THE 1978 ECONOMIC REPORT OF THE PRESIDENT

584

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-FIFTH CONGRESS

SECOND SESSION

PART 4

INVITED COMMENTS

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

30-495 O WASHINGTON : 1978

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

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ORGANIZATIONS RESPONDING

THE 1978 ECONOMIC REPORT OF THE PRESIDENT

The following 13 organizations and individual were invited by the Joint Economic Committee to submit their views and comments on the 1978 Economic Report of the President: American Bankers Association, American Council of Life Insurance, Conference on Economic Progress, Federal Statistics Users' Conference, Machinery and Allied Products Institute, National Association of Manufacturers, National Consumers League, National Savings and Loan League, National Urban Coalition, New York Chamber of Commerce and Industry, Sierra Club, Taxation With Representation, United States League of Savings Associations, and Jerry Voorhis, former Member of Congress.

The statements received in response to this invitation were considered by the committee in the preparation of its annual report to the Congress and are printed here as part of the record of the committee's hearings on the 1978 Economic Report of the President. The text of the committee's letter of invitation appears below:

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., February 10, 1978.

DEAR ——————————: Under the Employment Act of 1946, the Joint Economic Committee has the responsibility of filing each year a report containing its findings and conclusions with respect to the recommendations made by the President in his Economic Report. Because of the limited number of days available for hearings, the committee is requesting a number of leaders of business and finance, labor, agriculture, consumer and other organizations to submit statements for the record on economic issues facing the Nation. These statements will be made a part of our hearings on the Economic Report in a printed volume containing such invited comments.

Accordingly, as chairman, I invite your comments on the economic issues which concern the Nation and your organization. Under separate cover I am sending you a copy of the 1978 Economic Report of the President, filed January 20, 1978.

We would like to distribute copies of your statement to the members of the committee and the staff, and would therefore appreciate your sending 30 copies by Wednesday, March 15, 1978, to Bill Chastka, staff assistant, room G–133, Dirksen Senate Office Building, Washington, D.C.

Sincerely,

RICHARD BOLLING, *Chairman.*

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ASSOCIATION

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20036

PRESIDENT
A.A. Milligan
President
Bank of A. Levy
Oxnard, California 93032

March 17, 1978

The Honorable Richard Bolling
Chairman
Joint Economic Committee
United States House of Representatives
Washington, D.C. 20515

Dear Mr. Chairman:

I appreciate this opportunity to present our Association's views on the current economic issues discussed in the 1978 Economic Report of the President and the Report of the Council of Economic Advisors. I asked our Economic Advisory Committee, a group of senior economists from banks throughout the country, to review and comment on the Report. I feel certain that most members of our Association would agree with their views as I have described them below.

We agree with the Administration's views expressed in the Report that the current recovery has been a vigorous and sustained one. The statistics are quite impressive. During the last year, employment has increased by over 4 million. Currently, the percentage of the adult population which is employed stands at the highest level since these figures were collected. The unemployment rate, while still relatively high, has declined by 2 1/2 percentage points in the nearly 3 years of the current recovery. At the same time, the rate of inflation has been kept well below the levels experienced in 1974 and 1975.

While agreeing with their assessment of the current recovery, we feel the Administration has made some inappropriate policy recommendations as a result of two incorrect assumptions about the economy. In particular, they have overestimated potential output and employment, and thus, have adopted a budget with an excessive deficit. In addition, the Administration's assumptions about the cause of inflation have led it to adopt an anti-inflation policy which is doomed to failure.

The overly optimistic estimate of potential employment reflects a failure to fully allow for the effect of the large number of women and teenagers which have recently entered the labor force. New entrants to the labor force typically experience high rates of unemployment for the first few years as they search for satisfactory jobs. These new entrants also frequently change jobs as they acquire additional skills. The resulting unemployment among new entrants in the labor force is

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CONTINUING OUR LETTER OF
March 17, 1978

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necessary to achieve a proper match of jobs and workers. The large number of new entrants in the labor force has increased the unemployment rate. However, this high unemployment rate overstates the ability of the economy to grow without putting pressure on the labor supply. As these new entrants gain experiencc, unemployment rates will decline to more normal levels.

Since these new workers have just begun to develop their job skills, they will be less productive than more experienced workers. Thus, a rapid growth in the labor force results in a temporary reduction in the growth of productivity. Failure to fully allow for this has resulted in the Administration overestimating the potential growth of productivity and, thus, potential output.

Likewise the estimate of industrial capacity utilized in the Report may be overly optimistic. These estimates do not take into account the significant amount of industrial capacity that has been made prematurely obsolete as a result of new environmental laws and the rapid rise in the price of energy.

These estimates of potential employment and output lead the Administration to conclude that a large federal deficit is necessary to achieve our potential. Large government deficits such as we are currently experiencing may be an appropriate way to spur aggregate demand at the very bottom of the business cycle. However, the size of the deficit should be reduced as other elements of aggregate demand increase. The Administration has proposed a budget for fiscal year 1979 which would provide only a slight narrowing of the deficit compared to the current budget. Failure to reduce the federal deficit may very well limit private investment. The large borrowing needs imposed on the federal government by the current deficit increase interest rates and reduce private investment.

Another key assumption underlying the Report is that voluntary wage and price restraint is the proper way to deal with inflation. We disagree. In the long run, inflation can only be controlled by proper monetary and fiscal policies. The rate of inflation cannot be reduced unless the rate of growth of the money supply is reduced and a moderate fiscal policy is followed.

Likewise, interest rates, in the long run, cannot be reduced unless the rate of inflation is lowered by reducing the growth of the money supply and following a moderate fiscal policy. During periods of rapid inflation, lenders demand higher interest rates to compensate for the less valuable dollars with which they will be repaid. In the short run, short term interest rates can be reduced by increasing the rate of growth in the money supply;

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but such reductions are short lived. The more rapid growth of the money supply leads to more rapid inflation which is eventually reflected in higher interest rates.

Rather than focusing on the real roots of inflation, the Administration has focused on increases in the price of food and energy. While such increases were an important component of inflation during the mid 1970s, they are unlikely to be an import nt factor in the next few years. Moreover, these increases would not have been prevented by voluntary wage and price restraint.

The dangers of relying on a program of voluntary price restraint is the temptation to make such a program mandatory when the voluntary program fails as it inevitably will. Voluntary controls are not only ineffective, but their existence may lead to a relaxation of monetary and fiscal policies resulting in even more rapid inflation. The experience with price controls during the late 1960s and early 1970s provides strong evidence that such controls only temporarily mask inflation and do nothing to deal with its underlying causes.

We would also urge the Administration to follow a more consistent approach to tax policy. The Administration previously indicated that it would delay its tax reform measures and only propose tax reductions in this Congress. Yet the Administration's tax package includes many other significant changes in the tax code. Such frequent changes in policy create uncertainty about the Administration's position. This uncertainty has been a factor in the somewhat slower than normal growth in capital investment during the current recovery. The profitability of capital investments can be significantly affected by changes in the tax policy that occur in later years. Increased uncertainty about future changes in tax policy makes businessmen reluctant to commit themselves to long term investments.

Finally, we would like to commend the Administration for its goal of limiting the percentage of GNP devoted to the government. We think this is a worthwhile goal and would suggest that the Congress and the Administration consider a more formal mechanism for insuring that this goal is achieved.

Sincerely,

A. A. Milligan
President

American Council of Life Insurance

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Washington, D.C. 20006
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Statement on Economic Policy Issues of 1978

Submitted to the Joint Economic Committee on the Congress
by the
American Council of Life Insurance

March 15, 1978

The American Council of Life Insurance is a national trade association with a membership of 473 life insurance companies which account for 92 percent of the legal reserve life insurance in force in the United States. At the end of 1977, the total assets of the life insurance business aggregated about $350 billion, representing the funds that have been entrusted to our business by millions of individual policyholders and employee benefit plans. We appreciate the invitation of the Joint Economic Committee to present the views of our business on the serious economic issues that confront the Nation and affect the well-being of our policyholders.

In our view, inflation is the overriding economic problem today. Accordingly, the Council is undertaking a wide-ranging study of the causes and possible solutions to the problem of inflation. During the course of 1978 and the early part of 1979, we will have five task forces of people from the life insurance business, economic consultants, government officials, and others, examining various possible approaches to anti-inflation policy, including traditional fiscal and monetary approaches as well as potential new measures. We expect to arrive at a careful critique of past policies and realistic proposals appropriate for the current conditions in our economy.

In view of the scope of this study, which we are just now undertaking, we do not plan to submit a detailed statement on economic issues at this time. We do, however, believe that curbing inflation should be given first priority in shaping fiscal policies. In considering the Administration's recent tax proposals, we do not support tax reductions beyond what may be needed to offset the recent social security tax increase and the impact of inflation in pushing taxpayers into higher taxable income brackets. We believe that further tax reductions at this time would be counterproductive by adding to inflationary pressures.

We hope, at your invitation, to submit a detailed analysis and policy review in 1979.

April 28, 1978

INVITED COMMENTS, CONFERENCE ON ECONOMIC PROGRESS
SUBMITTED BY LEON H. KEYSERLING*
TO THE JOINT ECONOMIC COMMITTEE

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CHARTS

*Chairman, Council of Economic Advisers to President Truman. President, Conference on Economic Progress.

CHARTS (Cont.) Chart No.

General Approach And Conclusions

In these Invited Comments, I shall use the term "Report" to apply both to the January 1978 Report of the President and the January 1978 Annual Report of the Council of Economic Advisers as transmitted therewith. The two documents are necessarily consistent and, although the Council's Report is much more detailed and technical than the President's, the nature of my comments do not require that I distinguish between the two. For my comments deal with the broadest aspects of the approaches common to the two Reports,with the broad nature of the policies recommended, and with my reasons for being concerned about both the economic analysis and the policy conclusions.

Essentially,the posture embodied in the Report is that we have been making a good although not entirely satisfactory economic recovery, and that the outlook with the aid of the policies proposed by the President if adopted by the Congress is also good. I disagree with both of these aspects of the Report,regretfully but profoundly. The recovery looks good only when we compare the near peak of a recovery with the trough of the previous recession; it looks very bad when, adjusting for cyclical factors, we find that the current stage of the recovery leaves us with more idleness of human and other production resources than the trought of two or three of the recessions since 1953. We are still in a chronic retreat from anything approximating the maximum resource-use goals of the Employment Act of 1946.

My disagreement with the economic outlook set forth in the Report stems in part from my disagreement with the appraisal of current conditions, in larger measure from the failure to set adequate growth targets for the future, and in the largest measure of all because of my conviction that the policies proposed repeat,to an amazing degree in view of available experience, the errors which initiated in past years have really done nothing to abate a "roller-coaster" economic performance. This has meant things getting worse and worse in the long run, when measured by the most fundamental test of all--the percentage of our available reasources which remain unused and wasted, and the terrific economic costs and human tragedies thus invoked.

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The central and repeated error in national economic policies has been the effort to stimulate the economy by blunderbuss methods, without regard for where the stimulus should be applied and in what degree. Stimuli of this type, although they give the economy a shot-in-the-arm for a while, have been so misdirected that they have accentuated in the longer run the imbalances or maladjustments among the various sectors of the economy which repeatedly have turned us from an inadequate upturn to stagnation and then recession. The prospects are clear that this is going to happen again; indeed, in the judgment of competent forecasters, it is already beginning to happen again. It is disconcerting in the least to note that, in the face of so many years of a fairly consistent malady, no substantial attempt at diagnosis has been made. My discussion relates primarily to the appropriate diagnosis, from which alone the appropriate remedies can flow.

The empirical evidence to date is clear. With inappropriate diagnosis, tax reduction has been transformed from a rational approach to an assumed cure-all; and the tax reductions actually undertaken have been so grossly misdirected in detail that they have further impaired the functioning of the economy in the long run, as well as being socially unjust. This is equally true of the President's current tax proposals, which my discussion analyzes in considerable detail.

The same combination of economic misdirection and poignant social injustice applies to the prevalent policies of the Federal Reserve Board, with no improvement evident with the advent of a new man at the top.

The money policy requires profound alteration, under appropriate pressures from the Congress. The proposed tax program needs to be altered drastically. Even more important, it needs to be replaced in part, and its intended effects greatly augmented,by increased Federal investment directed toward the great priorities of our domestic needs, without which we can have neither enduring economic health, nor assurance of social and civil peace. My discussion contains detailed proposals with respect to the Federal Budget, and also indicates why a combination of policies directed realistically and vigorously toward restoring a 4 percent rate of unemployment by the middle of 1983 is the only possible road to a balanced Federal Budget.

Finally, my discussion deplores the fact that, after some temporary awakening, national economic policy seems back on the dismal track of restraining the needed amount of economic stimulus in the name of fighting inflation. That policy has been an augmenting disaster for a decade or much longer, and its unworkability is now being

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demonstrated month by month, especially in the first quarter of 1978. We will continue to lose ground in the battle against inflation, until we develop and apply correctly those stimulative programs which bring us toward full resource use as rapidly as possible. The failure of the policymakers thus far to learn this lesson is almost inexplicable.

But what is inexplicable can in part be explained. It can be explained because we have a weird congeries of national policies and programs, but no national policy or program. We have little by way of systematic analysis, galvanizing goals, meaningful quantifications within a unified framework, or coherent policy-making founded in these other assets. The enactment and utilization of the Humphrey-Hawkins bill, the Full Employment and Balanced Growth Act of 1978, is therefore a sine qua non, although by no means an adequate solution, to the effective treatment of all of these persistent problems.

Run on page 2

1. Report Too Optimistic On Current Economic Situation And Outlook

Need for longer-term perspective

The Report is much too optimistic on the current economic situation and outlook, because it takes too short-term a look upon what has been happening to the U.S. economy to date, and thus does not derive an analysis of the large chronic problems. This makes far too ebullient the conclusions that we have done at least moderately well since the recession of 1974-1975 and that there are prospects of continuing to do as well as we should without very much more drastic changes in the size and composition of remedial policies than those now being proposed by the Administration and considered by the Congress. A longer-term and more penetrating analysis indicates clearly that the U.S. economy has been afflicted by a chronic "roller-coaster" economic performance from early 1953 to date, immensely costly in nature and becoming progressively more so; and that the years immediately ahead offer the distinct threat of a further adverse progression and, within a few years at most, a downturn even worse than that of 1974-1975--short of a drastic reorientation of national policies.

The "roller-coaster" economic performance is graphically set forth on my Chart 1. The nub of the matter is that the average real annual growth rate of only 3.2 percent during 1953-1977, not to speak of the average of only 2.3 percent during 1969-1977, has been lamentably lower than during any substantial period within relevant years when we have come anywhere within range of reasonably adequate use of labor force and other production resources.

The same Chart 1 also makes it abundantly clear that the recovery movement following the 1974-1975 recession (although the real growth rates look good when not subjected to careful analysis and when hailed by statements in the Report) has really been disappointing, when measured against some earlier growth rates which brought us closer to reasonable resource use. This is quite apart from the fact that the most recent growth rates needed to be higher than during these earlier periods, in view of the very much greater size of the deficiency or gap in total national production as it developed during the most recent recession.

Have recent growth rates been nonsustainable?

There is no justification for the apologetic tone in the Report, namely, that the much lower real growth rate during the most recent year than during the previous year is nothing to worry about because the 6.0 percent real growth rate from 1975 to 1976 was "not sustainable." My Chart 1 also shows that a very much higher real growth rate occurred during some other periods when we were working our way out of shallower recessions, and that at later periods such as 1958-1959 and 1965-1966 a growth rate of only 6.0 percent showed signs of weakness which were quickly followed by very drastic diminutions of the growth rate. At the time that the Report was written, it would have been not too hard to foresee that the same thing was happening again. The absolute stagnation of the economy during the first quarter of 1978, and the clear prospects for a lower real growth rate in 1978 as a whole than during 1976-1977 is nothing to cheer about.

The apologetic note about "nonsustainable" growth rates has become the recurrent fallback of economists of note and pleaders for weak national economic policies. The observation, that we have failed to sustain the growth rates needed to achieve anything better than progressively weaker recoveries followed by progressively more serious recessions, is too easily translated into the observation that nothing better could have nor can be achieved than this manifestly unsatisfactory record. In reality, this boils down to resignation to the abysmally poor average economic performance during 1953-1977, instead of any analysis and policy designed effectively to reverse the course.

Applying cyclical adjustments, we are still in a chronic retreat

The most frightening aspect of the whole problem is the attempt to gloss where we now stand, without application of adjustments or correctives based upon the stage of the business cycle, rather analogous to the application of seasonal adjustments to the rate of unemployment. In the face of a quarter century of the "roller-coaster" economic performance during which five cycles have revealed in general more unused resources at the trough of each succeeding recession and at the peak of each succeeding recovery, it is tragically late for official Reports to continue to point with pride to the fact that unemployment now is considerably lower than at the bottom of the worst downturn since the Great Crash. As shown by my Chart 2, both full-time unemployment and the true level of unemployment in 1977, and even in December 1977, were higher than at the trough of two or three of the previous recessions since 1953. This is not recovery so much as it is a secular or chronic continuation of a long-term retreat. The same Chart 2 indicates the critical significance of varying rates of unemployment among key groupings in the civilian labor force, with the rate of unemployment among black and other teenagers fantastically higher in December 1977 after 2-1/2 years of recovery than in any of the years depicted on the chart between 1954 and 1969, and higher than in 1975.

The cumulative costs of the "roller-coaster" performance

The Report might show less complacency about what we have experienced and where we are heading if it set forth forthrightly the costs of the "roller-coaster" performance. My Chart 3, on the basis of conservative approaches as indicated in the footnotes, estimates a forfeiture, 1953-1977, coming to almost 5.3 trillion 1977 dollars worth of total national production, and estimates an aggregate of more than 72 million man- woman- and teenager-years of unemployment in excess of the level compatible with reasonably full employment.

My Chart 4 apportions these G.N.P. forfeitures among various sectors of the economy.* The forfeiture of about 1.6 trillion dollars in private business investment should come as a shock to those who now correctly are talking so much about the vital importance of this sector; the deficiency of 2.7 trillion dollars in wages and salaries might help to call a halt to those who have attributed so much of our economic difficulties to excessive advances in wages (a matter to be discussed further). The meaning of the deficiency of more than 1.3 trillion dollars in Government outlays for goods and services at all levels can serve in part as an answer to those who feel that we have gotten into so much trouble because public outlays have been too high rather than too low. And it can serve in part to illustrate how much of the woeful inattention to those great priorities of our domestic economic and social needs which depend upon public investment to carry them forward (or to encourage others to carry them forward) has been attributable to the deficiencies in public revenues which have stemmed automatically at existing tax rates from the stupendous deficiencies in total national production.

Looking to the future, my Chart 5 sets forth estimates, again conservative, as to the further forfeitures which will result during the period 1977-1983, if one contrasts a generous appraisal of likely economic performance under projections of current national policies and programs (allowing for the inadequate and misdirected stimuli now under active consideration, as further to be discussed), with the achievable performance under realistic goals, and policies effectively attuned to their attainment. Looking back for a moment to the bottom half of Chart 4, these prospective forfeitures are translated into their meaningful components.

2. The Report's Growth Goals Are Far Too Low

Why the growth goals are too low

The Report reflects an underestimate of the weak elements in the current economic situation which require a high average annual real growth rate to bring us to full resource use even by 1983; it reflects failure to analyze the import

*All of my estimates and projections, as distinguished from presentation of actual data, are based upon a continuous model for an economy operating at balanced full resource use, which I have constructed year by year, and revised annually in the light of actual developments. This is rather similar to mandated approaches under the Humphrey-Hawkins bill.

of the varying growth rate patterns shown in Chart 1 in terms of their consequences as depicted on Chart 3; and reflects defective thinking about what a "sustainable growth rate" really means; and reflects an overly cautious unwillingness to propose sufficiently strong programs and then to defend them. In consequence, the needed growth rates set forth in the Report are demonstrably much too low. And while adequate growth targets do not of themselves produce adequate programs to accomplish them, adequate programs are hardly within the range of possibility when the growth rate targets themselves are so feeble and deficient.

The Report states on p. 5, in the words of the President, that "Over the next several years I believe we can increase our real output by 4-1/2 to 5 percent per year..." This evidently refers to the potential in terms of the high current amount of economic slack, and is consistent with the position expressed elsewhere in the Report that the long-term growth rate potential averages slightly above 4 percent per year when the need is only to hold unemployment constant rather than to reduce it.

The above estimates of the growth potential are derived from essentially the same error as discussed above in connection with treatment of the "sustainable" growth rate. Instead of looking at what we can do and need to do to get the economy back in reasonably healthy shape even by 1983, the so-called potential is determined by looking at what averages were actually struck by the economy during years when both the growth in productivity and the growth in the civilian labor force were severely inhibited by the very dislocations and aberrations from an acceptable performance which we must seek to avoid in the future. A condition of health cannot be determined by averaging the results of several years of sickness and inadequate recovery.

The needed growth rates

A look back to Chart 1 indicates that no period of substantial length marked by an average annual use of resources compatible with reasonably full use of resources has failed to display an average annual real economic growth rate very much higher than about 4 percent. Correspondingly, every period of substantial length marked by a return from very heavy resources disuse to reasonably full resource use has displayed an average annual rate of real economic growth very much higher than 4-1/2 to 5 percent. The lower targets in the Report, which are so clearly wrong, use average annual productivity growth figures which include years when such growth rates were very low or negative due to very high economic slack economic slack. These targets fail to observe that a strong movement toward or the maintenance of reasonably full resource use lifts the average annual productivity growth rate to a normative figure which cannot be stated as less than about 3.5 percent and which is closer to 4 percent under conditions close to full resource use, and much higher when we are moving vigorously from low resource use to high. This is indicated on Chart 39. Taking into account also the higher growth rate-need in the civilian labor force when unemployment is very low than when it is very high, it is hardly plausible to suggest a figure lower than 6 percent for the needed real economic growth rate in order to move vigorously toward full resource use, or to derive a figure lower than about 5 percent as needed after we are already at reasonably full resource use and need further growth only to absorb normal growth in the labor force and in productivity.

Consistent with the needed growth rates set forth in the footnotes to my Chart 5, my Chart 6 projects through 1983, the growth rates in employment and in the main components of total national production required to reduce unemployment in the overall to 4 percent by the middle of 1983 in accord with the objectives of the Full Employment and Balanced Growth Act of 1978. The projected distribution of additions to employment in accord with such goal and in accord with optimizing additions to private employment to the extent compatible with other essential national and social objectives, is set forth on Chart 7.

3. The Report's Remedial Programs Are Not Only Insufficient; More Important, They Are Misdirected

There would appear to be no need to belabor the point that the stimulative programs now being proposed by the President could hardly be adequate, except by accident, when the growth targets sought to be reached through these stimulative programs are much too low. Later on, nonethtless, I shall say more about the needed magnitudes of the stimulative programs required to reach goals properly adjusted to our needs and capabilities. But at this stage in the presentation, I shall limit myself to an even more important point by far: Hardly ever in the course of the "roller-coaster" economic performance since 1953 have the official economists and the Presidents guided by their advice come to grips with the basic reasons for that performance. Not only have they not come to grips with the basic reasons; they have given little evidence of efforts to discern them. The current report contains slight intimation of effort to diagnose as a precondition to effective prescription.

The "inflation" explanation alone is inadequate

Of course, some easy explanations have been tried by responsible officials. One is to the effect that the recurrent downturns have been caused by inflation, and consequently that combatting inflation is the first and foremost step toward preventing still more downturns. But the explanation simply will not stand up under the empirical evidence. There was remarkable price stability, except for falling farm prices, during 1922-1929 before the Great Crash. There was unusual price stability (or no large price inflation) before the recessions of 1953-1954 and 1957-1958, and the mini-recession toward the end of 1960. And later on, although there was high inflation both before and after the onset of recession, it was usually much higher after the onset than before the onset. The trends since 1953 are set forth on my Charts 1, 33, and 37, and I will treat this issue in more detail when I come more specifically to the problem of inflation.

At this stage, suffice it to say that trends in prices *per se*, within the context of the U.S. economy, are not prime conditioners of the performance of the economy when measured by whether it is moving upward or downward in real terms, and by the size of the gap between full employment and actual employment, between full G.N.P. and actual G.N.P. The economy may move from recession to recovery, or from full prosperity to stagnation and then recession, within a pattern of prices that are stable, rising, or falling. For prices are but one of the means toward allocation of resources and incomes, and it is these allocations which produce the equilibrium conducive to optimum performance or the maladjustments or imbalances which turn the performance downward.

Nature and significance of the economic imbalances; role of consumer spending and wages

The empirical evidence, which has been so thoroughly neglected by the economic policymakers for so many years, reveals clearly that the deteriorations which translate upturn or boom into stagnation and then recession have commenced when investment in plant and equipment which add to the ability to produce has grown very much faster than ultimate demand in the form of consumer expenditures plus public outlays. When the downturns have come, investment naturally has declined the most, but nonetheless ultimate demand has declined to levels insufficient to restimulate investment adequately and to fulfill the function of ultimate demand itself in bringing about complete recovery. Repeating earlier manifestations, from fourth quarter 1975 to fourth quarter 1977 investment in plant and equipment was growing at a rate in real terms almost twice as fast as ultimate demand. These manifestations of the recurrent generation of economic disequilibrium are depicted on my Chart 8, which also shows how disparities in various types of income have contributed mightily to the resource-use imbalances.

Consumer spending ranges upward toward two-thirds of total national production. Yet, despite the recognition that high unemployment and huge G.N.P. gaps must reflect deficiencies in total demand, the misplaced hue and cry about "excessive" consumer spending fortified by "excessive" increases in wage rates and wage incomes has blotted out practical attention to the deficient growth rate in consumer spending. Yet the fact is that the gap in consumer spending has persistently dominated the total G.N.P. gap, the relevant data being indicated on my Chart 9. My Chart 10 disposes of the common misimpression that the deficiency in consumer spending is attributable primarily to an excessive rate of saving; it is due basically to a deficiency in the flow of income to consumers.

The misreading of the consumer spending problem has interpenetrated with damaging notions about wages and wage-rate trends. My Chart 11 depicts the role of the chronic wage deficiency in the chronic deficiency in consumer income. In this connection, Chart 12 portrays the very serious lag in the rate of real increase in wage and salary rates behind the rate of increase in productivity during periods when the rate of real economic growth is high. The lag during the period from fourth quarter 1976 to fourth quarter 1977 is especially relevant to where we stand now. And during those periods when very low or negative real economic growth combined with very high disutilization of resources drive the productivity growth rate very seriously downward, such as during 1966-1977, the rate of increase in real wage and salary rates has moved downward accordingly, and in the manufacturing sector moved down even more.

Misdirection of stimulative programs in form of tax reduction

It must be clear, from the analysis I have thus far made of the nature of the imbalances in the economy, that a stimulative economic program should be directed toward redressing the above-defined imbalances, by bringing ultimate demand in the form of consumer outlays plus public outlays up to the equilibrium requirements for sustainable progress toward achievement and then maintenance of reasonably full resource use. Of course, even though business investment is moving upward on the high said relative to ultimate demand, it is moving at too slow a pace relative to the needs for full economic restoration. But taking into account the all-important relationships between business investment and ultimate demand, it is equally clear that the effective road to the adequate stimulation of the former is direct concentration upon stimulation of the latter.

The problem today is very similar to what it was in 1964, when dissatisfaction with the pace and certainty of an upward movement of the economy led to the adoption of powerful stimulatory measures. But these stimulatory measures, embodied in the tax reductions of 1964, grossly misjudged or did not consider the problem of equilibrium or balance, and indeed accentuated the economic distortions which I have just described. Testifying circa 1964 before the Joint Economic Committee and other Committees of the Congress, and/or / by means of Invited Comments analogous to those I am now offering, I pointed out that the 1964 tax reductions, having a value in the neighborhood of 20 billion dollars over a period of two years would give the economy a shot-in-the arm for a time in the form of an investment boom grossly out of line with the balance of the economy. But I also insisted that this would then be succeeded by a deteriorating rate of real economic growth, and in consequence (as I shall later stress) an accelerating rate of inflation. And so it came to pass, as indicated by my Chart 37.

