12 million.

Senator PROXMIRE. The busiest year ever.

Mr. FRASER. No; 1973 was the largest year.

Senator PROXMIRE. How big was that?

Mr. FRASER. 13 million and some odd. This would be the second largest year. In any event, the point is that we rose from 7.2 million to 12 million in round figures with 2.2 percent more hours.

Senator PROXMIRE. So you had that increase of about 85 percent with only what additional hours?

Mr. FRASER. With 2.2, but we are a little shaky on that.

Senator PROXMIRE. With 2.2 per week.

Mr. FRASER. Percent overall. I don't want to rely exclusively on that because there are some elements in measuring hours that are a bit shaky.

Senator PROXMIRE. It is even more impressive because the automobile is a greatly improved vehicle compared to what it was then.

Mr. FRASER. This greatly understates the case, because in 1977 the automobile is much more complex than in 1957. It has more equipment on it. It understates the case. It is an 84.4-percent increase in production, and it is 14 percent—14.2 percent—increase in manpower, measuring the hours shows 2.2 percent.

Senator PROXMIRE. Mr. Fraser, what is the name of your very capable colleague here?

Mr. FRASER. Howard Young.

Senator PROXMIRE. Both of you gentlemen have been most impressive. Your statements and responses have been just excellent. I think you have made a fine presentation, and we are grateful to you.

The committee will stand adjourned.

[Whereupon, at 12:30 p.m., the committee adjourned, subject to the call of the Chair.]