The tax reduction programs since 1964 have erred similarly, and in each case less excusably because of the failure to learn from cumulative experience. The managers of national economic policy have been like a driver moving his car up to a filling station and saying "Fill 'er up." When the attendant asks whether the gas should be poured into the tires, the oil into the gas tank, and the air into the radiator, the answer comes "What's the difference--just fill 'er up." This process has reached another apogee in the President's tax proposals now being considered by the Congress, and adequate appreciation of this requires an accounting of what has been happening on the tax front since 1964, with some reference to the period 1939-1945.

4. The History And Consequences Of Misdirected Tax Cuts

Importance of income distribution

As I have already stated, the primary focus of a stimulative economic program at this time, insofar as it takes the form of tax reduction, should be to promote greatly the expansion of all consumer disposable income and saving. In this connection, a starting point for tax-policy analysis must be a close look at the distribution of income in the U.S. and the trends from 1947 through 1976, as shown on my Chart 13. It is apparent that the distribution is extraordinarily uneven, while admitting as I do the need for vast differences in income based upon many considerations. Further, the distribution appears to have become more uneven over the years. In 1976, the three lowest income fifths received considerably smaller shares of the total than they did in 1947, and this usually follows when real economic growth has averaged too low and unused resources averaged too high. High unemployment, more than all else, redistributes income regressively.

The unfavorable situation with regard to income distribution operates very adversely upon economic performance through its adverse effects upon consumer spending, in that those lower down on the income ladder spend relatively more and save relatively less of their income for consumption than those higher up. By the same token, the very uneven distribution tends to promote the periodic investment excesses to which I have referred, in that those higher up in the structure spend a larger portion of their income for investment purposes. Actually, the chart understates the maldistribution, because it depicts before-tax income, while tax trends viewed as a whole have tended to make the distribution worse, as demonstrated by my subsequent discussion of these tax trends.

Increasingly regressive nature of U.S. tax system as a whole

The U.S. tax system, viewed as a whole, should be utilized to improve the distribution of income for all of the reasons earlier stated. But although the Federal tax system has remained progressive over the years, when account is taken of all forms of taxation at all levels, the distribution of the total tax burden is amazingly regressive. This is depicted on my Chart 14. Although I have not been able to bring the chart beyond 1968, the situation has worsened during the more recent years, for we all know that the most regressive types of taxes such as property and sales taxes have increased much faster than changes in Federal taxes have compensated for these increases.

Regressive trends in Federal tax structure

There were periods when changes in the Federal personal income tax structure were extremely progressive, when one considers that the real effect of tax rate changes is not to be found in the rate of tax change but in the effect upon personal income after taxes. Measured in this correct way, my Chart 15 demonstrates how extremely progressive were the personal tax increases during the World War II era, 1939-1945.

But when the time came after World War II to decrease personal income tax rates, the changes became extremely regressive in their effects upon after-tax income. The most notable use of tax reduction to stimulate the economy was in 1964. And as my Chart 16 demonstrates, the personal tax cuts in this year provided larger and larger increases in after-tax income on a percentage basis as those paying the taxes were higher in the income scale. For example, among married couples with two children, those with $3,000 income received only a 2.0 percent gain in after-tax income, those with $15,000 income received only a 2.7 percent gain, and those with $200,000 income received a 16 percent gain.

My Chart 17 applies the same type of analysis to the period 1945-1963, and speaks for itself as to the unsatisfactory distribution of after-tax income gains. For example, those four-person family units with $5,000 income enjoyed a gain of only 4.8 percent in after-tax income, and those with $15,000 only 9.8

percent, while those with $50,000 gained 26.7 percent, and those with $200,000 gained 47.2 percent.

Next, my Chart 18 applies the same analysis with respect to personal income tax cuts to the period 1963-1973. Here again, looking at the percentage increases in after-tax income, the income groups with incomes of under $3,000 to $50,000 received smaller increases in after-tax incomes than the groups over $50,000.

Personal tax aspects of President's current proposals

We may now turn to the estimated effects, for the year 1979, of the personal tax cuts proposed by the President, first excluding the social security (FICA) tax changes. Looking at the effects upon after-tax income, the proposal appears to be marginally progressive, but to a degree so small that it does not begin to compensate for the regressive trends over the years which I have already depicted, and certainly not progressive enough to meet the economic and social needs of today and tomorrow. This is shown on my Chart 19. And my Chart 20, applying the same analysis to the President's proposals including social security tax increases, indicates that, while the impacts as a whole would be marginally progressive but not nearly enough so, the percent gain in after-tax income would be lower than if the social security tax changes were not applied in the case of married couples with two children at $10,000 incomes, $15,000 incomes, and very much lower in the case of families with $20,000 incomes, $25,000 incomes, and $30,000 incomes. In the case of those with $40,000 incomes, to the contrary, the gain in after-tax income would be the same percentage with or without imposition of the increased social security tax.

Misallocation of tax cuts between investment and consumption function

More important still, in its bearing on balance or imbalance within the economy, there is to be considered the impacts of the distribution of tax reduction between the investment function and the consumer function. As shown by my Chart 21, the allocation of the tax cuts between 1962 and 1965 directed more dollars to the stimulation of consumption than to the direct stimulation of investment, but not nearly enough more in terms of the economic requirements for the establishment of balance. Actual economic developments bear this out.

But this was not as bad as what happened later on. Looking at the 1971 tax cuts as depicted by my Chart 22, 7.4 billion dollars were allocated directly to the stimulation of investment and only 2.7 billion to the stimulation of consumption. And what happened to the economy in the years thereafter, as I have already depicted, was the appearance of the types of imbalances which not too long thereafter resulted in stagnation and then the most severe recession since the Great Depression of the 1930s.

My Chart 23 depicts the allocation between investment and consumption during the period 1962-1973 as a whole. Here again, the allocation was far off the mark of the requirements for economic balance, and by 1974-1975 the results were felt in the deepest economic recession since the Great Depression of the 1930s.

Finally in this phase of my analysis, my Chart 24 depicts for the year 1979 the allocation between investment and consumption under the President's tax proposals, both excluding the proposed tax reforms and including such tax reforms. In both cases, the allocation to investment is actually higher than the allocation to consumption, and including the proposed tax reforms, it comes to 14 billion dollars as against 10.5 billion.

Coming on top of the erroneous trends in earlier years, I am sadly convinced that the main effect of the personal and corporate tax cut proposals of the President might well stimulate the economy for a brief spell, as did the tax cuts of 1964 and at times later on. But in the longer run, I fear that such action would increase the severe existing imbalances in the economy and help to bring on another period of stagnation and recession, possibly deeper than the most recent one.

Needed revisions in the President's tax proposals

In accord with my analysis, what do I now deferentially recommend to the Congress? I recommend that the allocation of tax cuts to the investment purpose, averaging about 15 billion dollars for 1979 (as the midpoint between the proposed cuts with and without the tax reforms) should be reduced by about 10-12 billion dollars, leaving tax cuts of only about 3 to 5 billion dollars for the direct stimulation of investment. I further recommend that the direct cuts for investment be redirected on a more selective basis to those who need help most in the business structure, especially small and middle-sized business. For it has been the unalterable tendency of the tax stimuli to investment during the years in the past under review to be directed far too largely to those who need help least, and far too little to those who need help most.

In addition to the 10 to 12 billion dollars thus being saved, I recommend, for reasons abundantly clear, that 2 to 4 billion dollars of the 1979 proposed tax cuts allocated to consumption be abandoned insofar as they are applicable to the higher ranges of the income structure.

The two proposals just made would yield 12 to 16 billion dollars for other types of tax cuts. I recommend that a very large portion of these, somewhere around 8-11 billion dollars, be utilized to reduce the impact of the proposed increase in the social security taxes over the period of time for which these increases are imposed, and that the balance be used to increase the tax reductions allocated to the consumer function in the lower half of the income structure.

I cannot vouch for the precise accuracy of my estimates or recommendations. But they are close enough to precise accuracy to provide, I believe, a sound guide to the Congress toward a redirection of tax action. This would avoid the errors of the past and their very adverse economic consequences, and contribute to objectives we all have in common--the sure and paceful move of the U.S. economy toward full resource use, and the doing of a modicum more of social justice.

5. Restoring The Federal Budget To Its True Purposes

More public investment is preferable to more tax reduction

In the preceding section, I have proposed revisions in the 25 billion dollar tax proposal of the President, to make it a more effective instrument for sound economic stimulation and to make it more compatible with equitable and social considerations. But I have not intended thereby to imply that, even with these changes, tax reduction should be so heavily relied upon in lieu of increases in Federal outlays. The augmenting tendency to turn more and more to tax reduction as the solution to almost every problem, the failure to remember that taxes are the price we pay for civilization, and the priority given to tax reduction over Federal outlays when stimulation is needed on the craven ground that it is politically easy to do so, are all in need of fundamental reconsideration.

First of all, even if the main purpose of the Federal Budget were to stimulate the economy, the very acceptance of the proposition that the stimulus must be directed in a selective and discriminating fashion in accord with the requirements for equilibrium and balance means that public investment is a much better tool than tax reduction toward these ends. It takes effect more quickly, and can be withdrawn more quickly. From the viewpoint of creating an additional job, almost every competent study, including several by the Congressional Budget Office, have reached the conclusion that a dollar of additional public spending, in contrast with a dollar of tax reduction, is much more effective in its economic impacts and much less costly to the Federal Government.

But the towering central purpose of the Federal Budget is not to stabilize the economy, although that is a worthy dividend of the appropriate use of the Federal

Budget. If the primary purpose were stabilization, that could be accomplished with a 50 billion dollar spending program and no taxation when the economy is very slack, and the reverse when the economy is under excessive strain. However, this would ignore the primary purpose of the Federal Budget, which is to allocate resources and incomes in accord with ultimate national needs, by having the "Government do for the people what they cannot do for themselves, or cannot do so well, in their separate and individual capacities." Accepting this proposition of Abraham Lincoln, it must be manifest that most of the most urgent of our domestic economic and social priorities of need require selective public investment on a much greater scale, and cannot be served by more and more tax reduction in an unrefined manner.

A long-range model Federal Budget

For these reasons, prior to the emergence on the scene of the tax-reduction program now under consideration, I developed, by no means for the first time, a long-range model Federal Budget. This takes into account the priorities of our national needs, and also the aggregate needed magnitudes of public outlays as a component of ultimate demand (previously discussed) as a factor in the development of equilibrium toward full resource use. The details of this Budget, designed among other things to reduce unemployment to 4 percent by the middle of 1983 in accord with the objectives of the Full Employment and Balanced Growth Act of 1978, are set forth on my Chart 25. Of course, no one would regard it as practical to carry forward a public investment program in these magnitudes so long as we remain committed to throwing tax reductions right and left when anybody sounds the clarion call for them. Nonetheless, this model budget is highly useful as a broad indication of the shifts in public policy required if we are ever to get where we certainly must want to go, in terms of economic restoration or social awareness.

My Chart 26 applies a costs and benefits analysis to the model Federal Budget. On the one hand, it projects the differences between the expenditure side of the model Federal Budget and the expenditure side of a Budget projected in accord with current national policies, allowing for such adaptations as now seem to be in the wind. The chart then contrasts alternative G.N.P. developments on the same basis, the first in accord with reaching 4 percent unemployment by the middle of 1983, and the second projected in accord with current national policies plus normally to be expected adaptations. The conclusion depicted on the chart is that the differential benefits in G.N.P. would average annually 200 billion dollars a year from 1978 through 1983, measured in fiscal 1978 dollars, while the differences in Budget outlays would average annually about 27 billion. Thus, the differential G.N.P. benefits would be more than 7 times the differences in Federal Budget outlays.

Realistic approaches to a balanced Federal Budget

From the viewpoint of achieving a balanced Federal Budget in contrast to merely talking about one, my Chart 27 contains estimates to the effect that policies adequately designed and applied to achieve a reasonably full economy by 1983 would result in a balanced Federal Budget or better by that time, while continuation of current national policies plus those now evolving would leave us with a still-horrendous deficit in that year. My Charts 28 and 29 contain further empirical observations as to the ineluctable connection between a healthy Federal economy and a balanced Federal Budget. And my Charts 30, 31, and 32 should help to dispel the thus far ungoverned propaganda to the effect that the Federal Budget has been getting out of hand in the context of the national economy which it serves and of which it is a part.

6. The Prevalent Monetary Policy Must Be Reversed

Sir Galahad outside President Carter's Court

All of the great and powerful policies which affect the national economy are inextricably interwoven. They either supplement or counteract one another. They either pull in the same directions or they pull in opposite directions. One of these great and powerful national economic policies is in the monetary field, under the aegis of the Federal Reserve. And the policies of the Federal Reserve and their consequences, since the great change wrought by the "accord" between the Federal Reserve Board and the Treasury more than a quarter century ago, have been a wonder to behold. When other national economic policies have tended to promote adjustments in the right direction, the Federal has frequently canceled these out in whole or in part. And when other national economic policies have tended to produce adjustments in the wrong direction, the Fed has usually doubled in spades.

The hallmark stance of the Fed and the core of its philosophy and program during the past quarter century to date are easy to describe. The Fed is the self-appointed Sir Galahad of the war against inflation, the evil of evils, and its heart is as pure as that of the son of Launcelot because it is "independent" of "politics" (in the sense that, unlike all others, it is responsible to nobody).

To be sure, the Fed is too sophisticated to admit that it wants to stop inflation at the expense of all else. According to the modern Sir Galahad of the money markets, the tournament against inflation will, if only we are patient enough, restore full employment on a sound basis, assure price stability forever, reveal the unwisdom reckless Federal spending, and balance the Federal Budget for all time. The trouble with the modern Sir Galahad is that there appears to be a Sir Modred in the picture who is besmirching Camelot. As the Fed has pranced along with its tilt against inflation, low economic growth has been chronic, unemployment and other unused production resources have chronically risen, the built-in rate of inflation (now mistakenly called an "inflationary psychology") has climbed persistently, and the horrendous size of the Federal deficit has grown/in the long run by leaps and bounds.

It is pragmatic common sense under the circumstances to undertake at long last an empirical examination of the consequences of the Fed's policies, and to modify the mistaken doctrine of non-interference with its prevalent course.

<u>What the Fed has done to the economy</u>

Scrutiny of my <u>Chart 33</u> lays bare the "roller-coaster" performance in the management of the money supply by the Fed, and the close connection between this and the "roller-coaster" performance of the U.S. economy measured in trends in real G.N.P. A discussion of this chart year by year would become too complex and extensive for this presentation. But a fair examination of the chart itself reveals the frequency with which drastic tightening of the money supply has preceded and helped to bring on periods of dwindling real economic growth, stagnation, and recession. The Fed can hardly claim that there has not been a causal relationship between the respective trends; the very reason offered by the Fed for its tight money policy has been that this would indeed slow down the economy and thus inevitably reduce the rate of inflation. But the Fed has never assumed the responsibility to explain whether the staggering deficiencies in employment and production during a quarter century of the "roller-coaster" performance, as depicted elsewhere in my presentation, have been a fair price to pay for the alleged marginal benefits in terms of price stability. And most inexplicable of all, the Fed has not yet awakened to the by now compelling empirical evidence of the positive rather than negative correlation between an induced low growth rate in G.N.P. (importing higher unemployment) and the amount of inflation, as indicated so clearly in the bottom cross-section of the same <u>Chart 33</u>. In short, the repeated onslaughts of stagnation and recession, abetted by the policies of the Fed, have in themselves been inflationary for reasons I shall set forth more fully.

<u>Using the money power to feed the fat by stripping the lean</u>

My <u>Chart 34</u> depicts the fantastic increases in interest rates from 1952 through 1977, which have transferred more than 1.3 <u>trillion</u> dollars from borrowers, both private and public, to lenders. These soaring interest rates have imposed an additional burden upon the Federal Government of more than 130 billion dollars during the quarter century. It does not require a scholar in the field of economics to recognize that transfers of money and spending power in these directions are not only socially iniquitous, but also have intensified the imbalances in the economy which I have already depicted and which have produced the "roller-coaster" economic performance.

My Chart 35 demonstrates how much more the Federal Budget could have done over the years to help meet the great priorities of our national needs, without worsening the condition of the Federal Budget and indeed benefiting it through efficient rather than inefficient use of funds, if the Federal Budget were not burdened by billions of dollars of excess interest costs, and almost 18 billion dollars of these in 1977 alone. And my Chart 36 depicts the shocking costs imposed upon the average American family by the prevalent monetary policy.

The change at the top at the Fed

Earlier this year, through a summoning up of will despite the cry that the "confidence" of the business and financial community would be ruffled, the Administration did not reappoint Dr. Arthur Burns, the Galahad of Galahads in the Camelot-like tilt against inflation. Mr. Miller became the new Chairman of the Fed, with the applause and expectancy so common when a new joust in the tournament gets under way. But the new knight thus far has done no better than the knights of the Round Table/did when Mark Twain's Connecticut Yankees at King Arthur's court confronted them with / some realism. As the pace of the economy recovery slows down seriously, and as this is accompanied by more inflationary pressures(as I would have expected),Mr. Miller assures us that the way to get hold of the inflation is to slow down the economy still more.

We have just learned that the veritable stagnation of the economy in the first quarter of 1978 caused per unit labor costs to rise alarmingly, this being still another proof that the sharply adverse impact of stagnation and recession upon productivity growth generates these rising per unit costs and thus intensifies inflationary pressures. But Mr. Miller's urgent remedy is to advise that the stimulative economic program proposed by the President should be reduced and postponed, on the ground that the way to fight inflation is to make sure that the economy crawls instead of grows.

I have at long last reached this conclusion: Even when reason and experience ultimately bring about the appropriate redirection of fiscal policies, the prospects for reasonably full utilization of the potentials of the U.S. economy will remain bleak until Federal Reserve policies are changed in a manner which will not originate from within that august institution. The time is late for the Congress itself to bring pressure to bear, and the provisions toward this end in the Humphrey-Hawkins bill are an extremely mild--perhaps an overly mild--step in this direction.

7. Myth Or Reality In The Fight Against Inflation

The sham issue: which is worse, unemployment or inflation?

National economic thought and action will never lead us out of the wilderness of our long and enduring troubles until an end is put to the spectacle of telling the public one month that unemployment is a bigger problem that inflation, and the next month that inflation is a bigger problem than unemployment. As an attempt to compare real values, this oscillation is preposterous. For it is always of economic and social benefit to use resources more fully and to produce and distribute more rather than less on a per capita basis; while price trends are always to be evaluated as means in terms of their effect upon these ultimate objectives. To care more about price trends than about these ultimate objectives, even temporarily, forgets what the function of prices really is, and to get more inflation to boot.

To attempt to make political capital by telling the American people that only 6 to 10 percent of them is hurt by unemployment, while everybody is hurt by inflation, borders upon the demagogic. For inflation does not hurt everybody; it hurts some and helps others. We have not studied who is hurt and who is helped by what types of inflation. Nor have we noted that fantastically high and rising interest rates in the name of fighting inflation are not only inflationary *per se*, but also the worse kind of inflation because of their iniquitous effects upon the redistribution of income and because of their damaging effects upon the economic balance conducive to fuller resource use.

In sharp contrast, high unemployment and high disuse of other production resources, systematically contrived by some national policies for egregiously wrong reasons over so many years, spawns economic losses of gigantic magnitude which can never be restored. This hurts almost everybody even while it hurts most those who need help most, aggravates poverty more than all else, augments volcanic pressures of social and civil unrest which could again burst forth, starves the great national priorities because the blood of adequate public revenues cannot be squeezed from the turnip of a stunted economy, and plays havoc with the efforts to get the Federal Budget in the black.

The so-called "trade-off" between unemployment and inflation would be an economic and social monstrosity even if it "worked." But it has never worked, and it does not work now, and it will not work in future. The continued effort now to make it work will merely repeat over and over again the failures and frustrations of similar efforts in the past.

The empirical record on the "trade-off" issue

The abysmal failure of the "trade-off" to work is thoroughly set forth on my Chart 37, which divides the entire period from 1947 through 1977 into subperiods reasonably selected in accord with differing characteristics in terms of national policies and economic results. The subperiod 1947-1953, especially when account is taken not only of averages for all the years but also for trends from the first year to the last, indicates by far the best economic performance record since World War II. This, despite difficulties at home and conditions overseas as complex and troublesome as any which have appeared since. As Vice Chairman and then Chairman of the Council of Economic Advisers during these years, I am in a moderately good position to appraise why the results were good. They were good because every other objective was subordinated and made supplementary to what I then called "the great non-secret weapon of the U.S. economy," its unrivaled production and production-growth powers at reasonably full resource use. Controls were used and needed during Korea; but it was full resource use that really licked inflation.

The subperiod 1953-1961 commenced under the economic guidance of Dr. Arthur Burns as Chairman of the President's CEA. It would seem that Dr. Burns felt that an inherited rate of inflation of 0.8 percent meant that inflation was the great problem, accompanied by the feeling that 2.9 percent unemployment was probably too low. Accordingly, fiscal and monetary policies were tightened, the real rate of economic growth averaged about half that registered during the earlier subperiod, and unemployment rose from 2.9 percent to 6.7 percent. There is some question as to whether these terrible economic developments were contributory to the low rate of inflation during the subperiod. But in any event, it should be noted that these developments provided no support for the "trade-off," in that the rate of inflation was 50 percent higher when unemployment was 6.7 percent than when it was 2.9 percent.

The subperiod 1961-1966, with much help from CEA Chairman Walter W. Heller, proved once again that a very high rate of economic growth, accompanied by a tremendous reduction in the rate of unemployment, could be accompanied by remarkable price stability. And indeed, price stability was encouraged by the favorable performance of the fundamental economy. But during 1966-1969, due to gross errors in the 1964 stimulative tax-reduction program as I have already described these, and due also to the emergence of the view that the economy needed to be slowed down to protect against inflation, the rate of real economic growth turned again in a very adverse direction. And correspondingly, the inflation rate shot up from 2.9 percent in the first year to 5.4 percent in the last. This acceleration of inflation could not be attributed to the slight further reduction in unemployment from 3.8 percent in 1966 to 3.5 percent in 1969, nor to the economy being "pumped up too much in 1968, in order to win an election." That "pumped up" argument is merely more of the foolish animadversion to full employment. The true reason for the accelerated inflation was the hesitancy and inadequacy with respect to tax increases with the great acceleration of expenditures for the Vietnam War. Taxes were increased promptly and decisively during the Korean War, and the result by 1953 was 2.9 percent unemployment and 0.8 percent inflation.

The subperiods 1969-1977 and 1976-1977 provide the most vivid and most well-known demonstration of the abominable results on all fronts when the "trade-off" idea that inflation can be abated by holding the economy back became the honored gospel of national economic policy.

My Chart 38 provides a good deal more empirical evidence against the attempted use of the "trade-off," including the period from first quarter 1974 to first quarter 1975, when the highest rate of inflation since the Civil War was accompanied by the most serious economic downturn since the Great Crash of the 1930s. It will not do to say that the double-digit inflation was due to extraneous factors such as Arab oil actions and crop failures; the underlying rate of inflation of about 6 percent during this period was more than twice as high, if not three times as high, as during earlier periods when unemployment had been very low. This chart is also valuable because it shows the tremendous drop in the rate of inflation from fourth quarter 1975 to first quarter 1976, when the rate of real economic growth, as a measure of the rate of economic recovery was extraordinarily high. The chart is further valuable because it shows that, from first quarter 1976 to fourth quarter 1977, the rate of inflation began to move disturbingly upward again as the progress of the economic recovery measured in terms of real economic growth began to recede substantially.

To extend the empirical observation still further (and as adverted to earlier in my discussion), the first quarter of 1978 evidenced economic stagnation accompanied by still more inflation, and the forecasts now are that a very disappointing rate of real growth during the 12 months or more ahead will be accompanied by a still further accentuation of the inflationary problem.

The reasons why the "trade-off" won't work

The reasons why the "trade-off" theory is upside down, the reasons why low growth and high unemployment aggravate inflation and vice versa, are easy to state. The most important reason is that an economy of high resource disuse becomes increasingly inefficient in terms of costs per unit of production. The best example of this, as shown on my Chart 39, is the positive correlation between the rate of productivity growth and the degree of vigor in the economic performance.

As illustrated poignantly once more in first quarter 1978, the emergence of a no-economic-growth pattern drove up per unit labor costs so severely that this development has/come to be hailed as one of the strongest additions to inflationary pressures. The/following is quite a commentary upon the state of our economic thinking, and upon our national economic policies: The additional evidence of the direct relationship between a limping economy and inflation leads /policymakers to conclude that the fight against inflation be augmented by causing the limp to continue or get worse, through reducing the size or postponing the advent of the tax program proposed by the President to change the limp into a walk.

The other reasons why high unused resources augment inflation are equally clear. The higher costs of production per unit, combined with a disappointing volume of sales, prompt those in in the administered price areas to lift their prices more rapidly than they otherwise would. The high costs imposed by a policy of very high and rising interest rates are inflationary *per se*. Low economic growth and high unemployment tend strongly to redistribute income upward, which means inflating the fat and starving the lean, even while the cry is raised about how much inflation hurts those who are most vulnerable. The shortages caused by a national policy,designed to fight inflation by "protecting" the Federal Budget from the costs of adequate programs in such areas as medical care and housing and adequate food supply are really highly inflationary. The troubles of the utilities and the shortages in fuel and facilities are due predominantly, not to the misdeeds of the Arabs, but rather to the impact of the doubling of interest costs upon utilities who finance so largely out of borrowed capital. Much lower interest rates, the farmers also being heavy borrowers of capital, would impact favorably upon food supply. More public outlays, in years gone by, for health services, would have been highly anti-inflationary. There are many other examples of why the attempt to fight inflation through the deliberate creation of scarcities defies all reason and has been confounded by all experience.

The Administration's new anti-inflation "program"

When we now survey the listing of the Administration's new program to combat inflation, most of it is picayune or misdirected. Inflation will not be inhibited by discriminating against Federal employees in the wage rate increases they receive measured against those received by others. The amounts involved would be too small, even if the current inflation were due to an excess of purchasing power, which is far from the case. And the effort by way of Federal example to restrain the growth of wage purchasing power is utterly inconsistent with any quantifications relevant to full economic restoration. The movement in some quarters of the Administration toward reducing the size of the tax stimulus to the economy, and the renewed emphasis upon attempting to balance the Federal Budget through means which cannot possibly lead toward balance because that balance requires a full economy, are equally indictable. We are continuing to shadowbox with the entire issue of inflation,by naming the wrong culprits and punching wildly in the wrong directions.

It passeth all understanding that, under all the circumstances thus far detailed, national policy has not yet recognized that the utmost of efforts to accelerate the real rate of economic recovery(in accord with the Humphrey-Hawkins objective of 4 percent unemployment by the middle of 1983) is the sure and true road to price stability and a balanced Federal Budget.

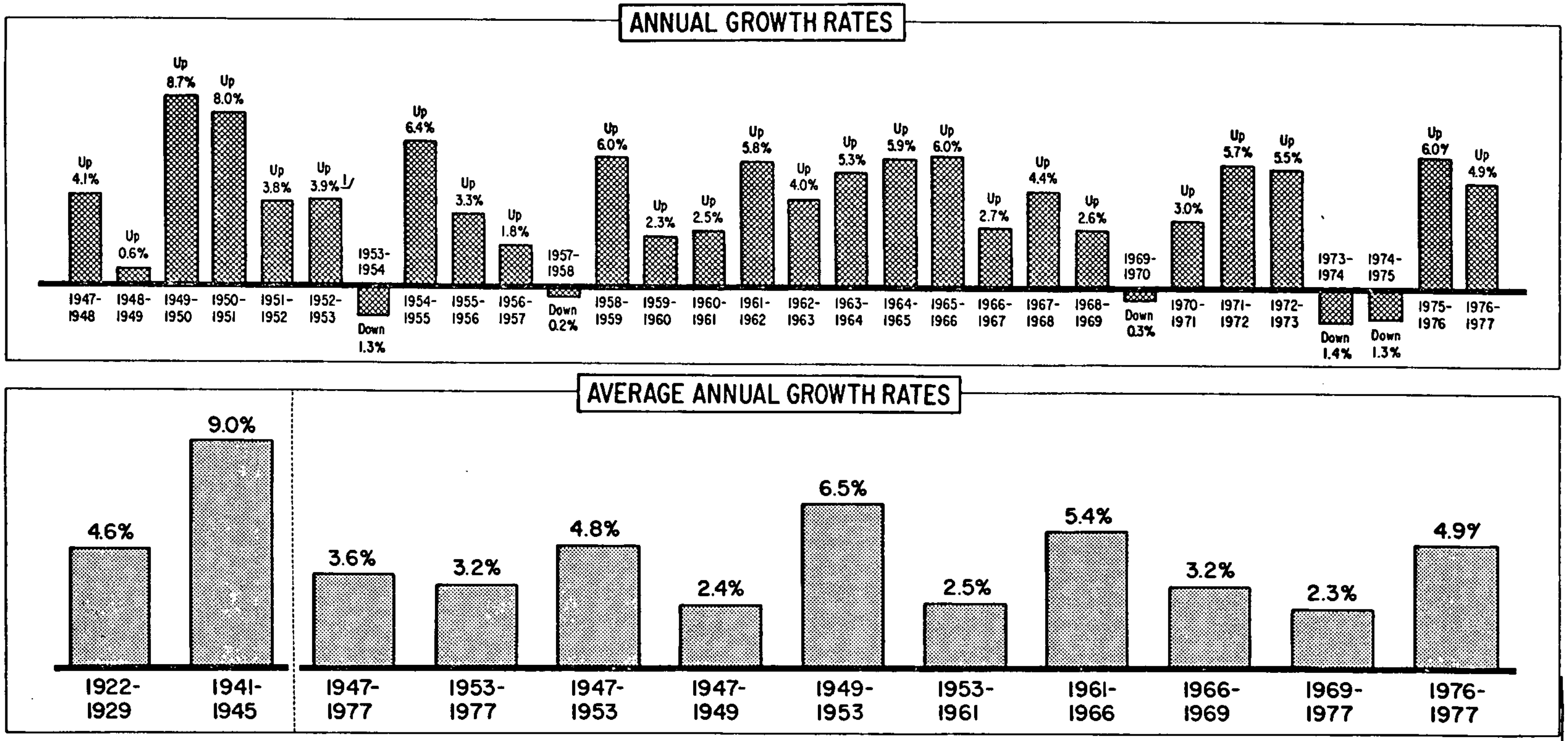
8. Time For Planning

economic policy

Towering above all the details regarding national/sins of omission and commission, there emerges the clear picture of a great Government of a great people, wandering from one series of programs and policies to another, but never yet recognizing the need for one program or policy which pulls things together and reconciles the parts. The beacon light in this direction is the Humphrey-Hawkins bill. Enactment of the Full Employment and Balanced Growth Act of 1978, with the mandates set forth therein, will provide a sounder foundation on which to build. It remains to be seen how rapidly the Congress will move in this direction, and how effectively the Administration will use the better tools when they are made available.

THE "ROLLER-COASTER" ECONOMIC PERFORMANCE: ECONOMIC GROWTH RATES, 1922-1929, 1941-1945, AND 1947-1977

(Uniform Dollars)

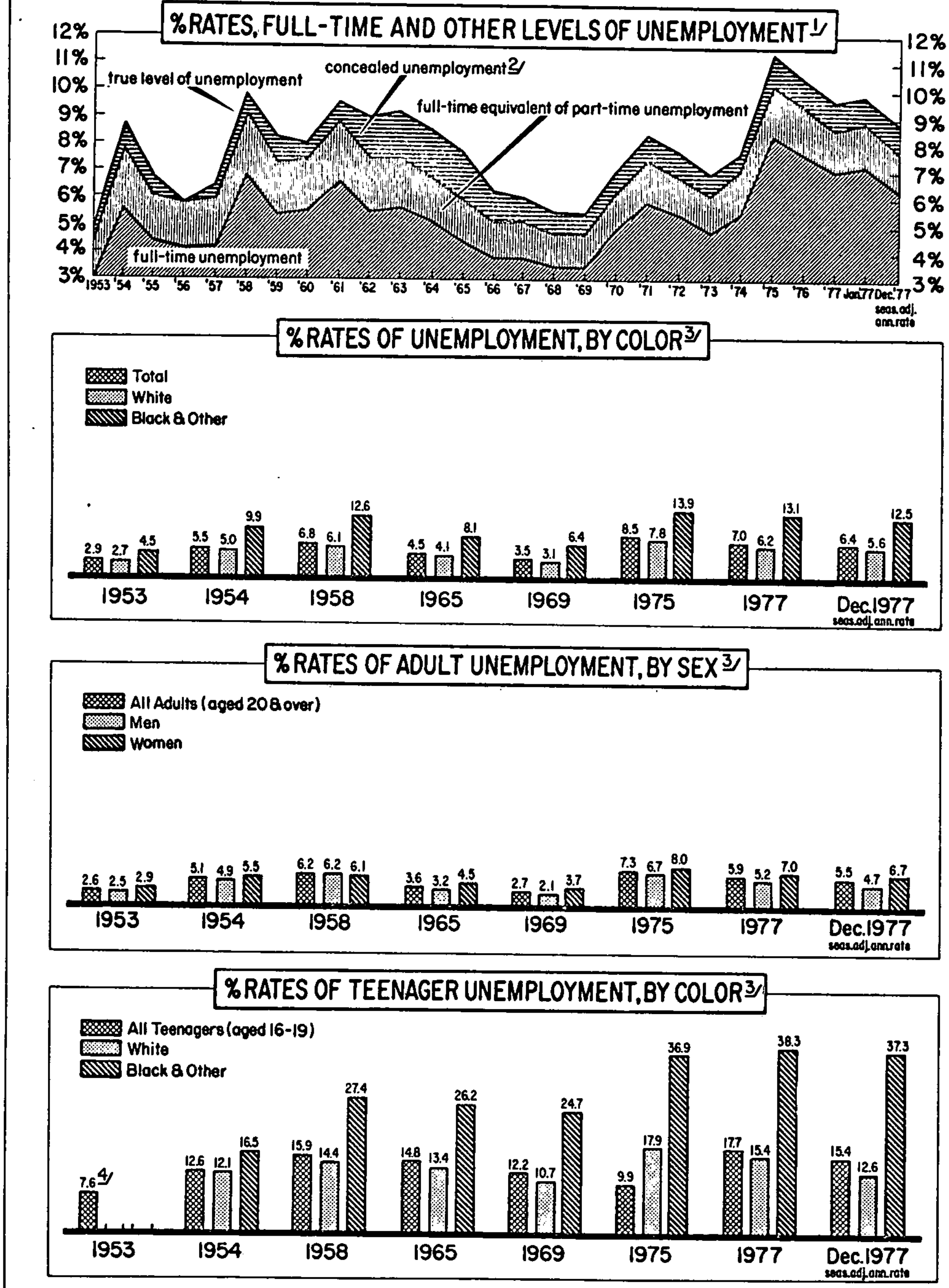


1/ Recession during part of period. There were five recessions, 1953-1977, but some were entirely within one year, and began and ended in different years.

CHART 1

CHART 2

UNEMPLOYMENT, % RATES & DISTRIBUTION, 1953-1977



1/ In deriving these percentages, the officially reported civilian labor force is augmented by concealed unemployment. Thus, some of the rates for full-time unemployment are very slighly lower than in the official reports of full-time unemployment

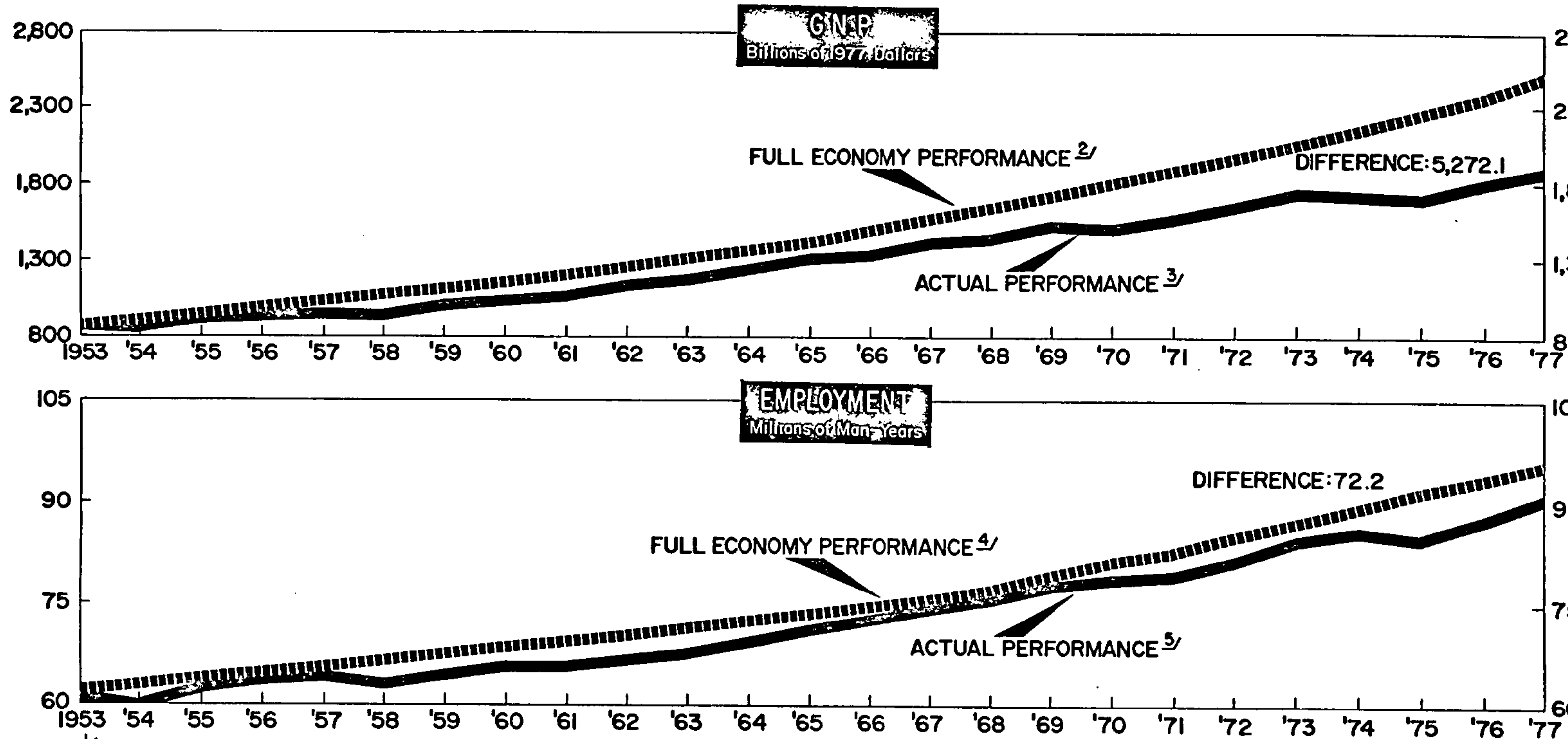
2/ Withdrawals from labor force, due to scarcity of job opportunity.

3/ Officially reported concept of full-time unemployment.

4/ Distribution by color unvailable.

Note: Some totals affected by rounding.

COST OF DEPARTURES FROM FULL ECONOMY, 1953-1977 [1]



1/ 1977 estimated.

2/ Real average annual growth rate of 4.4 percent.

3/ Real average annual growth rate of 3.2 percent, the 1953-1977 average.

4/ Average true level of unemployment of 4.1 percent, or 2.9 percent full-time unemployment.

5/ Average true level of unemployment of 7.7 percent, or 5.3 percent full-time unemployment.

Basic Data: Dept. of Commerce; Dept. of Labor

CHART 3

COSTS OF DEFICIENT ECONOMIC GROWTH U.S. ECONOMY, 1953-1977 AND PROJECTED 1978-1983

(Dollar items in billions of 1977 dollars, except average family income)

1953-1977[1]

Total National Production (GNP)	Man-years of Employment[2]	Personal Consumption Expenditures	Gov't Outlays for Goods and Services[3]
1953-1977: $5,272.1 1969-1977: 1,828.4 1977: 357.8	1953-1977: 72.2 Million 1969-1977: 34.0 Million 1977: 5.3 Million	1953-1977: $2,349.0 1969-1977: 847.9 1977: 176.4	1953-1977: $1,331.2 1969-1977: 484.0 1977: 101.4
Private Business Investment (Incl. Net Foreign)	**Median Family Income (1977 Dollars)**	**Wages and Salaries**	**Residential and Commercial Construction**
1953-1977: $1,591.9 1969-197: 496.5 1977: 80.0	1953-1977: $43,880 1969-1977: 12,217 1977: 2,816	1953-1977: $2,702.0 1969-1977: 835.4 1977: 191.5	1953-1977: $689.2

1978-1983[4]

Total National Production (GNP)	Man-years of Employment	Personal Consumption Expenditures	Gov't Outlay for Goods and Services
1978-1983: $1,155.0 1983: 339.5	1978-1983: 16.4 Million 1983: 4.1 Million	1978-1983: $506.5 1983: 179.3	1978-1983: $332.8 1983: 84.5
Private Business Investment (Incl. Net Foreign)	**Median Family Income (1977 Dollars)**	**Wages and Salaries**	**Residential and Commercial Construction**
1978-1983: $315.7 1983: 75.7	1978-1983: $4,791 1983: 1,411	1978-1983: $762.3 1983: 205.0	1978-1983: $183.0 1983: 40.0

1/ Deficits 1953-1977 are calculated from a 1953 base, in that growth rates since then have averaged far too low. Deficits 1969-1977 and 1977 are projected from a 1968 base, writing off the cumulative deficits 1953-1968. 1977 figures are estimated. Residential and commercial construction deficits are calculated only from a 1953 base. In terms of what would have been needed, 4Q 1977 to restore full production as of then, the estimated deficit in GNP was 150-200 billion dollars, at an annual rate.

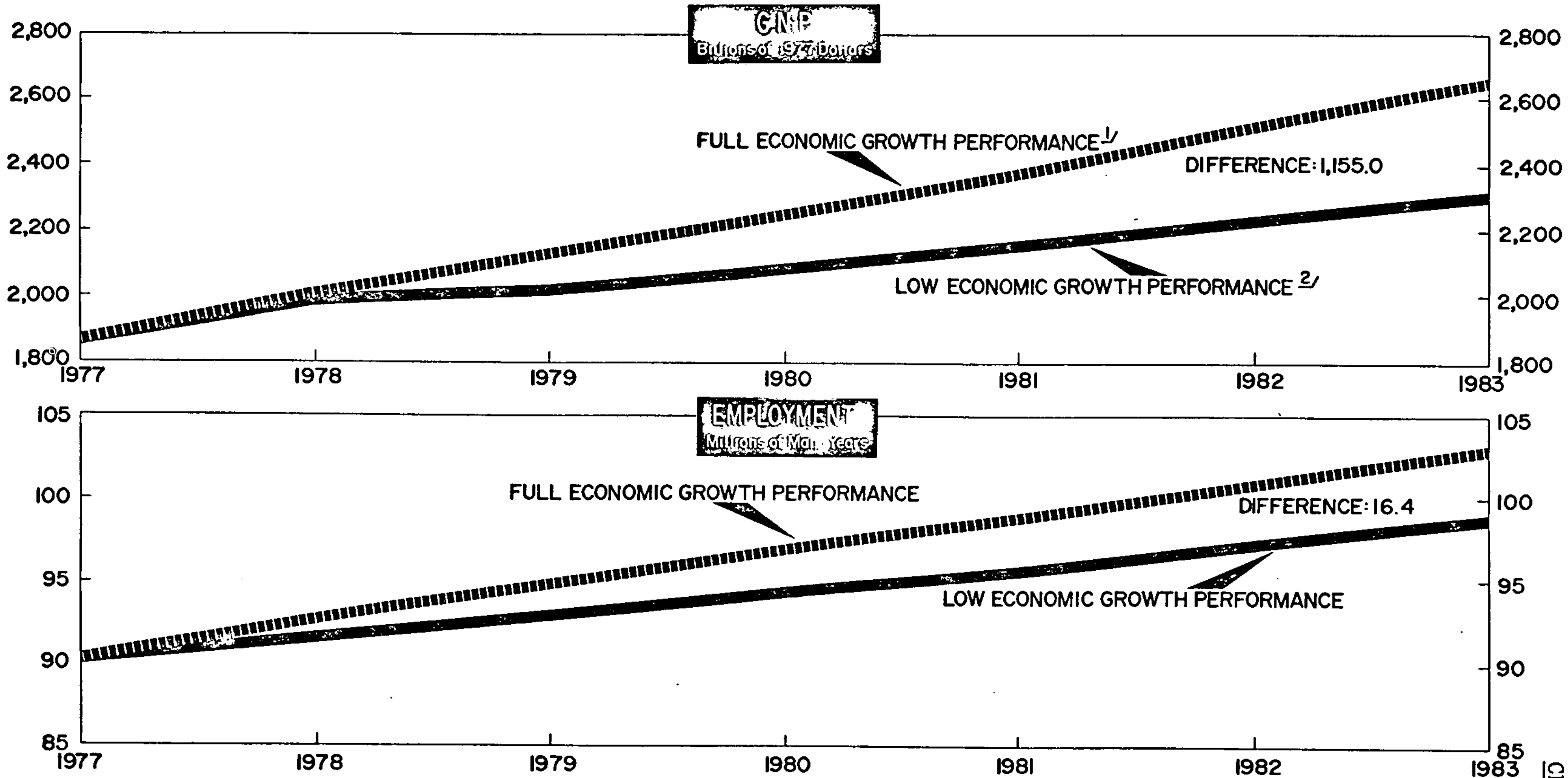
2/ Based upon true level of unemployment, including full-time unemployment, full-time equivalent of part-time unemployment, and concealed unemployment (nonparticipation in civilian labor force) due to scarcity of job opportunity.

3/ Based upon reasonable relationships to GNP and to government receipts.

4/ These deficits are projected from a 1977 base, writing off the cumulative deficits 1953-1977. The higher figures are based on assumption that some actions compatible with the Humphrey-Hawkins bill will be taken in 1978, that the bill will be enacted in 1978, and that the first Economic Report of the President under it will be issued in January 1979.

Basic Data: Dept. of Commerce; Dept. of Labor

BENEFITS OF FULL ECONOMIC GROWTH, 1977-1983



1/ Real growth rate of 6.0%, 1977-'78, assuming that some actions compatible with the Humphrey-Hawkins proposal will be taken in 1978. Real average annual growth rate of 5.8%, 1978-1983, if the Humphrey-Hawkins bill is enacted in 1978 and the first Economic Report of the President under the Act is issued in January 1979. These growth rates would be cosistent with reducing overall unemployment to 4% by the middle of 1983.

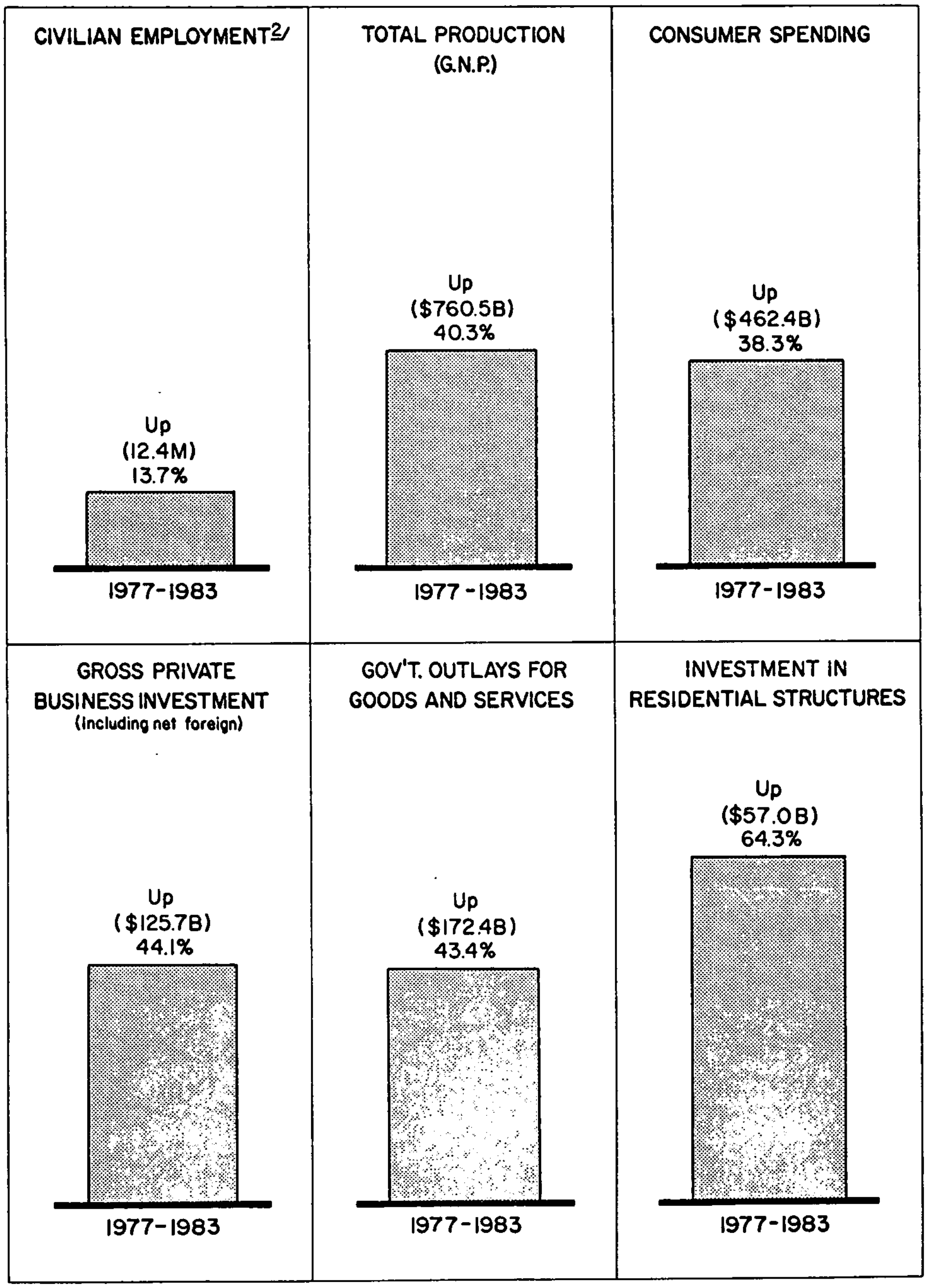
2/ Real average annual growth rate of 3.4%, compared with 2.6%, 1969-1977.

CHART 5

CHART 6

MAJOR GOALS FOR 1983, CONSISTENT WITH 1983 GOAL FOR REDUCTION OF UNEMPLOYMENT[1]

Total Percentage Changes
(Dollar Items in 1977 Dollars, Absolute Data in Parentheses)



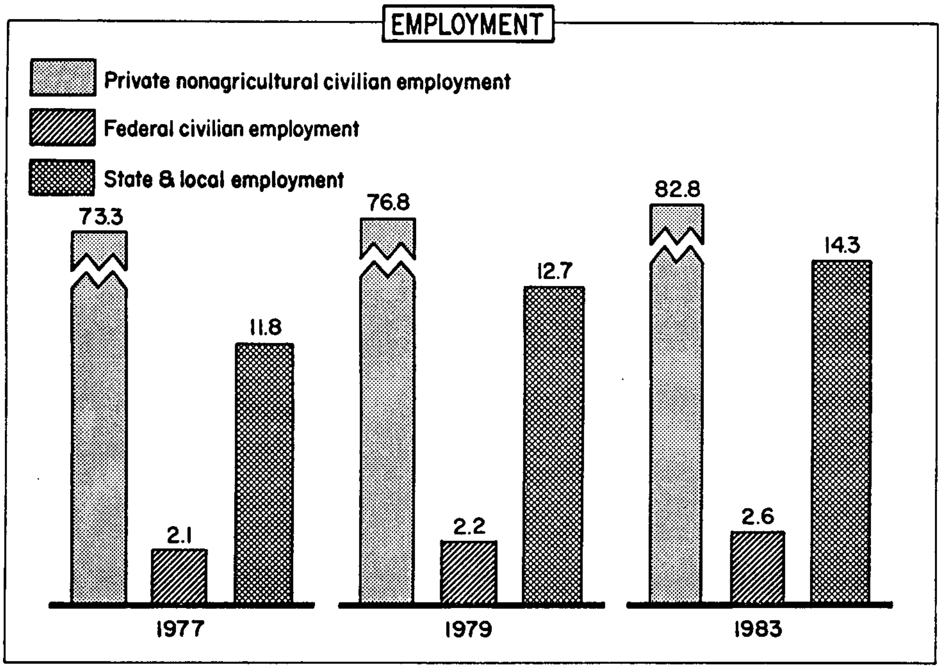
1/ Assumes some actions compatible with the Humphrey-Hawkins bill will be taken in 1978, that the bill will be enacted in 1978, and that the first Economic Report under it will be issued in January 1979.

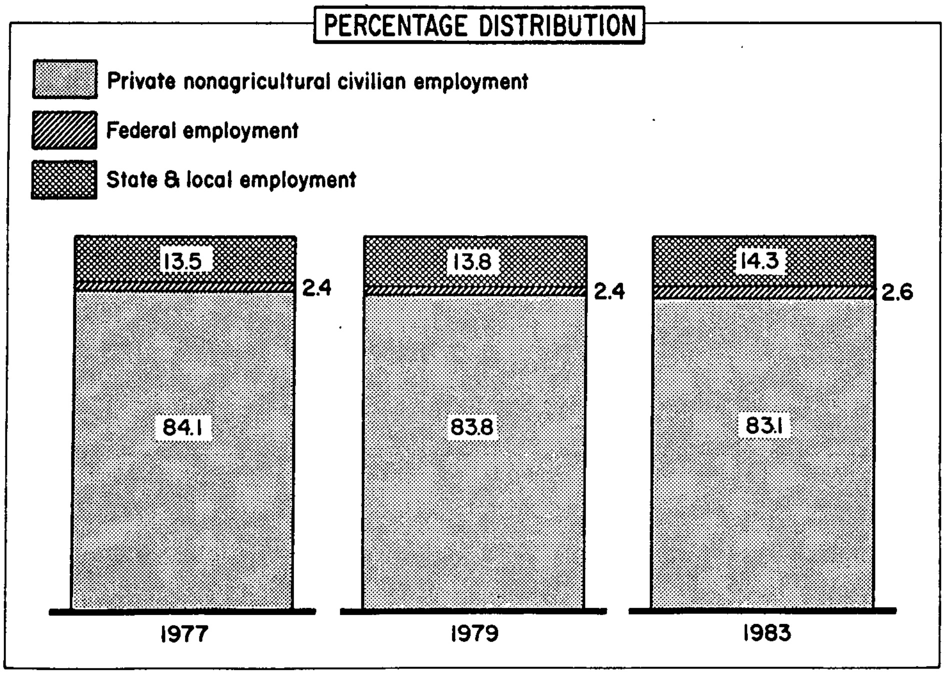
2/ Full-time unemployment down from 7.1% (6.9 million) in 1977 to 4.0% (4.3 million) in 1983.

CHART 7

DISTRIBUTION OF EMPLOYMENT, 1977 AND PROJECTED,[1] 1979 AND 1983

(Millions)



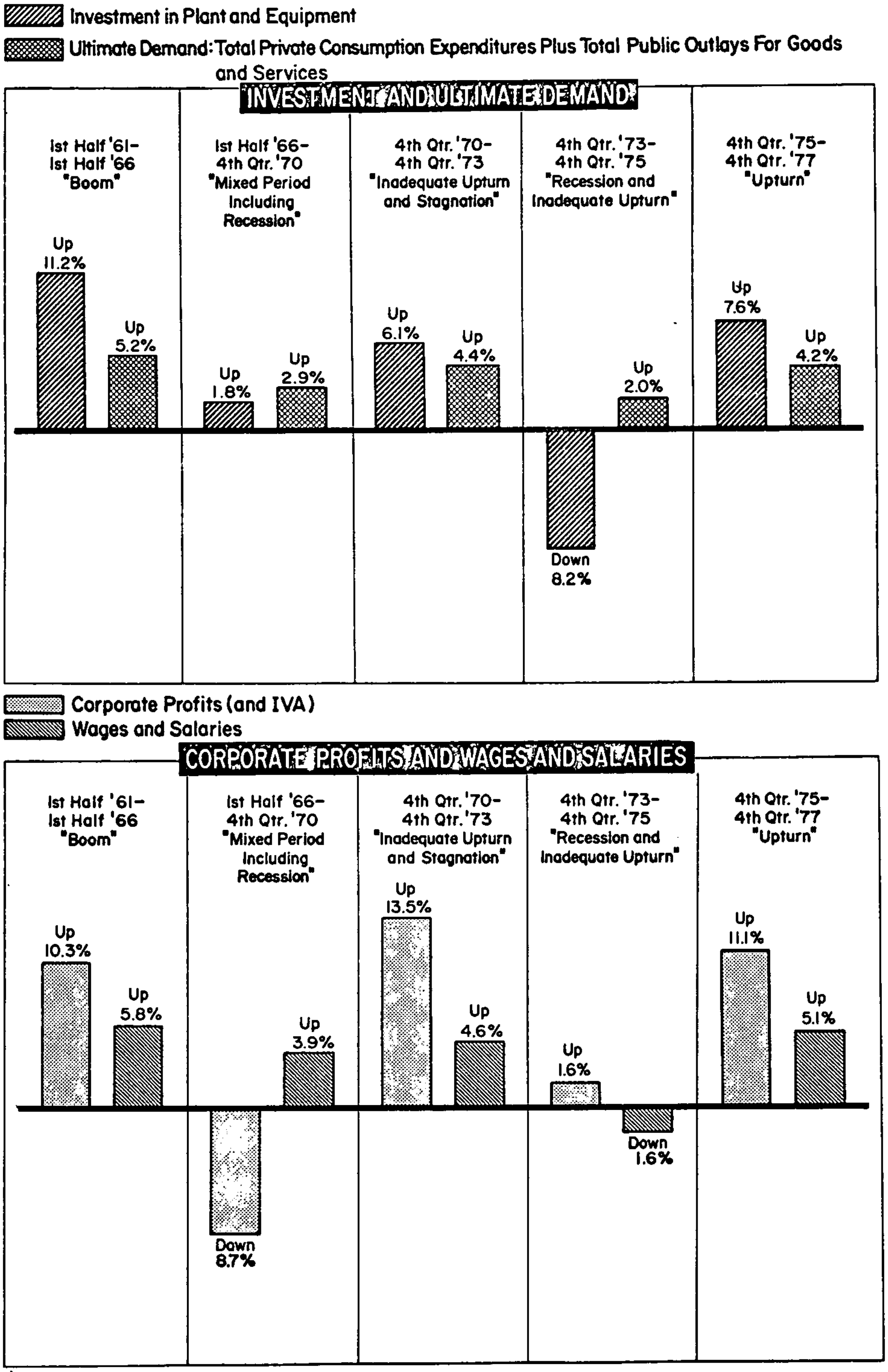


[1] Projected in accord with unemployment reduction goal for 1983. Assumes some actions compatible with the Humphrey-Hawkins bill will be taken in 1978, that the bill will be enacted in 1978, and that the first Economic Report under it will be issued in January 1979.

CHART 8

COMPARATIVE GROWTH RATES, 1961-1977[1]

(Average Annual Rates of Change, in Uniform Dollars)



[1] 1977 estimated.
Basic Data: Dept. of Commerce

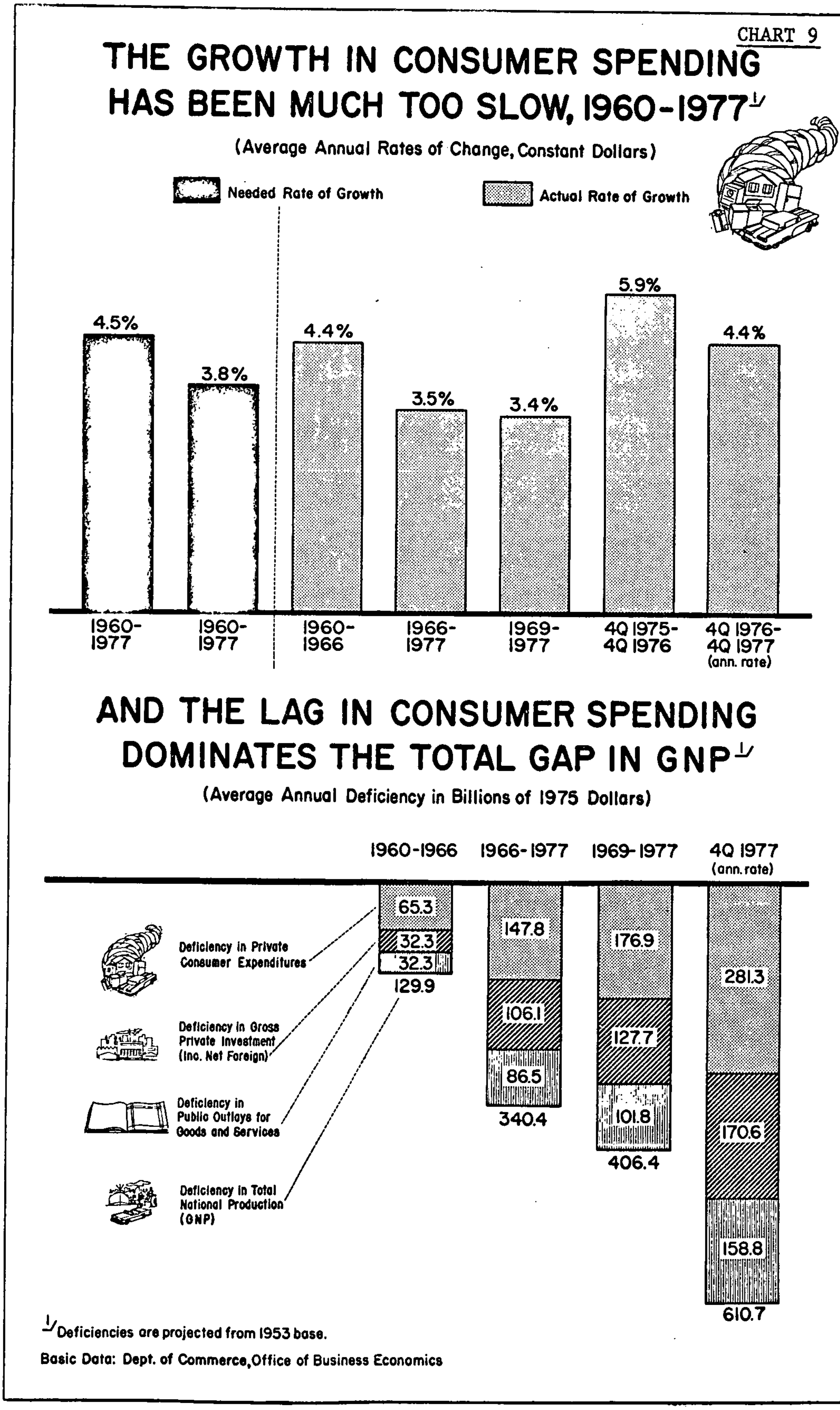
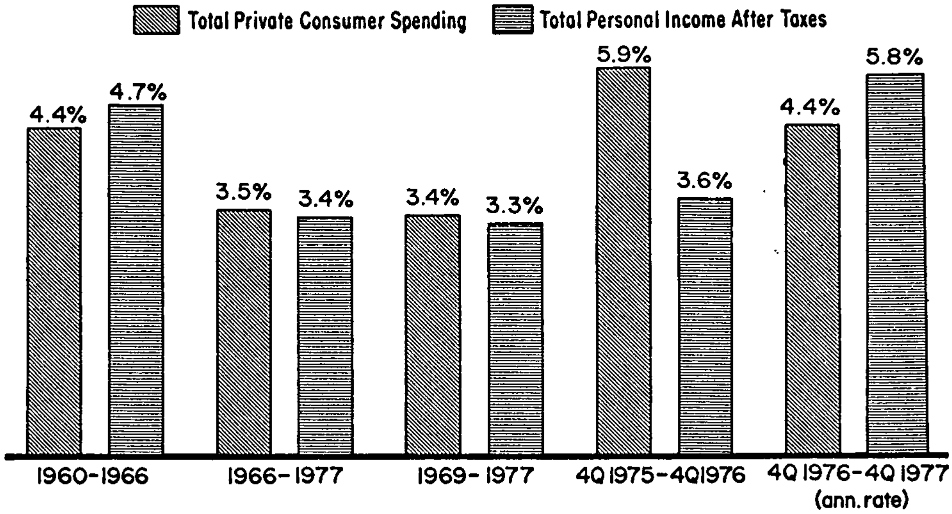


CHART 9
THE GROWTH IN CONSUMER SPENDING HAS BEEN MUCH TOO SLOW, 1960-1977[1]
(Average Annual Rates of Change, Constant Dollars)
Needed Rate of Growth
Actual Rate of Growth
4.5%
3.8%
4.4%
3.5%
3.4%
5.9%
4.4%
1960-1977
1960-1977
1960-1966
1966-1977
1969-1977
4Q 1975-4Q 1976
4Q 1976-4Q 1977 (ann. rate)
AND THE LAG IN CONSUMER SPENDING DOMINATES THE TOTAL GAP IN GNP[1]
(Average Annual Deficiency in Billions of 1975 Dollars)
1960-1966
1966-1977
1969-1977
4Q 1977 (ann. rate)
65.3
32.3
32.3
129.9
147.8
106.1
86.5
340.4
176.9
127.7
101.8
406.4
281.3
170.6
158.8
610.7
Deficiency in Private Consumer Expenditures
Deficiency in Gross Private Investment (Inc. Net Foreign)
Deficiency in Public Outlays for Goods and Services
Deficiency in Total National Production (GNP)
1/ Deficiencies are projected from 1953 base.
Basic Data: Dept. of Commerce, Office of Business Economics

CHART 10

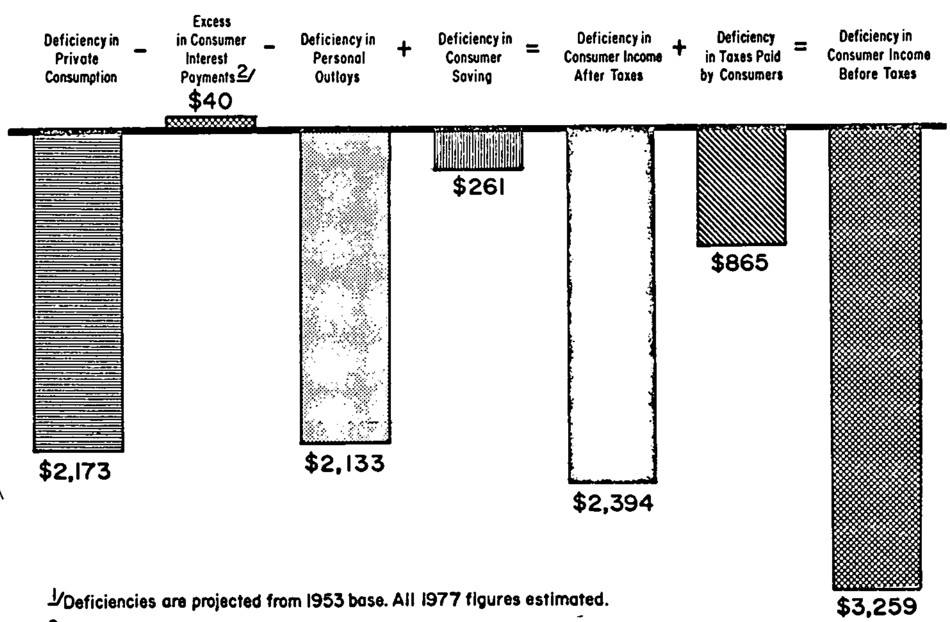
INADEQUATE CONSUMPTION GROWTH STEMS FROM INADEQUATE INCOME GROWTH[1]

Average Annual Rates of Change in Constant Dollars



THE PRIVATE CONSUMPTION DEFICIENCY OF $2,173 BILLION, 1960-1977, REFLECTED A $3,259 BILLION INCOME DEFICIENCY[1]

Billions of 1977 Dollars



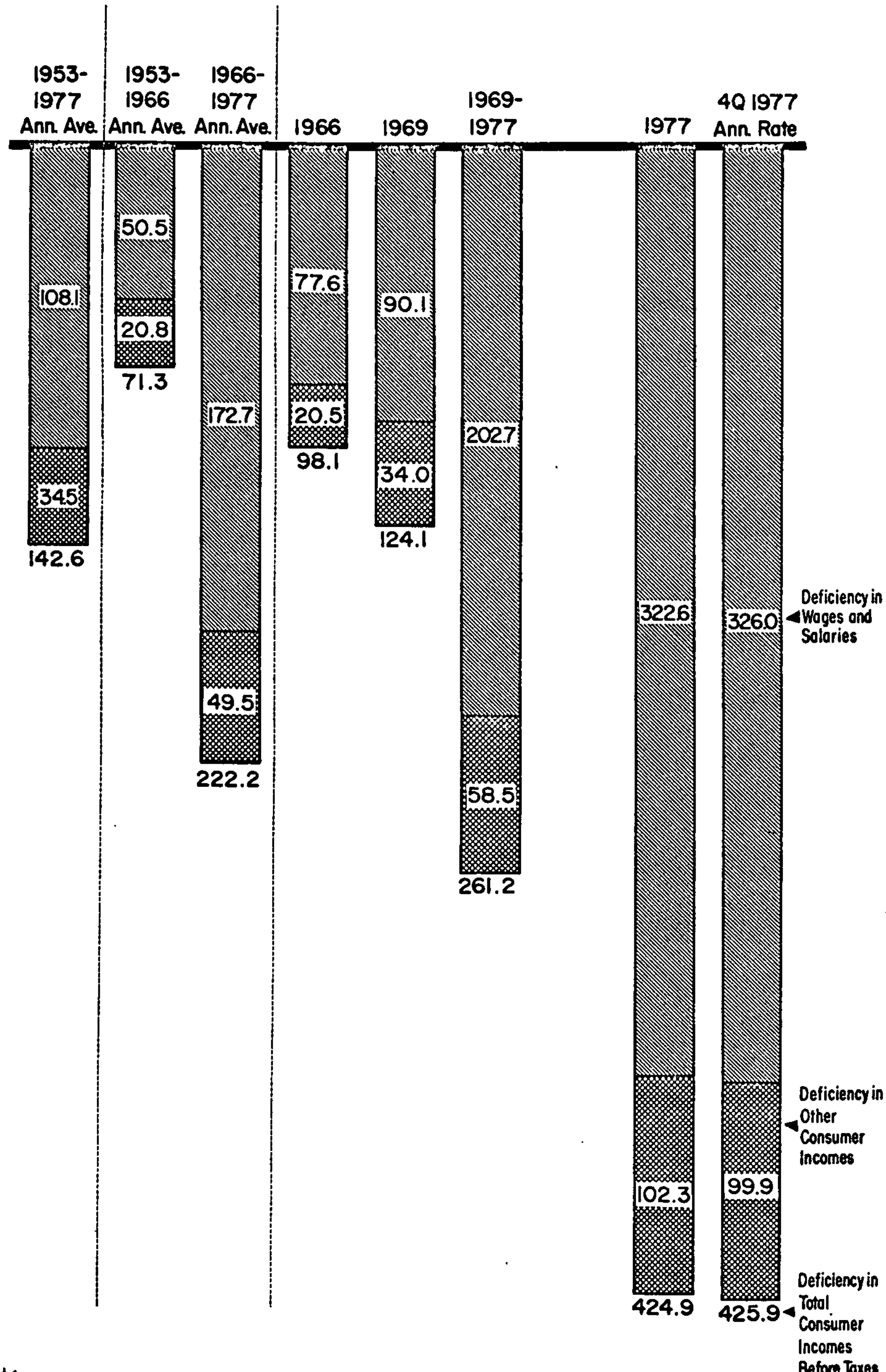
[1] Deficiencies are projected from 1953 base. All 1977 figures estimated.

[2] Also includes personal transfer payments to foreigners, which is a minimal amount.

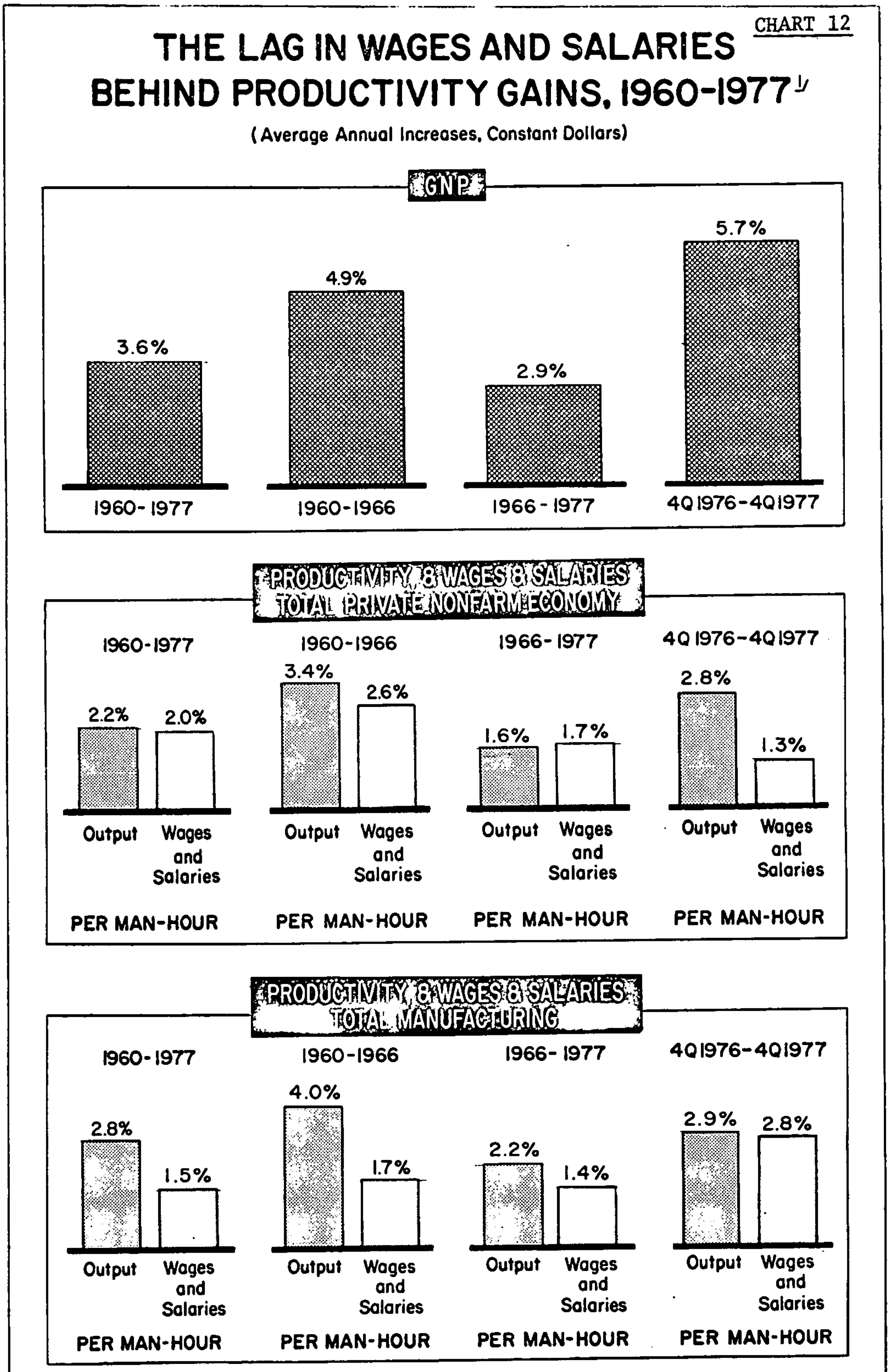
CHART 11

DEFICIENCIES IN WAGES AND SALARIES ARE LARGE SHARE OF DEFICIENCIES IN TOTAL CONSUMER INCOMES BEFORE TAXES[1]

Billions of 1977 Dollars



[1] Deficiencies are projected from 1953 base. All 1977 figures estimated.

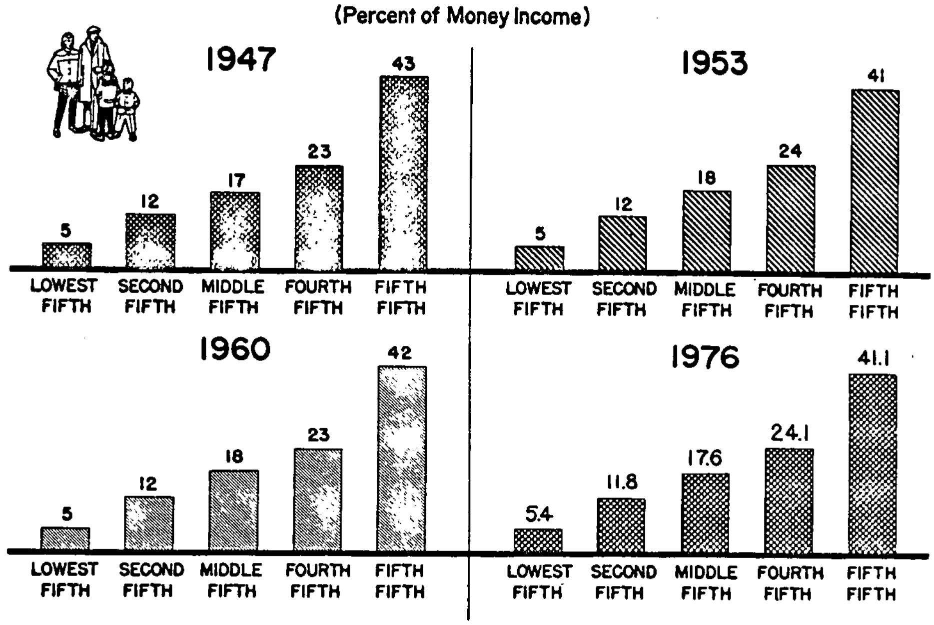


Basic Data: Dept. of Commerce; Dept. of Labor

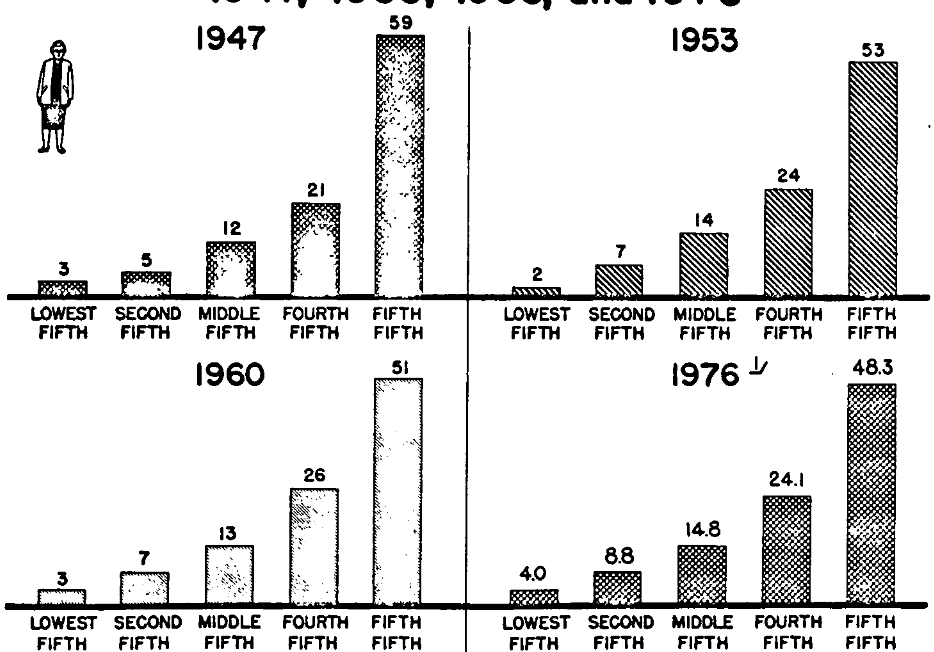
CHART 13

SHARE OF FAMILIES IN TOTAL FAMILY INCOME BY QUINTILES, 1947, 1953, 1960, and 1976

(Percent of Money Income)



SHARE OF UNATTACHED INDIVIDUALS IN TOTAL INCOME OF UNATTACHED INDIV., BY QUINTILES, 1947, 1953, 1960, and 1976

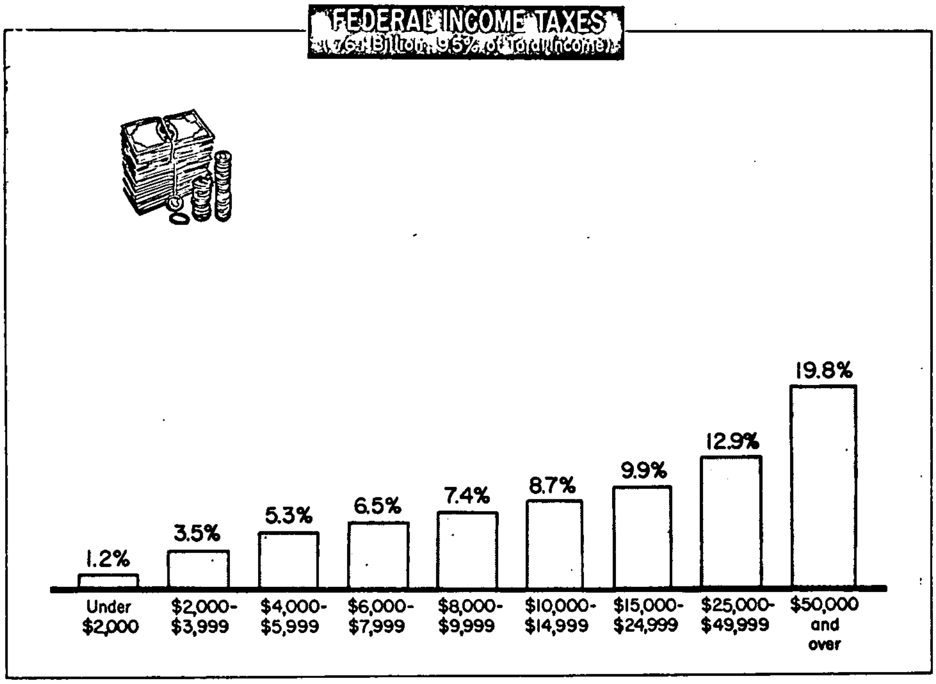


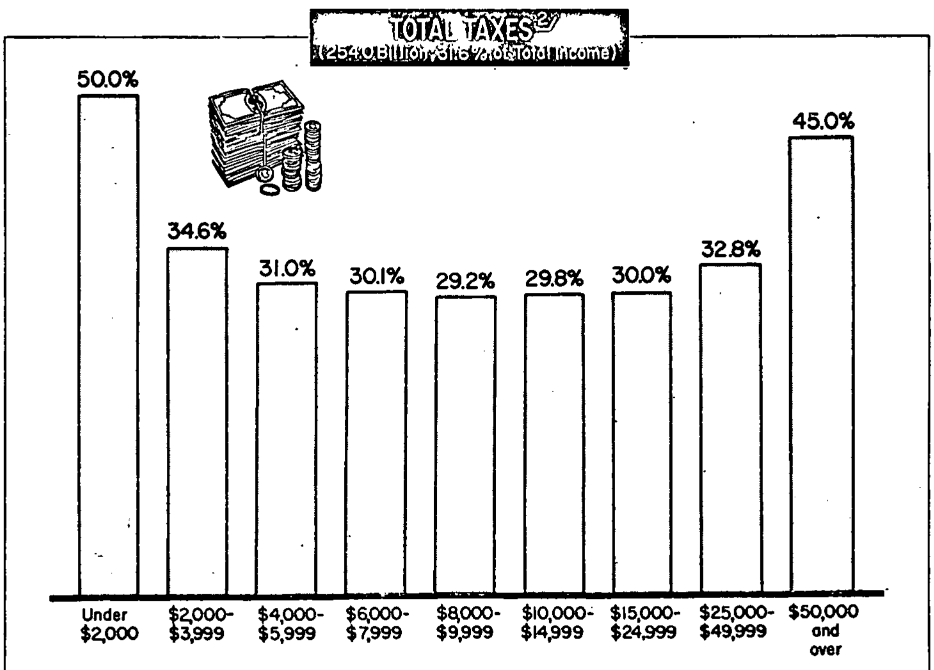
1/ Latest year available.

Data: Bureau of the Census.

CHART 14

TAXES PAID AS PERCENT OF INCOME, U.S. 1968[1]





1/ Income relates to total income of all persons in the adjusted money income classes shown. Total income is adjusted money income, plus imputed income, less direct taxes, plus retained corporate earnings, plus taxes minus transfer payments, plus realized capital gains.

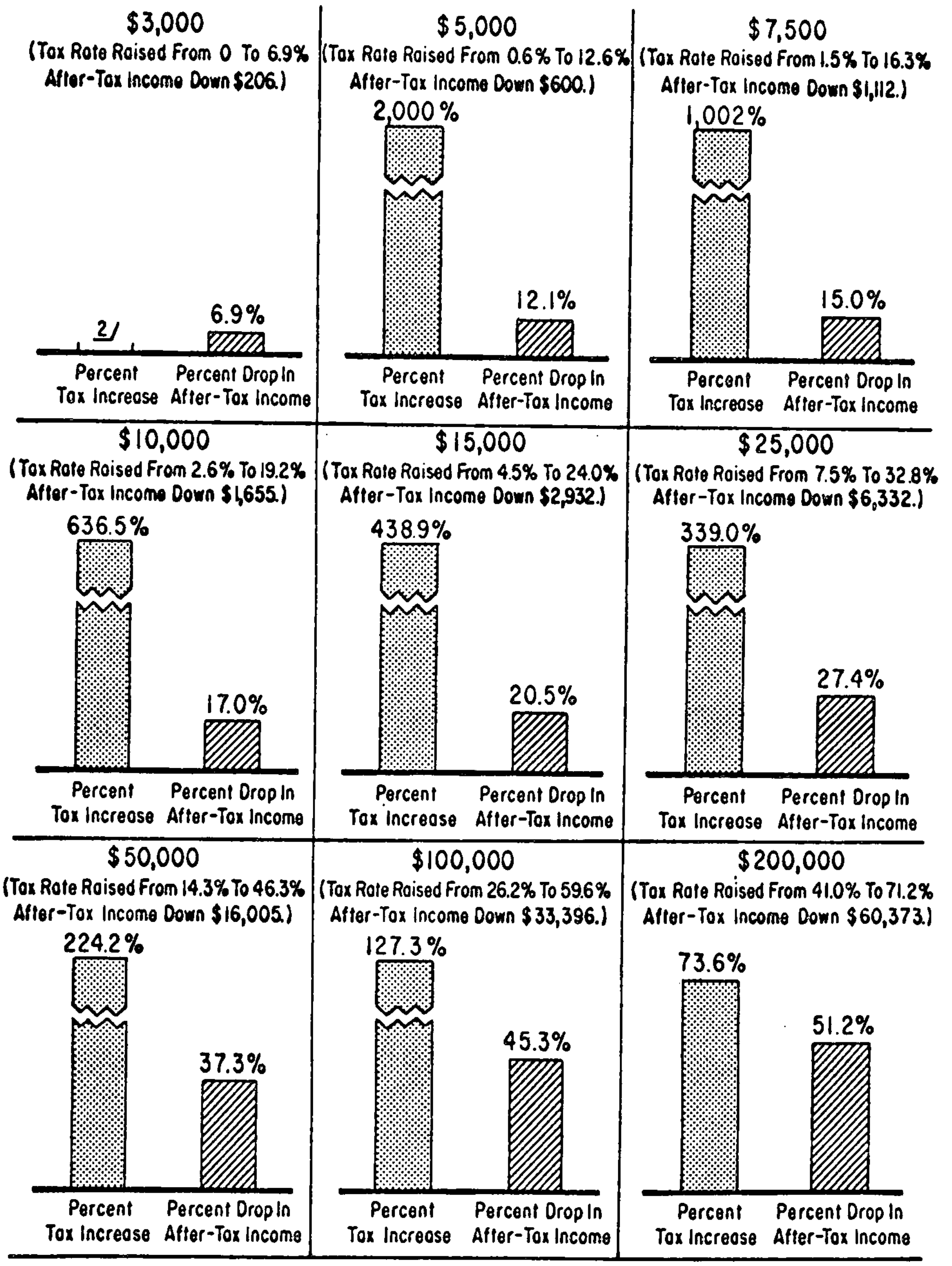
2/ Includes the following Federal and State and Local taxes: Individual income, estate and gift, corporate profits, and social security. Also includes Federal excise and customs taxes, and State and Local sales taxes, motor vehicle licenses, property taxes, and miscellaneous other taxes.

Basic Data: Dept. of Commerce, Bureau of the Census

CHART 15

PERSONAL TAX INCREASES, 1939-1945

Percent Federal Tax Increase And Percent Decrease In After-Tax Income Married Couple With Two Children At Various Income Levels[1]



1/ Federal tax for 1939 and 1945, as applied to adjusted gross income, estimated by CEP, assuming 10 percent deduction for taxes, interest, contributions, etc. Allowance was also made for earned income credit in 1939.

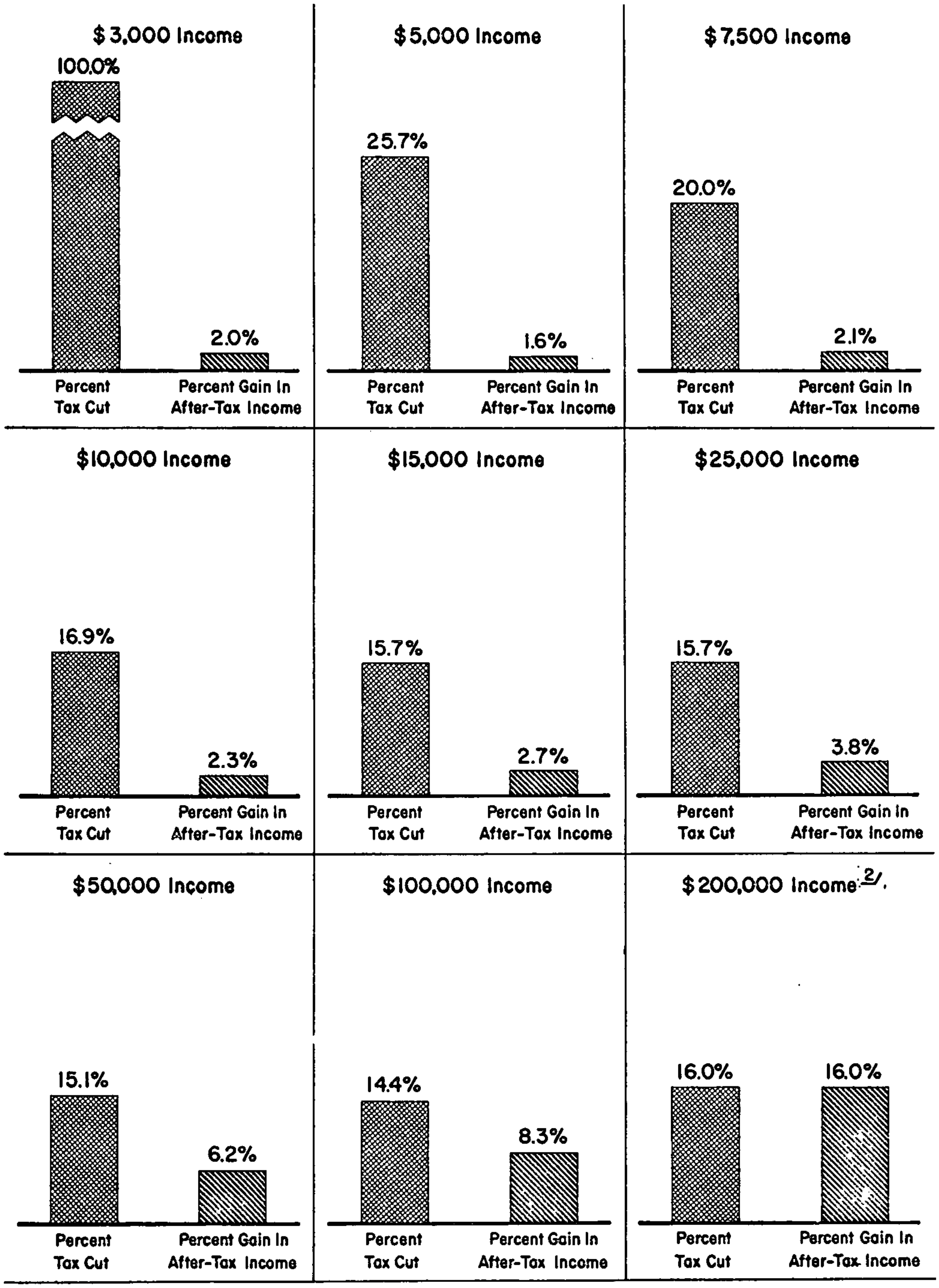
2/ No tax at this level in 1939.

Note: Tax rates shown are effective tax rates.

CHART 16

1964 TAX ACT, PERSONAL TAX CUTS

Percent Tax Cut And Percent Gain In After-Tax Income
Married Couple With Two Children At Various Income Levels [1]



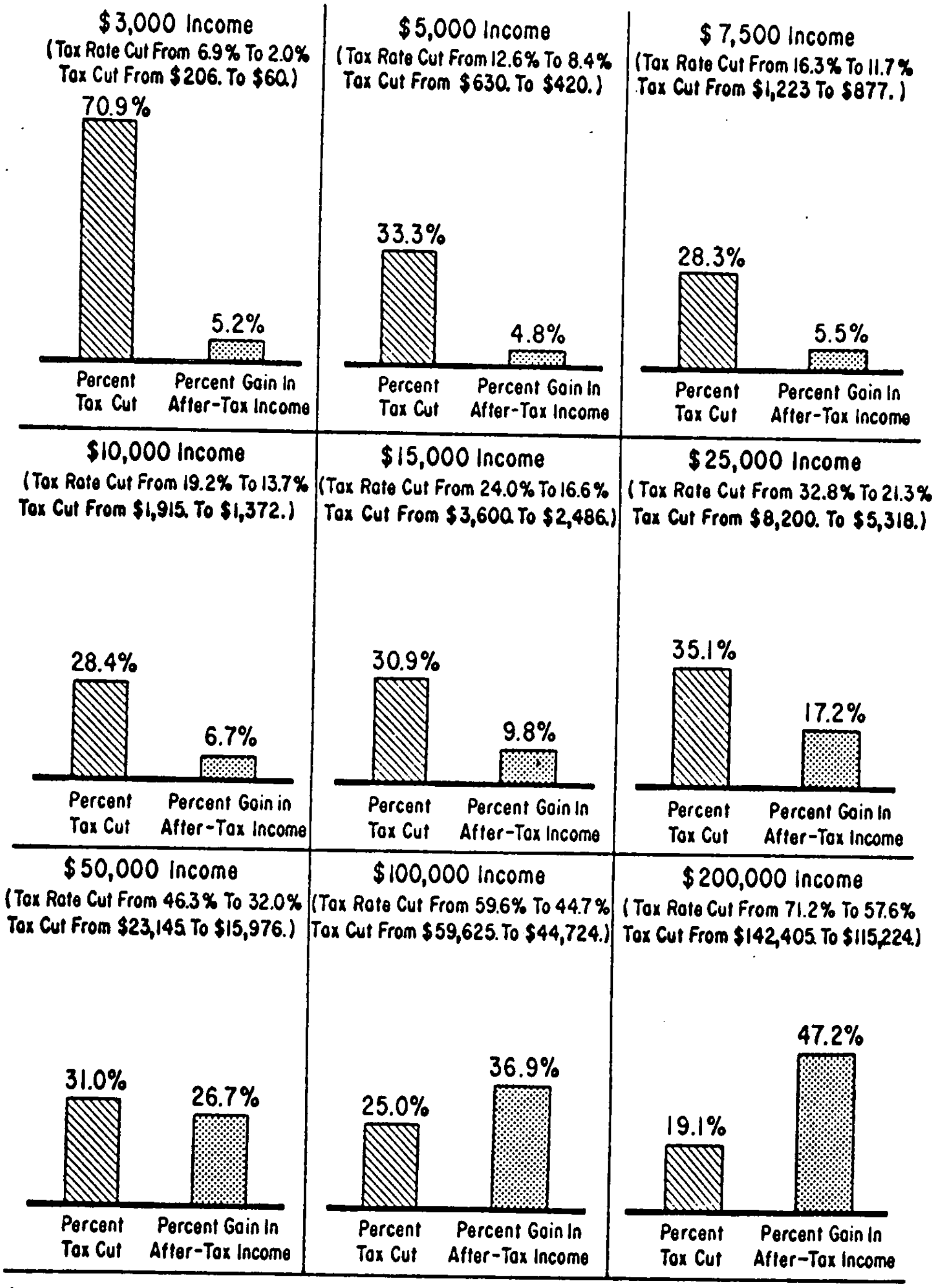
[1] Adjusted gross income levels. [2] Estimated

Note: Standard deductions for $ 3,000 income level. Typical itemized deductions for other income levels.

CHART 17

PERSONAL TAX CUTS, 1945-1963:

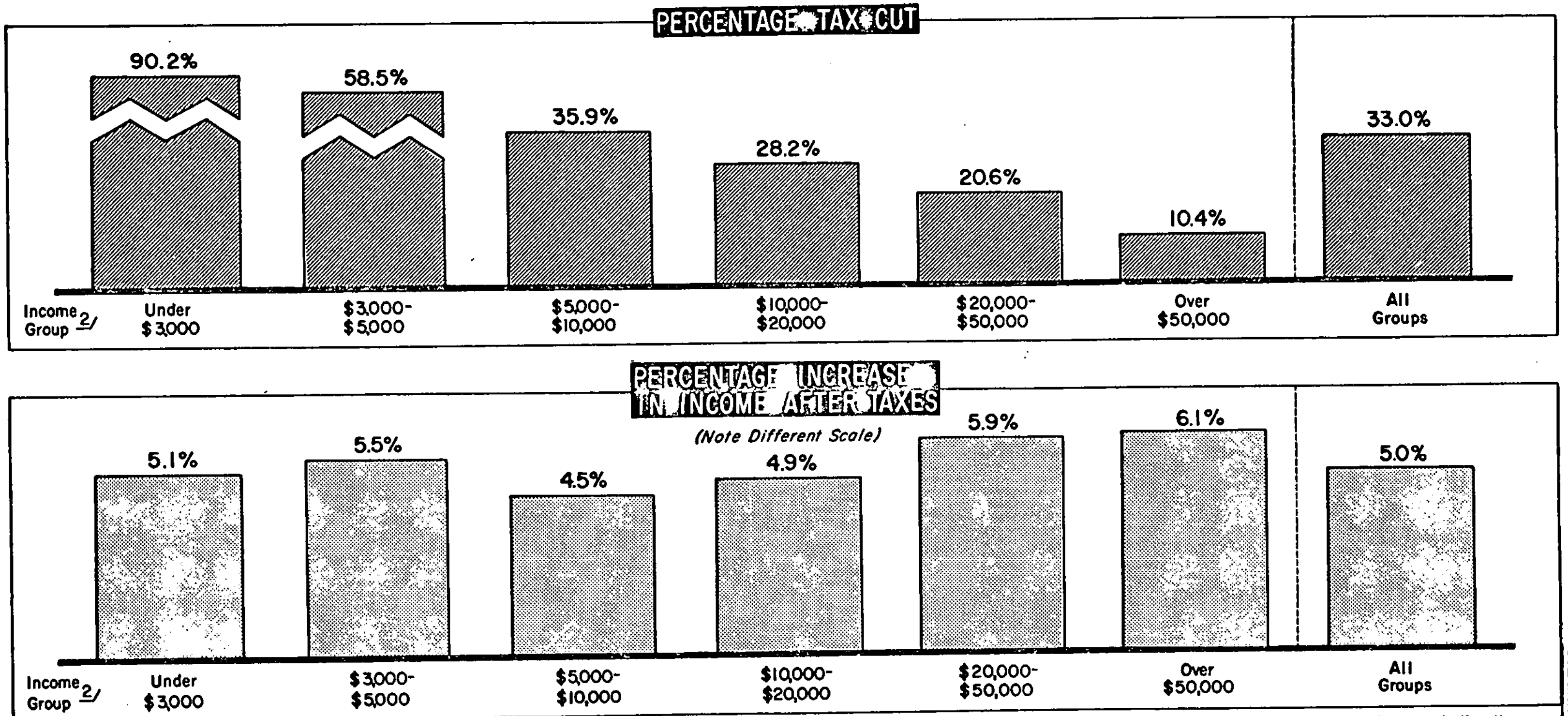
Percent Federal Tax Cut And Percent Gain In After-Tax Income Married Couple With Two Children At Various Income Levels[1]



[1] The amount of Federal tax, as applied to adjusted gross income, was estimated for 1945 by CEP and for 1963 by Treasury Dept. Both estimates assume 10 percent deduction for taxes, interest, contributions, medical care, etc.

Note: Tax rates shown are effective tax rates.

PERCENTAGE TAX CUT AND PERCENTAGE INCREASE IN INCOME AFTER TAX, VARIOUS INCOME GROUPS, 1963-1973[1]



1/ Effects due to changes in personal tax under Revenue Act of 1964, Tax Reform Act of 1969, and Revenue Act of 1971 (H.R. 10947, as reported by the House-Senate Conference Committee, excluding the effect on personal taxes of removing the first year convention under the Asset Depreciation Range system).

2/ Adjusted gross income class.

Basic Data: House Ways and Means Committee and Senate Finance Committee Reports, and Congressional Record

CHART 18

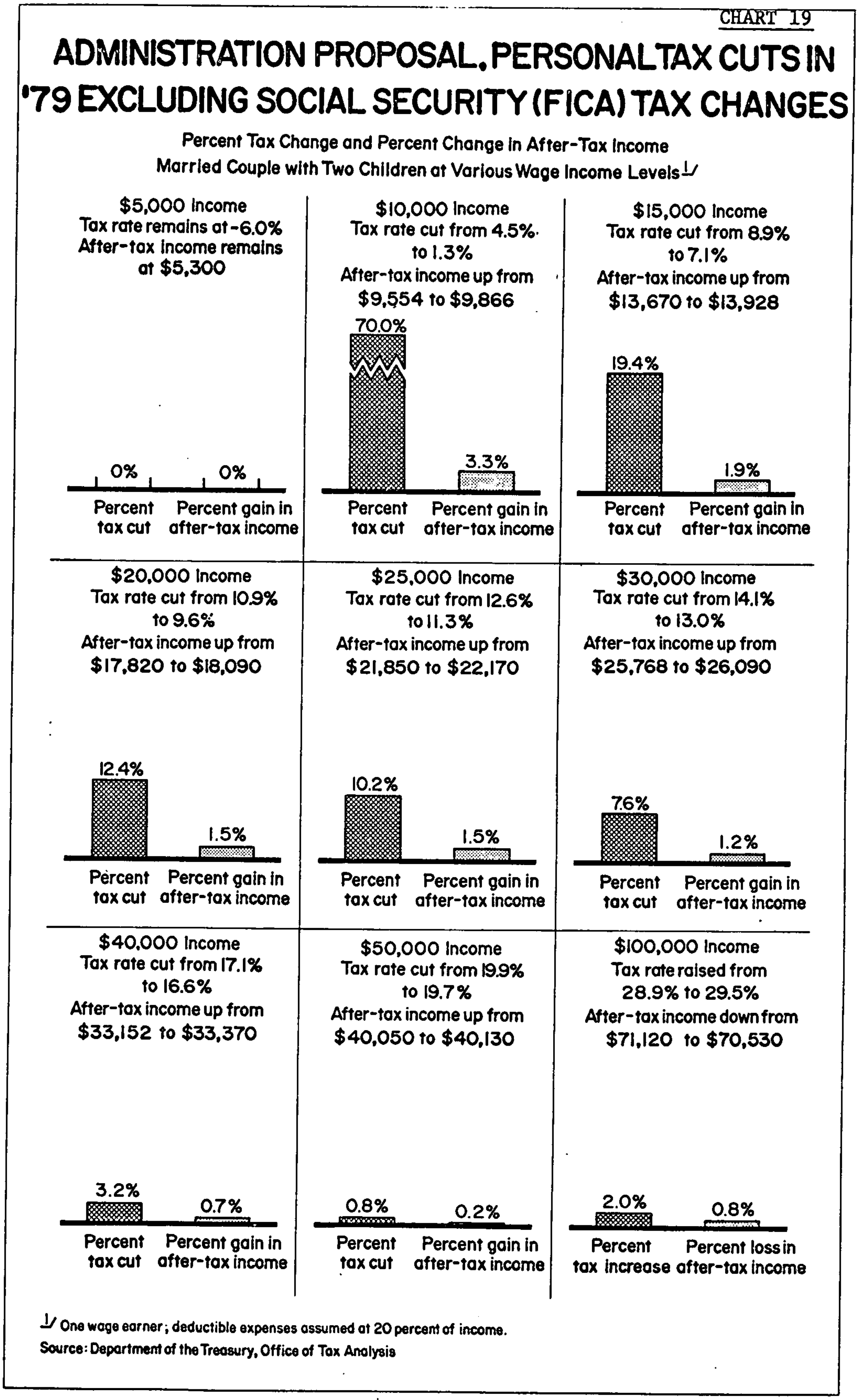
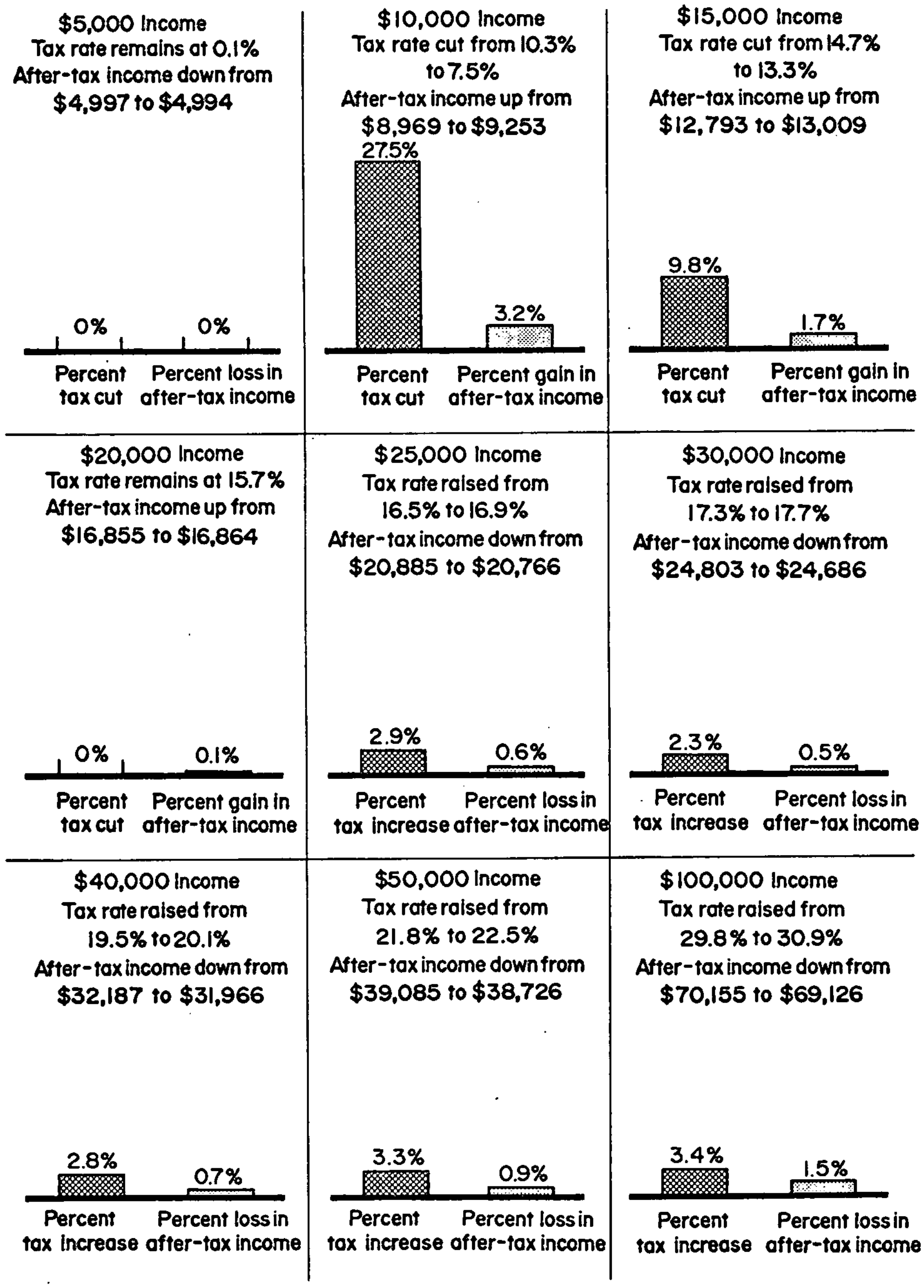


CHART 19
ADMINISTRATION PROPOSAL, PERSONAL TAX CUTS IN '79 EXCLUDING SOCIAL SECURITY (FICA) TAX CHANGES
Percent Tax Change and Percent Change in After-Tax Income
Married Couple with Two Children at Various Wage Income Levels 1/
$5,000 Income
Tax rate remains at -6.0%
After-tax income remains at $5,300
0%
0%
Percent tax cut
Percent gain in after-tax income
$10,000 Income
Tax rate cut from 4.5% to 1.3%
After-tax income up from $9,554 to $9,866
70.0%
3.3%
Percent tax cut
Percent gain in after-tax income
$15,000 Income
Tax rate cut from 8.9% to 7.1%
After-tax income up from $13,670 to $13,928
19.4%
1.9%
Percent tax cut
Percent gain in after-tax income
$20,000 Income
Tax rate cut from 10.9% to 9.6%
After-tax income up from $17,820 to $18,090
12.4%
1.5%
Percent tax cut
Percent gain in after-tax income
$25,000 Income
Tax rate cut from 12.6% to 11.3%
After-tax income up from $21,850 to $22,170
10.2%
1.5%
Percent tax cut
Percent gain in after-tax income
$30,000 Income
Tax rate cut from 14.1% to 13.0%
After-tax income up from $25,768 to $26,090
7.6%
1.2%
Percent tax cut
Percent gain in after-tax income
$40,000 Income
Tax rate cut from 17.1% to 16.6%
After-tax income up from $33,152 to $33,370
3.2%
0.7%
Percent tax cut
Percent gain in after-tax income
$50,000 Income
Tax rate cut from 19.9% to 19.7%
After-tax income up from $40,050 to $40,130
0.8%
0.2%
Percent tax cut
Percent gain in after-tax income
$100,000 Income
Tax rate raised from 28.9% to 29.5%
After-tax income down from $71,120 to $70,530
2.0%
0.8%
Percent tax increase
Percent loss in after-tax income
1/ One wage earner; deductible expenses assumed at 20 percent of income.
Source: Department of the Treasury, Office of Tax Analysis

CHART 20

ADMINISTRATION PROPOSAL, PERSONAL TAX CUTS IN '79, INCLUDING SOCIAL SECURITY (FICA) TAX INCREASES

Percent Tax Change and Percent Change in After-Tax Income
Married Couple with Two Children at Various Wage Income Levels[1]



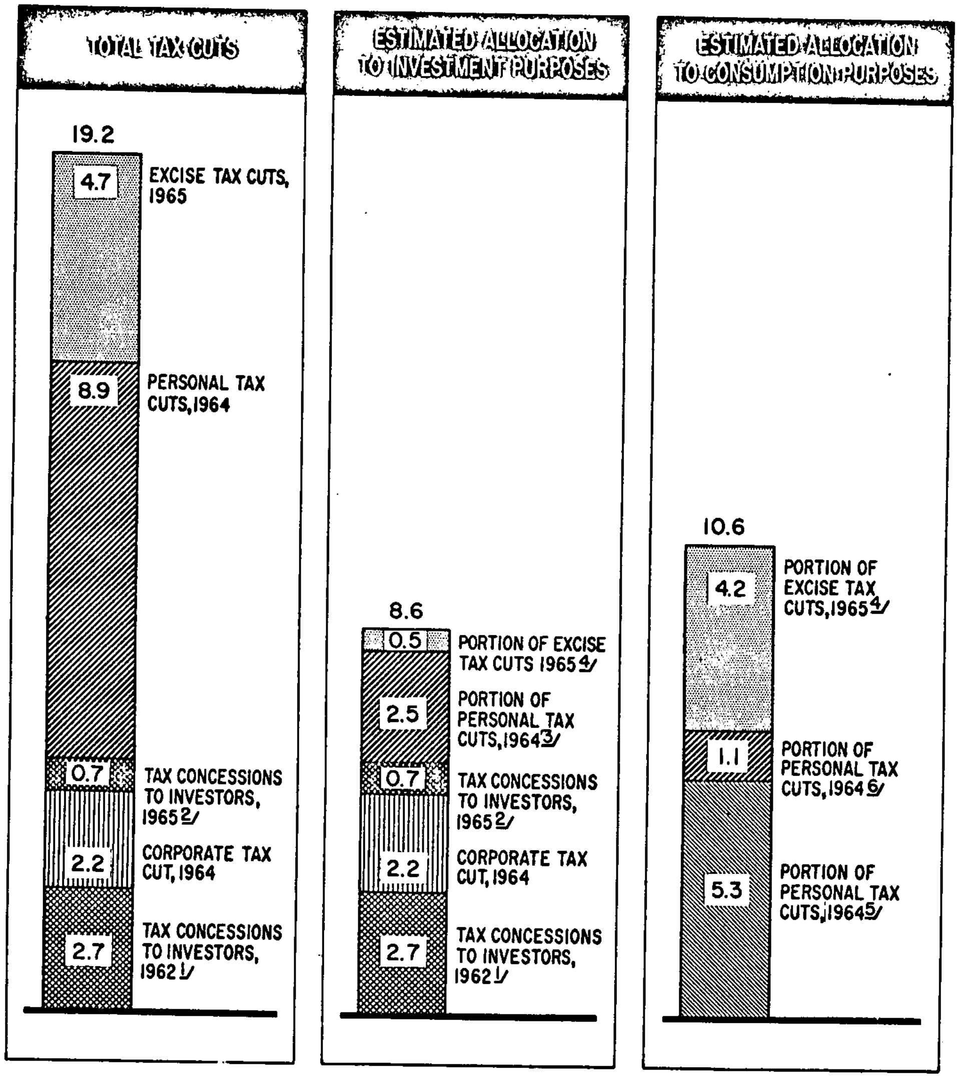
[1] One wage earner; deductible expenses assumed at 20 percent of income; FICA tax calculated under prior law rate and base for 1977 (5.85% and $16,500) and present law rate and base for 1979 (6.13% and $22,900), employees' share only.

Source: Department of the Treasury, Office of Tax Analysis

CHART 21

ALLOCATION OF TAX CUTS, 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



1/ Through Congressional & Executive Action

2/ Through Executive Action

3/ Estimated portion of personal tax cut, for those with incomes of $10,000 and over, which they would save for investment purposes.

4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.

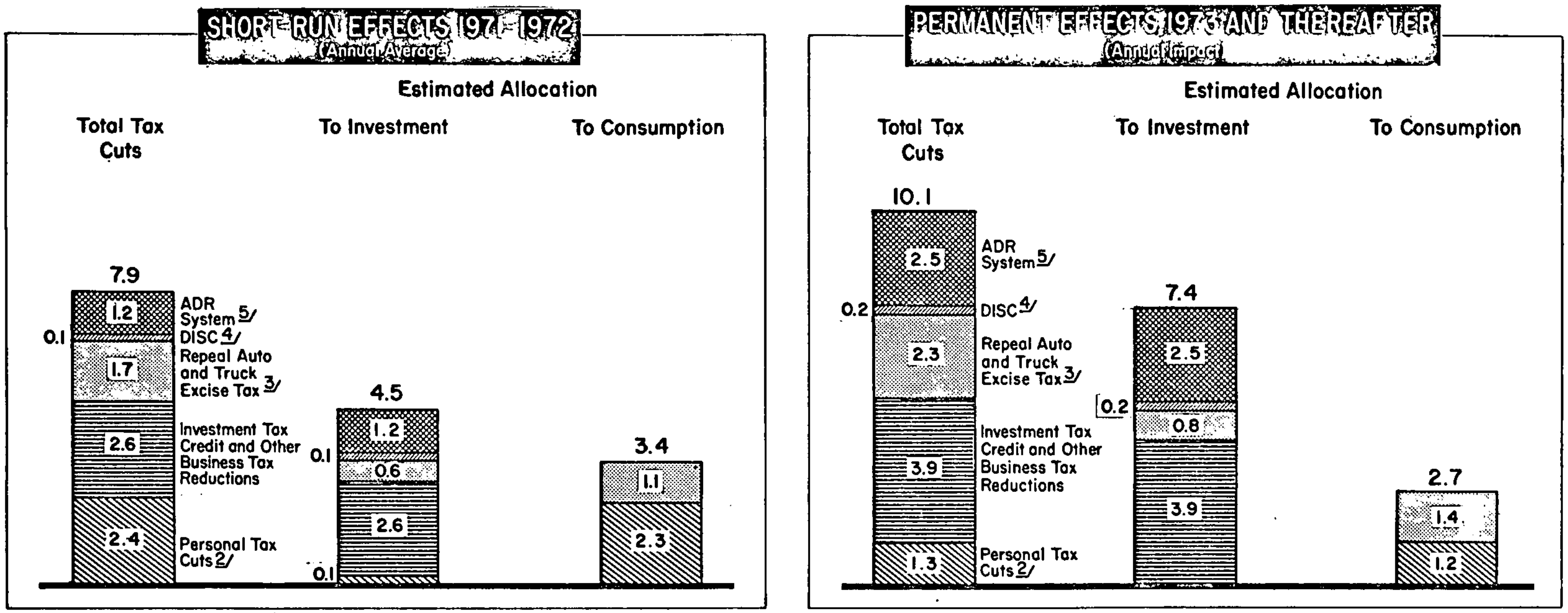
5/ Personal tax cuts for those with incomes under $10,000.

6/ Estimated portion of personal tax cuts for those with incomes of $10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions.) However, a large portion of this did not go to low income consumers.

ALLOCATION OF 1971 TAX CUTS:[1] BETWEEN INVESTMENT AND CONSUMPTION

(Billions of Dollars)



1/ H.R. 10947, as reported by the House-Senate Conference Committee, and Asset Depreciation Range (ADR) System promulgated by the Treasury Department.

2/ Allocation to investment based on portion of cuts for those with income over $15,000, which they would save; remainder allocated to consumption.

3/ Allocation between investment and consumption based on business or nonbusiness use of vehicles.

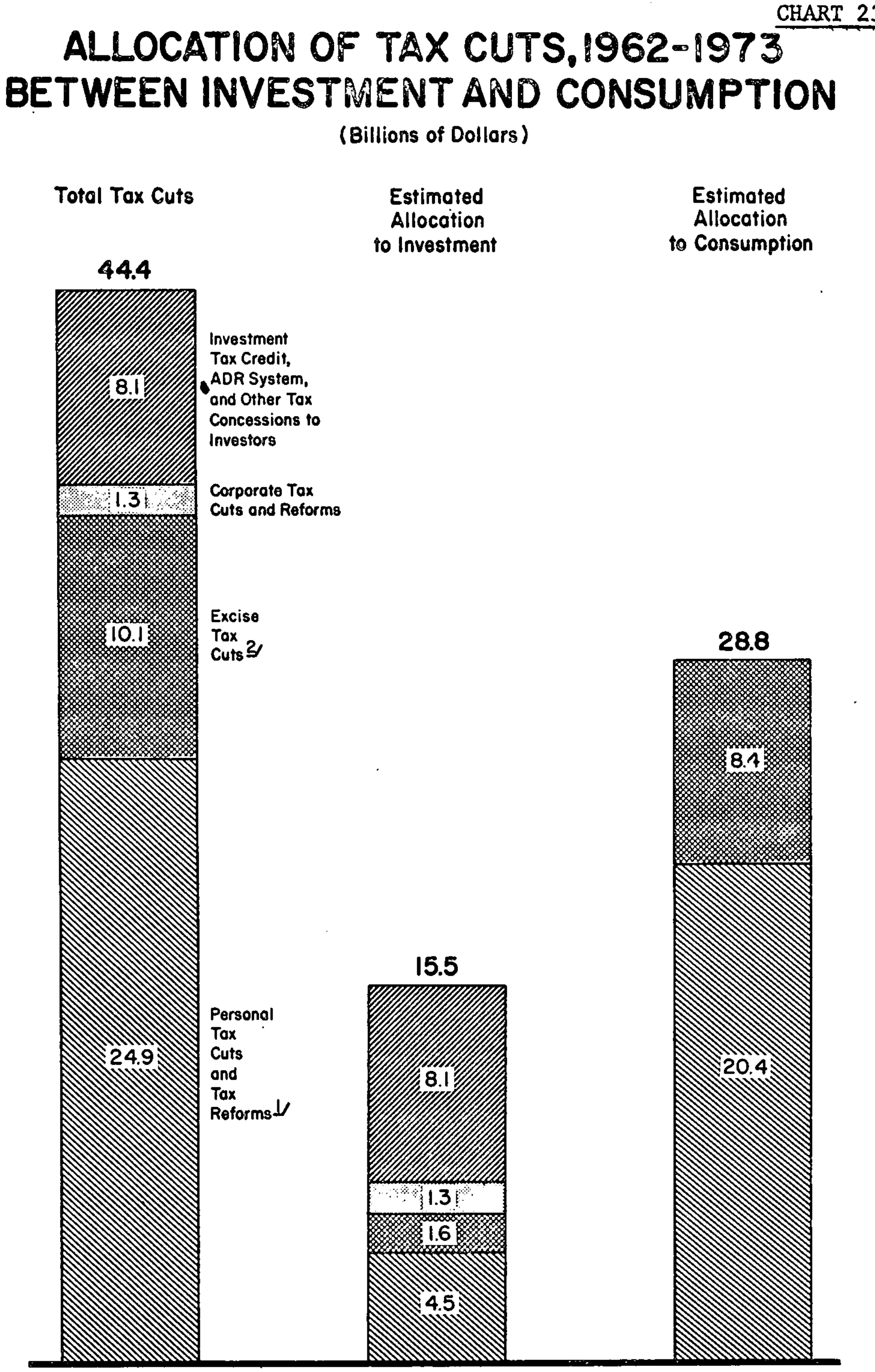
4/ Tax deferral by Domestic International Sales Corporations (DISCs).

5/ Treasury regulations as modified by H.R. 10947 as reported by the conference committee.

Note: Components may not add exactly to totals, owing to rounding.

CHART 22

CHART 23



1/ Allocation to investment based on estimated saving by those with high incomes.

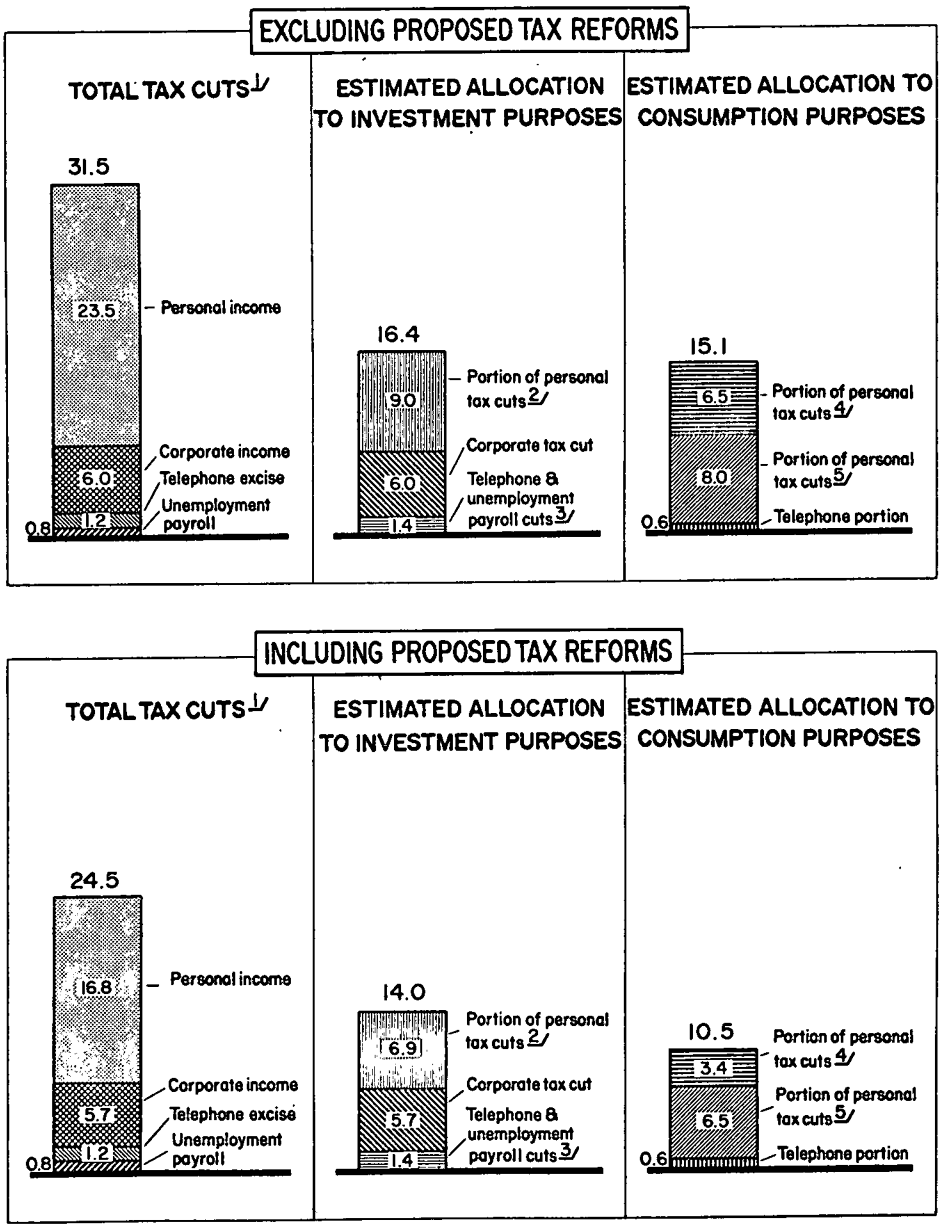
2/ Allocation to consumption based on amount estimated to be passed on to purchasers of goods for nonbusiness use.

Note: Components may not add to total owing to rounding.

CHART 24

ESTIMATED DIVISION--PROPOSED TAX CUT BETWEEN CUTS FOR INVESTMENT PURPOSES AND CUTS FOR CONSUMPTION PURPOSES

(Effects on Calendar 1979 Tax Liability)



1/ Total tax cuts for calendar 1979, as estimated by Department of the Treasury.
2/ L.H.K. estimate of portion of personal tax cuts for those with incomes of $15,000 and over.
3/ L.H.K. estimate of portion of telephone excise cut going for investment.
4/ L.H.K. estimate of portion of personal tax cuts for those with incomes of $15,000 and over which would be spent for consumption.
5/ L.H.K. estimates of personal tax cuts for those with incomes under $15,000.

GOALS FOR A MODEL FEDERAL BUDGET, FISCAL 1978 & FISCAL & CALENDAR 1980 CONSISTENT WITH OTHER GOALS TO REACH 1983 UNEMRLOYMENT REDUCTION GOAL AND TO SERVE ADEQUATELY THE GREAT NATIONAL PRIORITIES[1]

(In billions of fiscal 1978 dollars. All are fiscal years except calendar 1983)

	ALL FEDERAL OUTLAYS			NATIONAL DEFENSE, INTERNATIONAL AFFAIRS, SCIENCE AND SPACE			DOMESTIC PROGRAMS[2]			INCOME SECURITY, OTHER THAN VETERANS (Excluding Subsidized Housing)			MANPOWER PROGRAMS, INCLUDING PUBLIC AND PRIVATE NON PROFIT PUBLIC SERVICE JOBS		
	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP
President's Budget, 1978	459.8	2,107.24	22.90	118.8	544.45	5.92	341.0	1,562.79	16.98	142.5	653.07	7.10	12.1	55.45	0.60
Goals for 1978	467.0	2,140.24	22.84	119.2	546.29	5.83	347.8	1,593.95	17.01	145.0	664.53	7.09	12.3	56.37	0.60
Goals for Fiscal 1983	580.0	2,543.86	21.39	124.8	547.37	4.60	455.2	1,996.49	16.79	165.0	723.68	6.09	16.5	72.37	0.61
Goals for Calendar 1983	585.5	2,562.36	21.31	125.0	547.04	4.55	460.5	2,015.32	16.76	166.0	726.48	6.04	16.7	73.09	0.61

	TRANSPORTATION			AGRICULTURE, NATURAL RESOURCES, ENVIRONMENT AND ENERGY			EDUCATION			HEALTH			HOUSING AND COMMUNITY DEVELOPMENT		
	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP	Total Expenditures ($ Billions)	Per Capita ($)	% of GNP
President's Budget, 1978	9.2[3]	42.16	0.46	26.8	122.82	1.33	10.9	49.95	0.54	43.9	201.19	2.19	16.9	77.45	0.84
Goals for 1978	9.6	44.00	0.47	27.5	126.03	1.34	11.3	51.79	0.55	45.0	206.23	2.20	17.3	79.29	0.85
Goals for Fiscal 1983	17.5	76.75	0.65	40.0	175.44	1.47	23.0	100.88	0.60	60.0	263.16	2.21	21.0	92.11	0.77
Goals for Calendar 1983	17.8	77.90	0.65	40.5	177.24	1.47	23.4	102.41	0.61	61.0	266.96	2.22	21.3	93.22	0.79

1/ Dollar goals would be higher to extent of further inflation. President's budget, 1978 is President Carter's budget as revised through November 11, 1977.

2/ Includes categories other than those listed in detail, i.e. veterans benefits, law enforcement, general government, interest, commerce, area and regional development, revenue sharing, and allowances. The goals for domestic programs allow for savings of one billion in fiscal 1978, 29 billion in fiscal 1983, and 30 billion in calendar 1983, for lower interest, lower unemployment-related costs, government reorganization, etc.

3/ The housing portion of this $9.2 billion in the President's Budget proposed for 1978, coming to $4.3 billion, appears mostly in "income security" and in part in "commerce and transportation" in the President's Budget. The proposed goal increases for "housing and community development" include $4.5 billion for housing for fiscal 1978 and $12.0 billion for calendar 1983.

Note: Population--218.2 million for April 1, 1978, 228.0 for April 1, 1983, and 228.5 for July 1, 1983. GNP (in fiscal 1978 dollars)--$2,008 billion for President's Budget; $2,045 for fiscal 1978 goal; $2,711 for fiscal 1983 goal; and $2,748 for calendar 1983 goal. Goals assume that some actions compatible with the Humphrey-Hawkins bill will be taken in 1978, that the bill will be enacted in 1978, and that the first Economic Report of the President under it will be issued in January 1979.

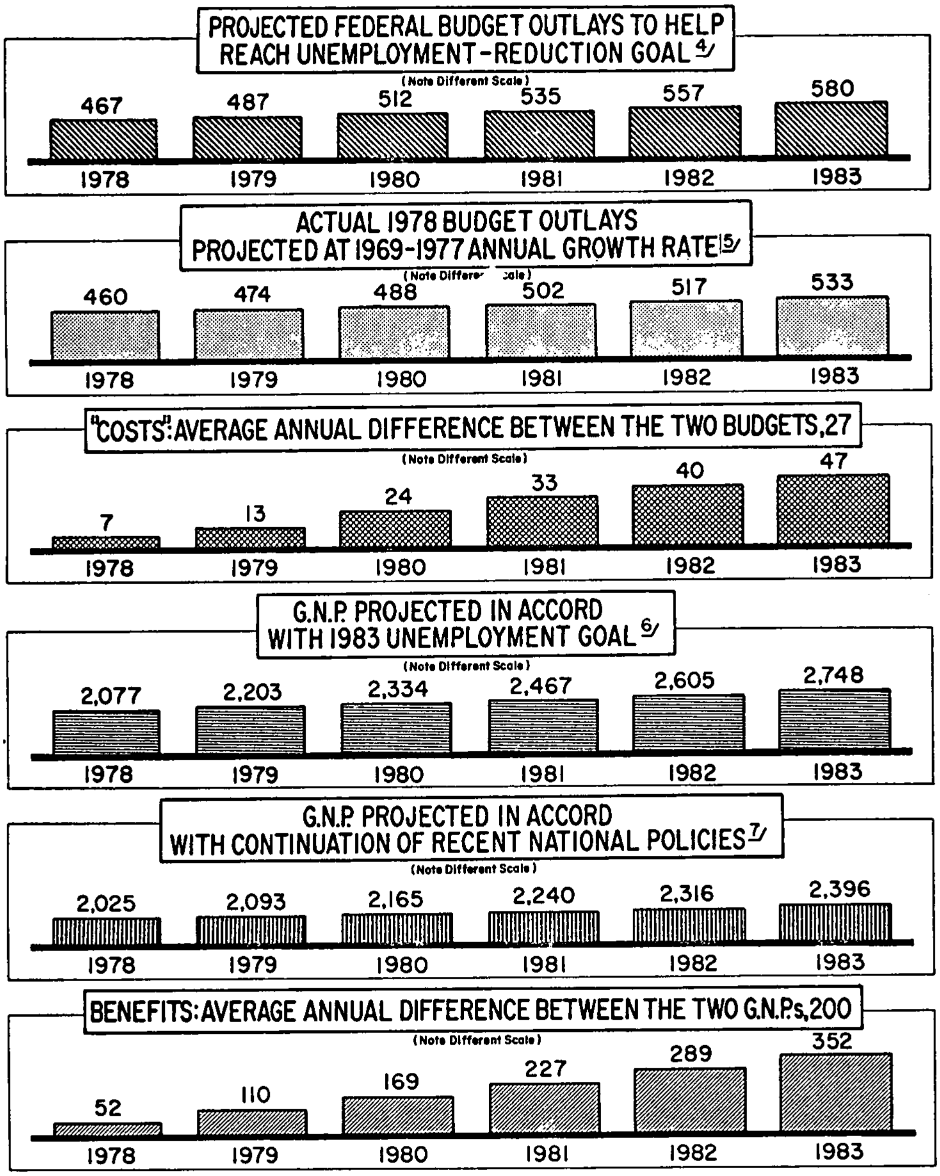
Basic Data: Office of Management and Budget and Dept. of Commerce.

CHART 25

CHART 26

"COSTS"[1/] & BENEFITS[2/] THROUGH 1983, CONSISTENT WITH REACHING UNEMPLOYMENT-REDUCTION GOAL[3/] BY 1983

(Budget, fiscal years; G.N.P., calendar years; billions of fiscal 1978 dollars)



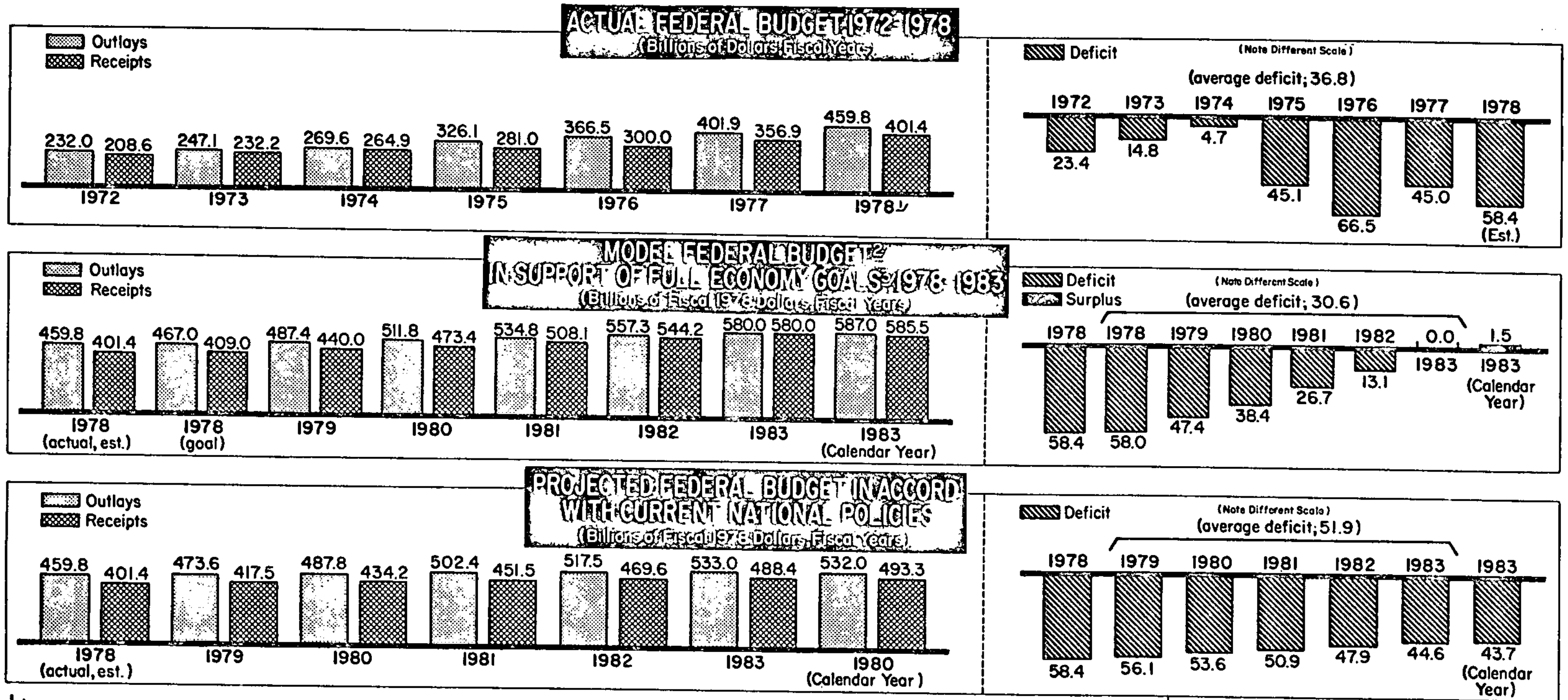
1/ "Costs" are difference between Federal Budget outlays needed to help achieve 1983 unemployment-reduction goal and 1978-1983 Budget outlays projected with reasonably estimated projections of recent policies and programs.

2/ Benefits are difference between G.N.P. in accord with 1983 unemployment-reduction goal and G.N.P. projected in accord with reasonably estimated projections of recent national policies and programs. 3/ 4 percent unemployment (3.0% adult) by middle of 1983. 4/ The Full Employment & Balanced Growth Program in H.R. 50 & S. 50 would use other policies besides those in the Federal Budget to help achieve the full employment goal. The average annual real growth rate in Budget outlays used for these projections is 4.5 percent, projected from fiscal 1977. 5/ The lower Budget projection is at the 3.0 percent real average annual growth rate, consistent with lower projections for G.N.P.

6/ The real average annual growth rate used for these projections is 5.8 percent, projected from calendar 1977 base.

7/ Based upon real average annual growth rate of 3.4 percent, projected from calendar 1977 base. The average was only 3.2 percent during 1953-1977, and only 2.6 percent during 1969-1977.

FROM FEDERAL DEFICITS IN AN UNHEALTHY ECONOMY TO A HEALTHY BUDGET IN A HEALTHY ECONOMY



1/ President's Budget, as sent to the Congress in February 1977 and revised in Nov. 11, 1977 OMB release.

2/ Model Federal Budget depicted in detail on another chart. Goals would be higher in each year's dollars to extent prices rise above fiscal 1978 dollars.

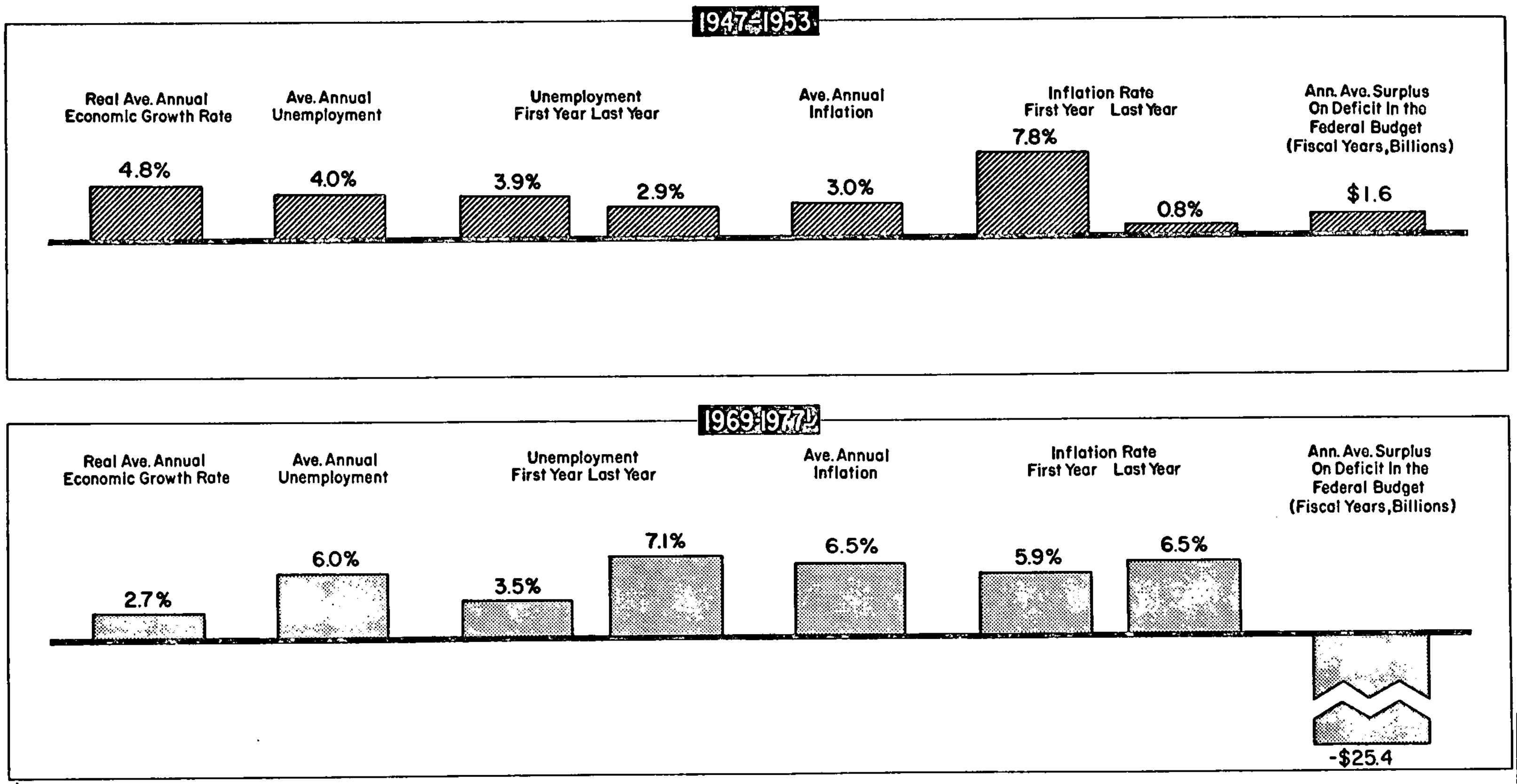
3/ Full economy goals shown on another chart.

Note: The model Federal Budget projections assume that some action compatible with the Humphrey-Hawkins bill will be taken in calendar 1978, that the bill will be enacted in 1978, and that the first Economic Report of the President under the Act will be issued in January 1979.

Basic Data: Office of Management and Budget for actual Federal Budget

CHART 27

ECONOMIC PERFORMANCE AND THE FEDERAL BUDGET

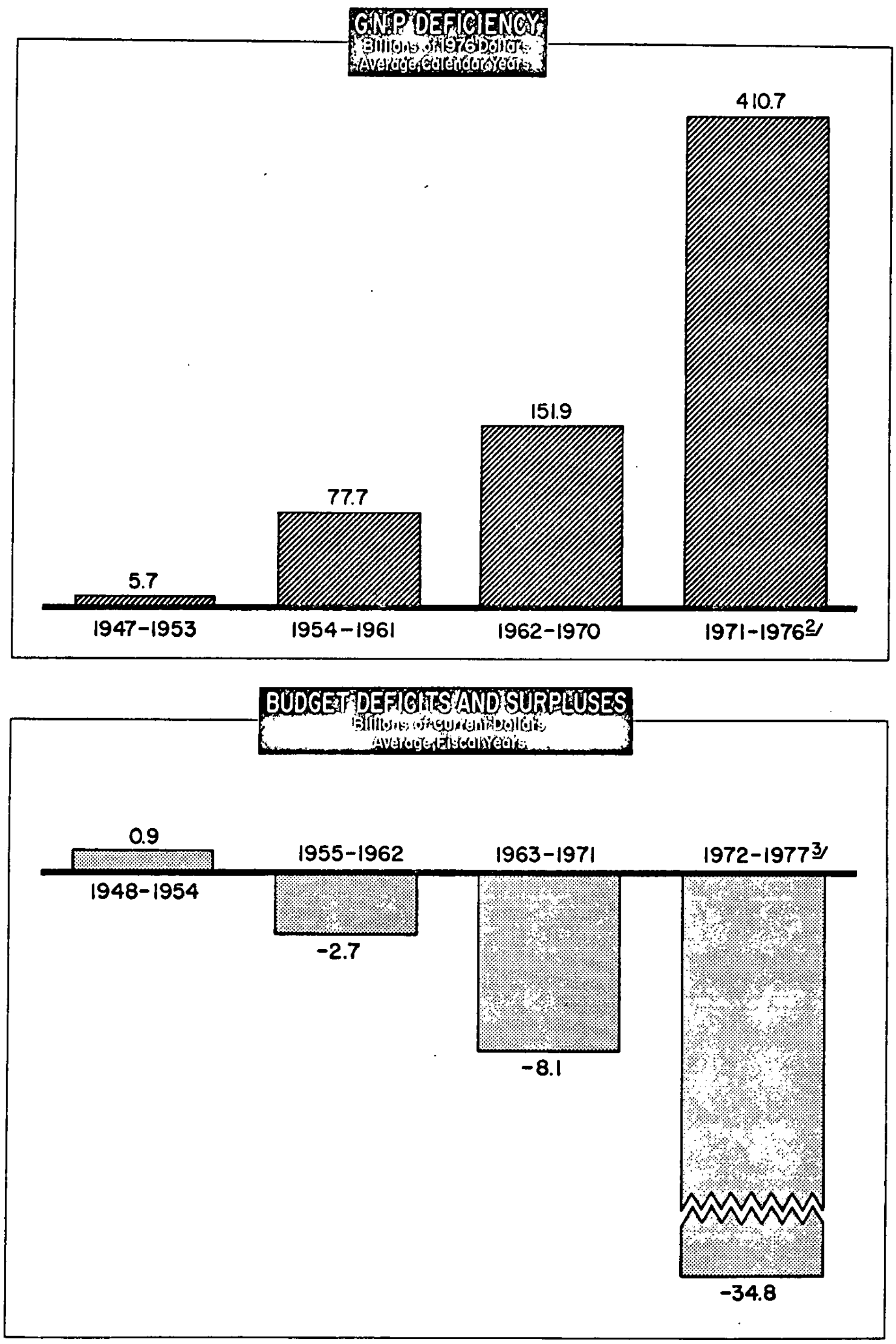


1/ All 1977 figures estimated.
Source: Dept. of Commerce; Dept. of Labor; Office of Management and Budget

CHART 28

CHART 29

G.N.P. DEFICIENCIES[1] AND BUDGET DEFICITS



1/ Production deficiencies represent differences between actual production and production at full economy rate of growth. Projections from 1946.

2/ 1976 estimated.

3/ 1977 estimated.

Source: Dept. of Commerce; Office of Management and Budget, for actual figures

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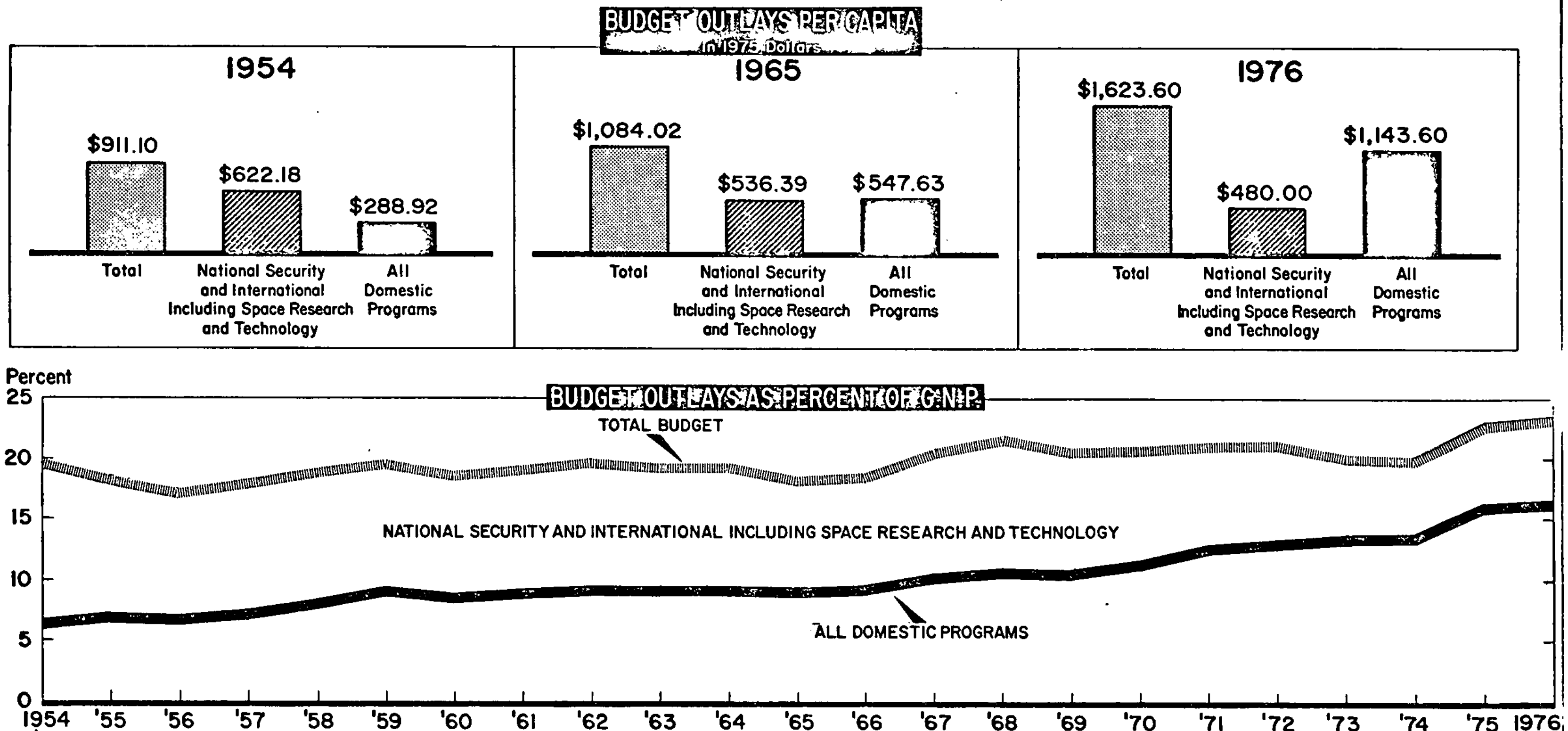
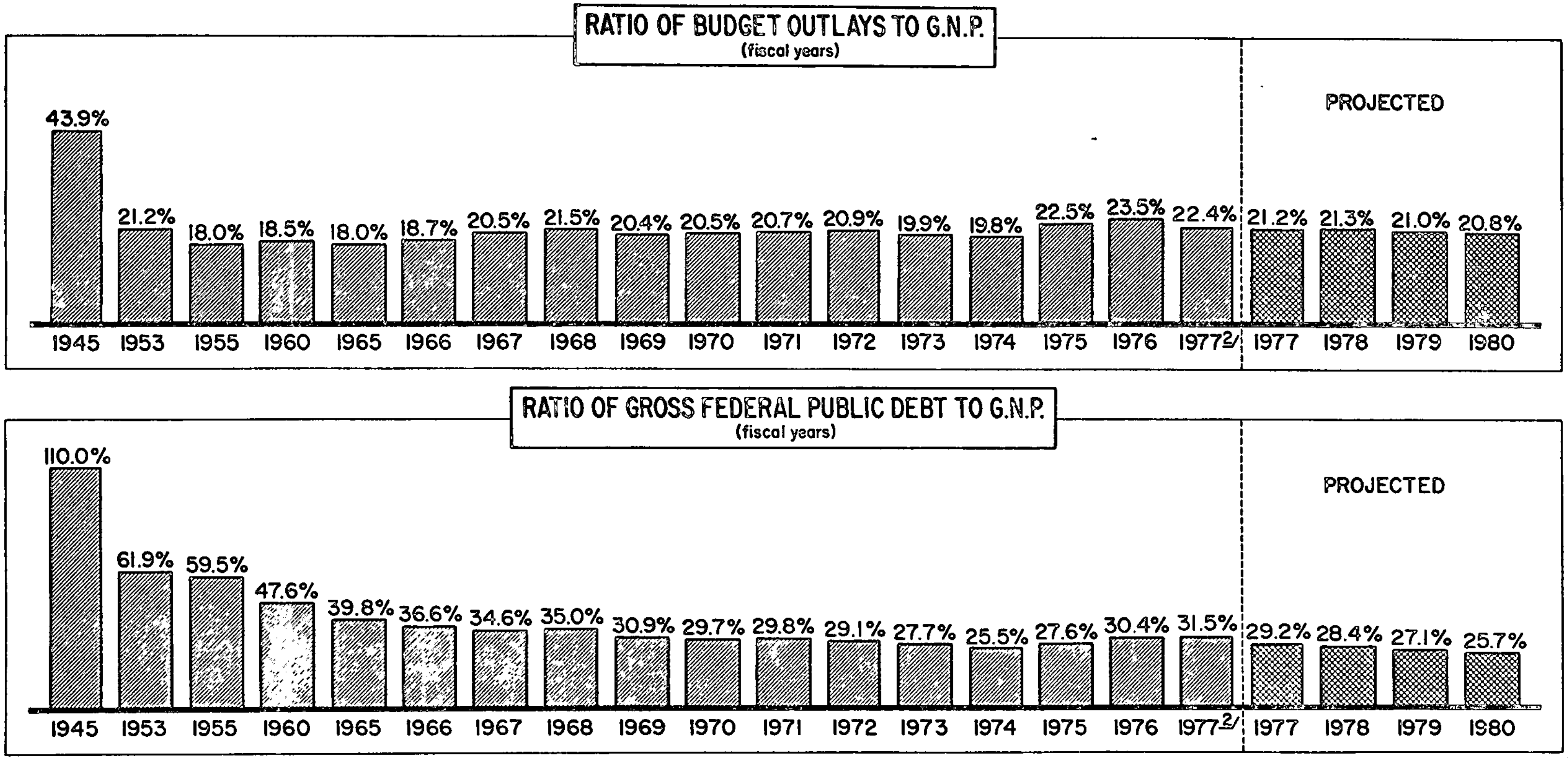
FEDERAL BUDGET ON A PER CAPITA BASIS AND IN RELATION TO G.N.P., 1954-1976[1]

Fiscal Years



[1] 1976 estimated.
Source: Dept. of Commerce, Office of Management and Budget

FEDERAL BUDGET OUTLAYS, GROSS FEDERAL PUBLIC DEBT, AND G.N.P. 1945-1977, AND PROJECTED, 1977-1980 [1]



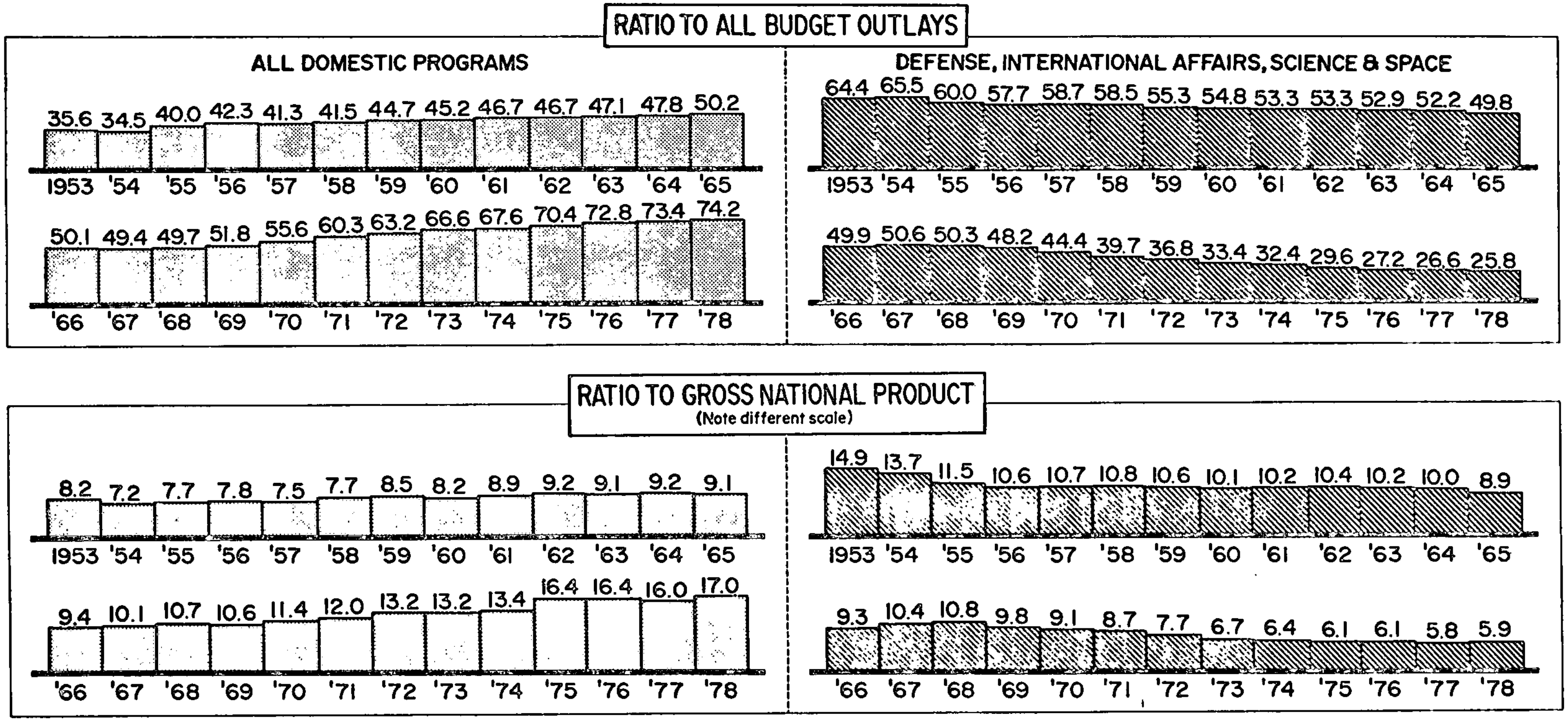
1/ Projections for Budget, Public Debt, and G.N.P. in accord with "model" Budget and G.N.P. goals.

2/ In accord with President's 1977 Budget, as submitted on January 21, 1976.

CHART 31

RATIO OF BUDGET OUTLAYS FOR ALL DOMESTIC PROGRAMS, & FOR DEFENSE, INTERNATIONAL AFFAIRS, SCIENCE, & SPACE TO ALL BUDGET OUTLAYS & GROSS NATIONAL PRODUCT, 1953-1978[1]

(Fiscal Years, percentages)



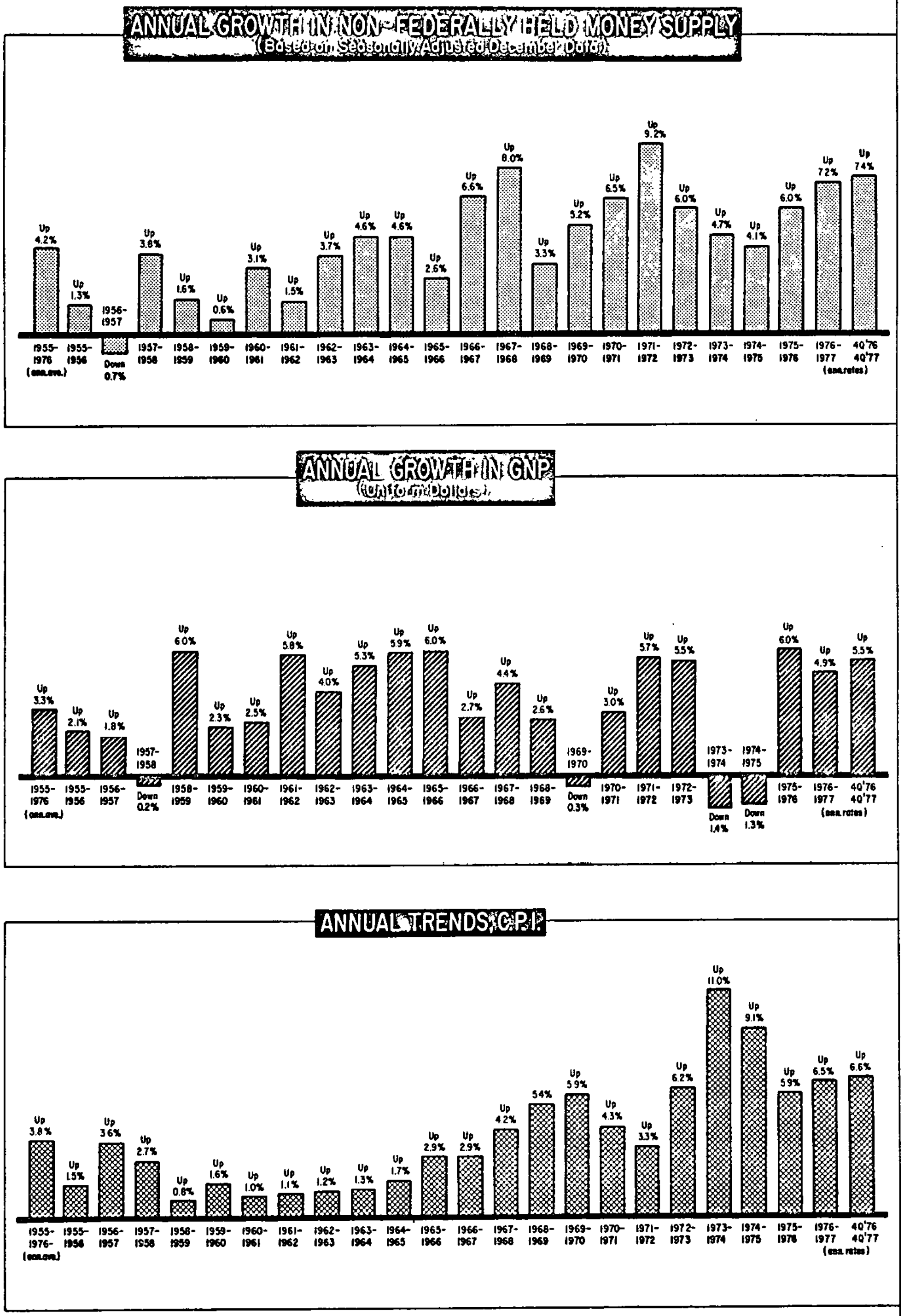
[1] 1978 estimated; also 1953-1957 estimated due to change in budget concepts.

Basic Data: Office of Management and Budget and Dept. of Commerce

CHART 32

CHART 33

COMPARATIVE TRENDS IN NON-FEDERALLY HELD MONEY SUPPLY, G.N.P., AND PRICES, 1955-1977 [1]

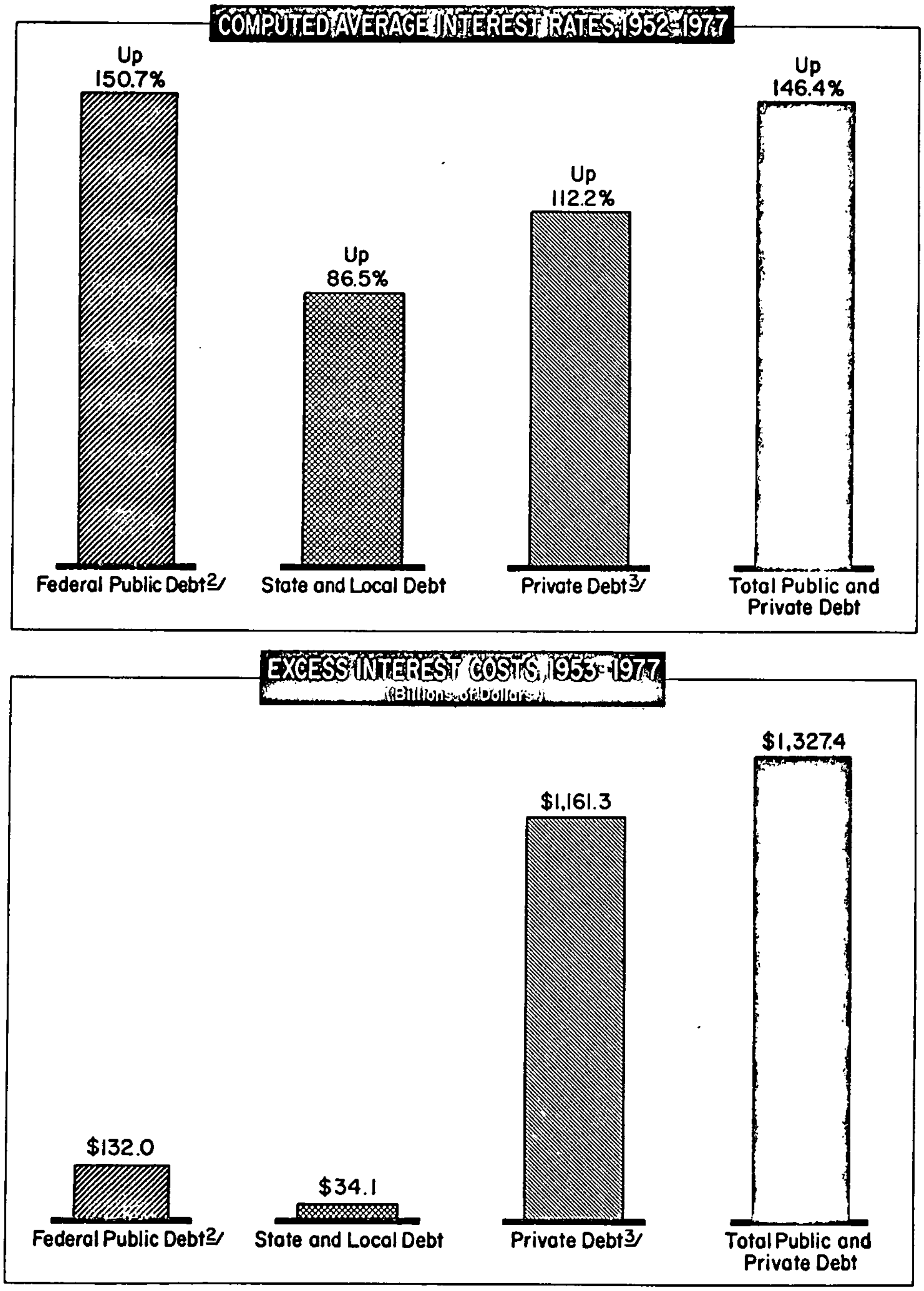


[1] 1977 estimated.

Data: Dept. of Commerce; Dept. of Labor; Federal Reserve System

CHART 34

INCREASES IN AVERAGE INTEREST RATES, AND EXCESS INTEREST COSTS DUE TO THESE INCREASES, 1952-1977 1/



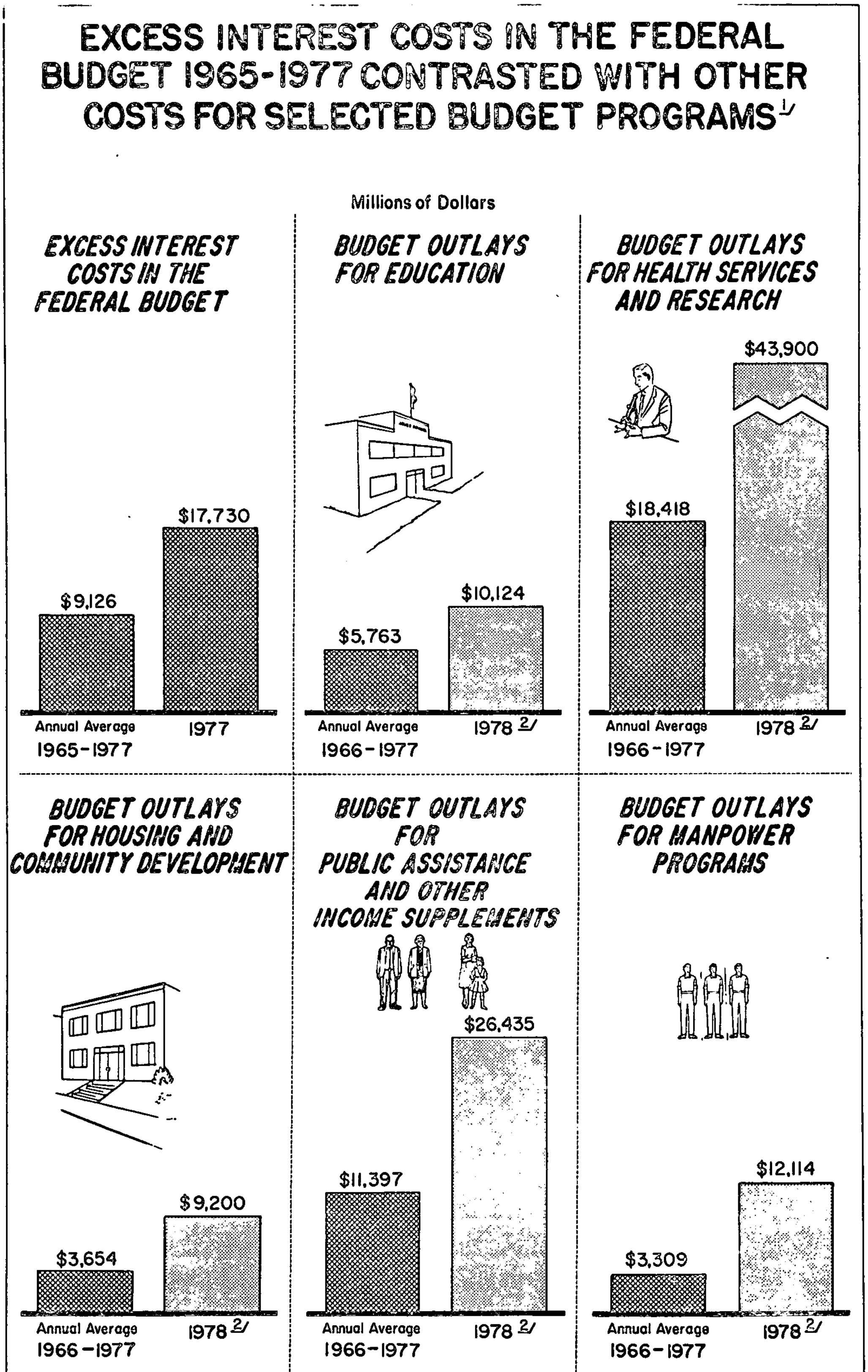
1/ 1976-1977 estimated.

2/ Includes net foreign interest.

3/ Computed as a residual by subtracting Federal Government and state and local debt from total public and private debt. Includes debt of federally-sponsored credit agencies.

Source: Dept. of Commerce; Economic Report of the President

CHART 35



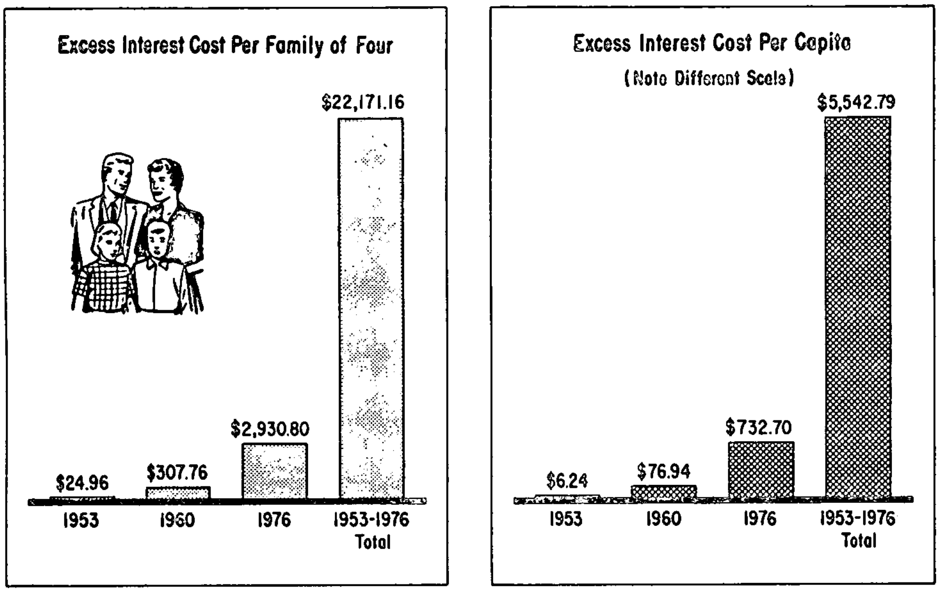
1/ Interest costs, calendar years; budget outlays, fiscal years. 1977 interest costs and 1978 budget outlays estimated.

2/ Proposed in fiscal 1978 Budget of President Carter, as revised November 11, 1977.

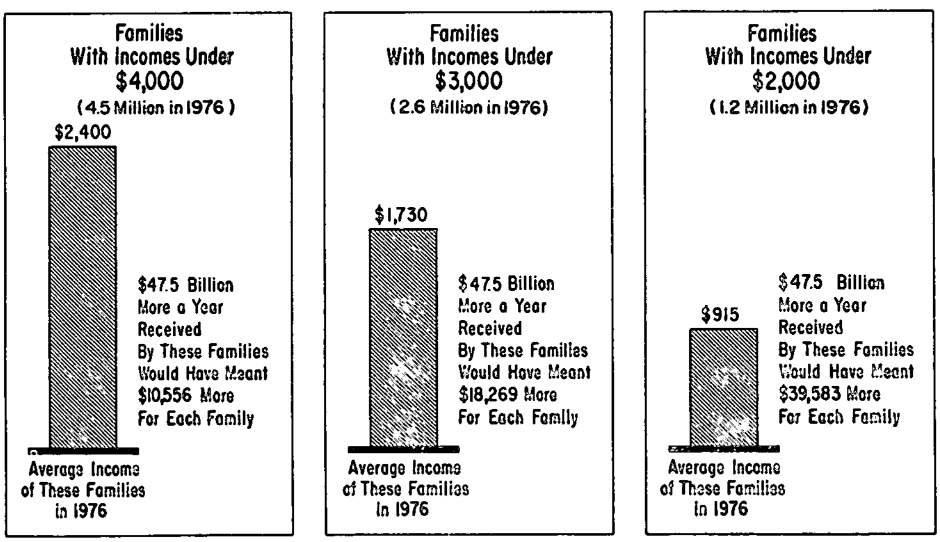
CHART 36

THE BURDEN OF $1,138.9 BILLION IN EXCESS INTEREST COSTS, 1953-1976[1] UPON THE AMERICAN PEOPLE

Calendar Years



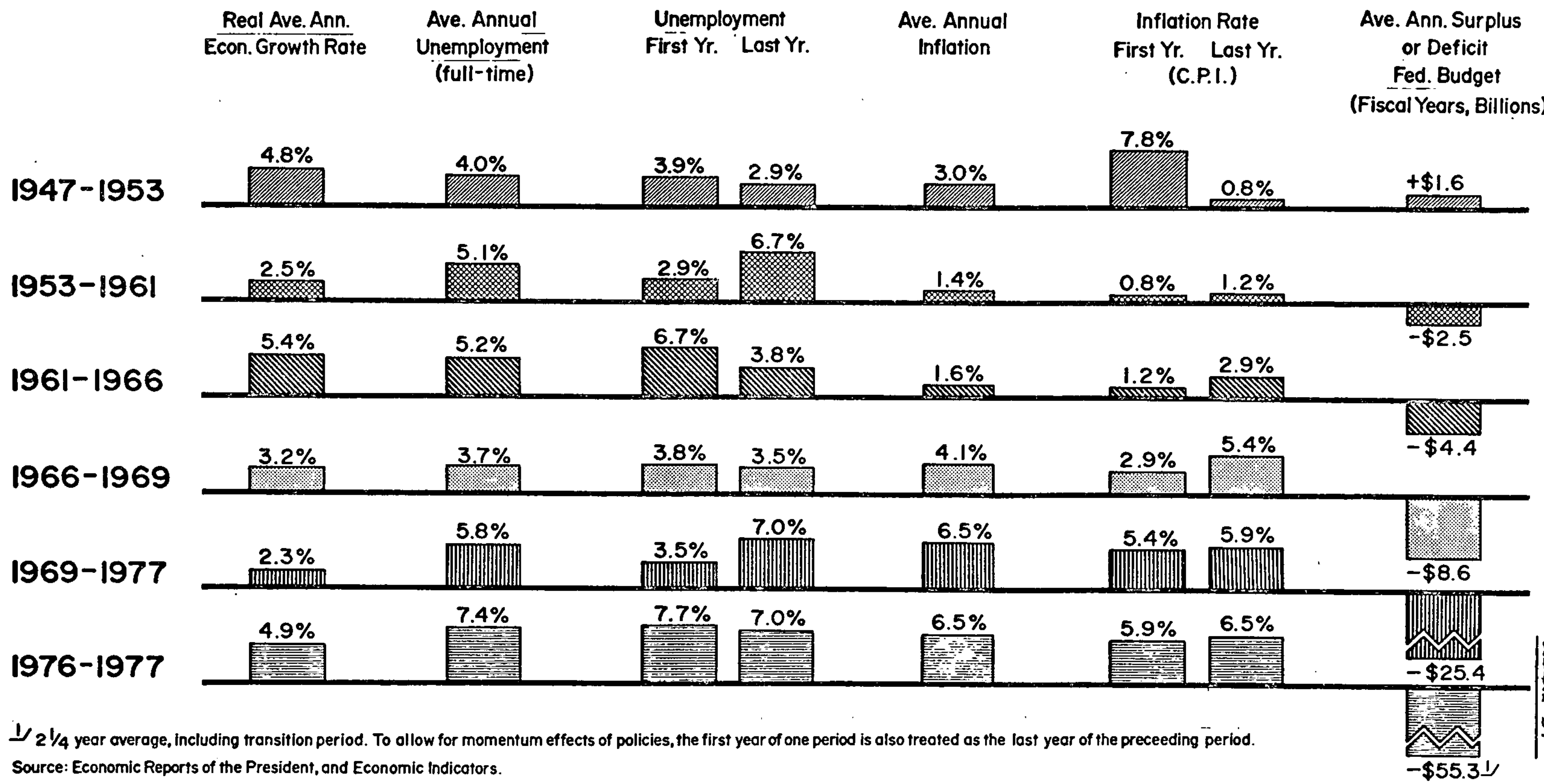
HOW $47.5 BILLION A YEAR, 1953 - 1976 - EQUAL TO ANNUAL EXCESS INTEREST - MIGHT HAVE HELPED LOW-INCOME FAMILIES



[1] 1976 estimated.

Source: Economic Report of the President, Dept. of Commerce, Bureau of the Census.

REAL ECONOMIC GROWTH RATES, EMPLOYMENT & UNEMPLOYMENT, INFLATION, AND FEDERAL BUDGET CONDITIONS, DURING VARIOUS PERIODS, 1947-1977[1]



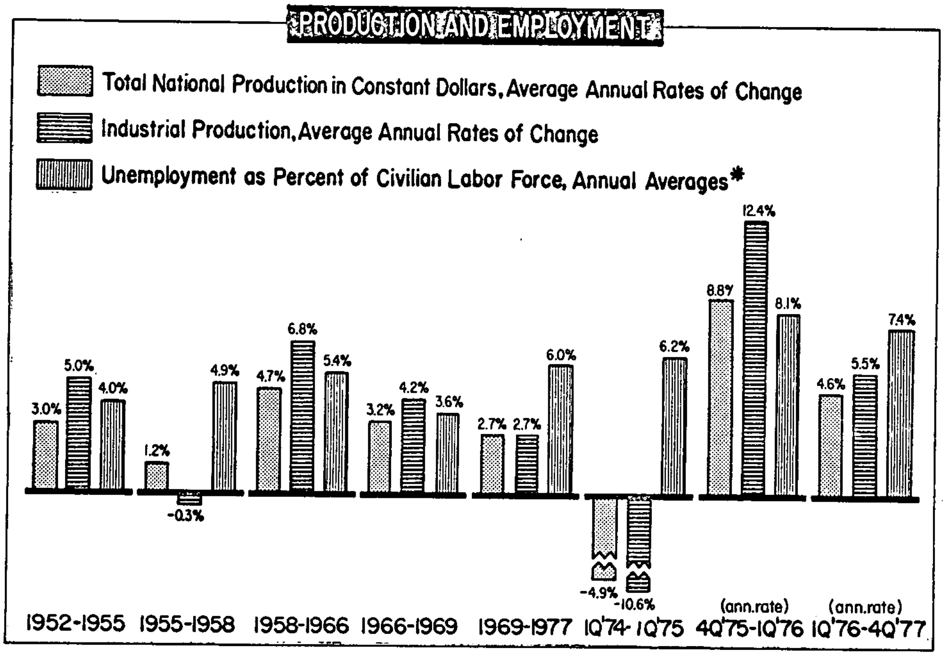
[1] 2 1/4 year average, including transition period. To allow for momentum effects of policies, the first year of one period is also treated as the last year of the preceeding period.

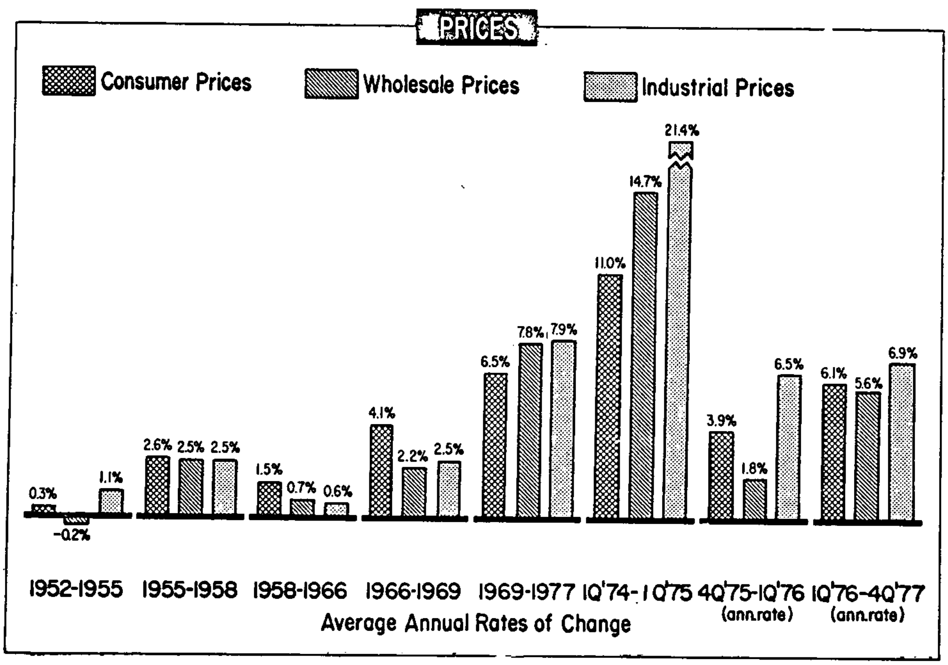
Source: Economic Reports of the President, and Economic Indicators.

CHART 37

CHART 38

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952-1977



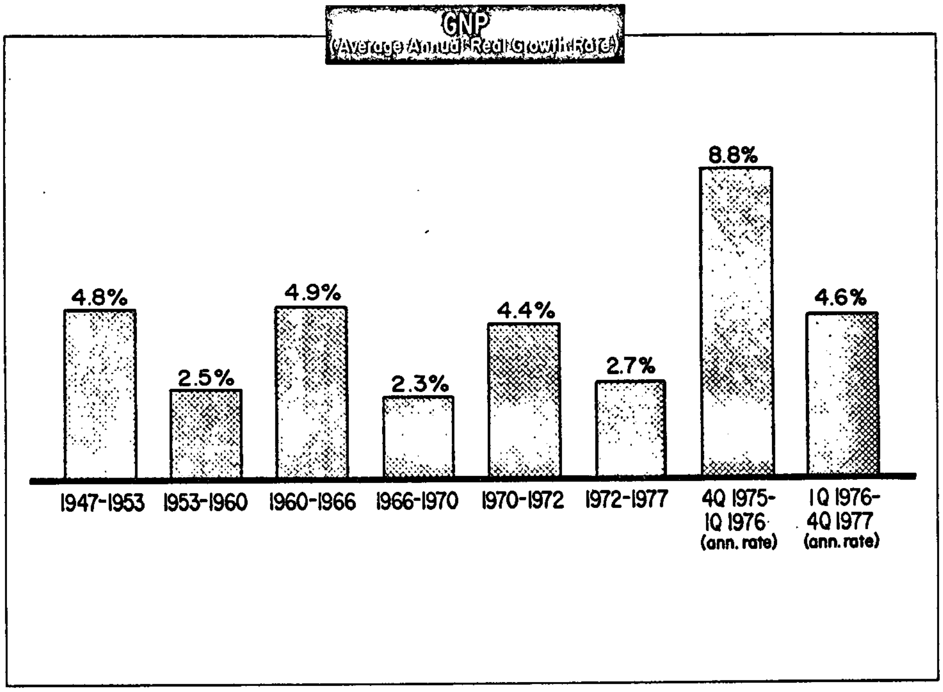


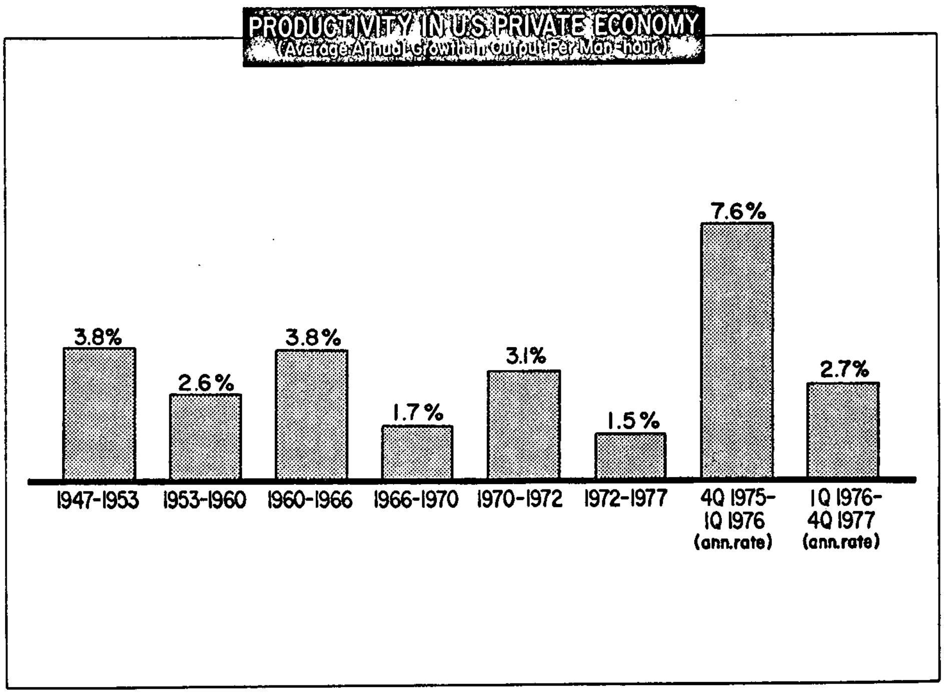
*/ These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept. of Labor, Dept. of Commerce, & Federal Reserve System

CHART 39

IMPACT OF ECONOMIC GROWTH UPON PRODUCTIVITY GROWTH





Source: Dept. of Labor, Dept. of Commerce

STATEMENT BY J. R. PETERSON, ASSOCIATE DIRECTOR, MISSISSIPPI RESEARCH AND DEVELOPMENT CENTER AND CHAIRMAN, FEDERAL STATISTICS USERS CONFERENCE

The two major economic problems facing the nation are inflation and lagging investment. The lagging investment is aggravating the inflation by restricting the amount of goods and services produced. It has led to lagging employment and will lead to an economic slowdown next year. The investment lag is likely to be with us for awhile. Moreover, the reported investment we do have is, to a large degree, not production investment. Some is for pollution control; some is for energy reduction; and some is replacement of transportation equipment. Much of it does not add employment.

This is not to say that if investments were proceeding at the normal rate unemployment would not be a problem. It would -- but it would be less of a problem. Likewise, if we were producing the energy in the United States that we are importing, unemployment would be less of a problem. I did not list unemployment as a major problem because the part of it that can be corrected is a result of the low investment rate. It is a result -- not a cause. The government's attempt to deal directly with unemployment is treatment of a symptom. It creates very few jobs and those jobs it does create can only marginally be described as producing services. They do, however, produce inflation.

Part of the current unemployment rate has occurred because during the recent recession companies became more efficient. Part of the current unemployment is with us because we have had during this decade a surge in the number of young people entering the work force without a corresponding increase in the population to be served. The baby boom of the fifties led to the work force of the seventies. The unemployment is not 7 percent overall but 17 percent of the young.

In my own state, just a few years ago those looking for jobs with the Employment Service tended to be in the 45- to 60-year-old group. Today an unemployed person in that age group is rare. The unemployed are the inexperienced. Employers feel that this young group is both unproductive and unstable -- therefore expensive. The problem was not helped by the change in minimum wages. Moreover, many of these young unemployed will not accept jobs they think are beneath them.

It is probable that full employment today means a much higher unemployment rate than it has in the past, as suggested by Herbert Stein; but there are still large numbers of unemployed who could be put to work if business could be persuaded to invest. Senator Hatch, in his article in "National Review" last August, listed the needs: reduce taxes, reduce spending, reduce regulation.

These are definite needs. If these three tasks could be accomplished soon, the economy would recover and generate even more taxes than were previously collected.

But business must be convinced that these are not just grudging gestures; that the federal government acknowledges profit as a legitimate motive. Business must also be convinced that the government is aware of what it is doing. This awareness was not at all obvious when all in one day last year the Administration proposed a tax break for investment and also proposed cancelling the capital gains tax break. On February 13 of this year, there were two front page stories. Secretary Blumenthal told about tax cuts designed to encourage the private sector to invest. Secretary Kennedy backed an Administration plan to increase taxes on those making more than $50 thousand a year -- the people Secretary Blumenthal is trying to persuade to invest.

In the same newspaper was a paragraph on proposed additional regulation of business.

Today the economy is made in Washington. If all the steps taken henceforth are the correct ones, it is still too late to prevent the slowdown. Investment decisions made today won't have any effect on production for several years. But they will improve business confidence. But the investment decisions will not be made if the business climate in Washington does not improve. Improvement is more than giving tax cuts with one hand and increasing taxes with the other.

MACHINERY and ALLIED PRODUCTS INSTITUTE

1200 EIGHTEENTH STREET, N.W. WASHINGTON, D.C. 20036 202-331-8430

April 12, 1978

The Honorable Richard Bolling
Chairman
Joint Economic Committee
G-133 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Bolling:

We are pleased to have this opportunity to comment on "The 1978 Joint Economic Report." Since the 1978 Joint Economic Report has already issued, we address ourselves to that Report which, of course, comments on the other two economic documents.

As the economy enters the thirty-sixth month of economic recovery, it is important that we review the policies and programs of the Administration in a search for the combination which will bring about a rate of economic growth that is both substantial and sustainable. The Joint Economic Committee Report is a most useful step in this process.

Since, basically, we all have the same goals--albeit in varying degrees--of sustaining further growth, reducing unemployment, and achieving a more stable price level, rather than discuss such goals, we will confine our statement to comments on specific recommendations contained in the Joint Economic Report.

<u>The Size of the Budget</u>

The Report sets forth as a "major recommendation" the following:

> In fiscal year 1979, total Federal expenditures should fall within a $500-$505 billion range and total tax receipts should be approximately $440 billion. This fiscal policy, combined with the monetary policy discussed . . . , will achieve the economic goals set forth in this Report. [Page 11.]

<u>MAPI comment</u>.--As stated bluntly by Senator Proxmire in a footnote to this recommendation, "This level of spending is excessive." We agree. In a period when inflation is our No. 1 problem--even the Administration has belatedly come around to this position--the $500 billion level of federal expenditures is excessive for several reasons: (1) it calls

for too large a proportion of the nation's resources to be allocated to the federal government; (2) since tax receipts are estimated to be $60-$65 billion short of expenditures, the budget will add to the inflationary pressures; and (3) the size of the budget itself contributes to inefficiency and waste. Further, sustained deficiteering can have a negative effect on the economy by reducing private saving and investment which in turn slows the secular growth of productivity and output. (For a discussion of the theoretical weaknesses of fiscal policy, see "Changing Theories of Fiscal Policy," copy attached, by George Terborgh, MAPI Economic Consultant.)

Monetary Policy

The Report suggests that, in addition to the economic stimulus provided by the budget deficit, monetary policy should be expansionary. To wit:

> . . . . To achieve this stimulus, the growth of the money supply should be such that the rise in short-term interest rates is reversed. Policy in 1978 should tend to move short-term rates toward their 1977 levels. Interest rates should be maintained at these lower levels in 1979. [Page 10.]

MAPI comment.--The emphasis on the level of interest rates results in a blindness concerning the growth of monetary aggregates that is both unrealistic and fails to consider the danger of even further inflation. It is unrealistic in that it implies an abnormally low or even negative real interest rate for a sustained period, and the rate of growth in the monetary aggregates that is implied is not likely to be consistent with a reduction in the rate of inflation.

In sum, the combination of excessively rapid growth in federal spending and in the monetary aggregates (i.e., growth substantially beyond the real growth of the economy) is the fundamental cause of inflation.

Independence of the Fed

The pertinent recommendation in the Report in this respect suggests that the Federal Reserve should:

> Discuss in exact quantitative terms how the proposed monetary policies are designed to reconcile the President's targets and the Federal Reserve's own forecast. [Page 13.]

MAPI comment.--This could well be a prelude to chipping away at, if not destroying, the independence of the Federal Reserve System. At a time when confidence in the U.S. dollar is reaching new lows both at home and abroad we should avoid even hinting at actions that could undermine a prudent monetary policy on the part of the Federal Reserve System.

The Lack of Goals for Inflation

The recommendation here reads as follows:

> We strongly recommend that the Congress formally establish specific targets for employment, growth of real output, and productivity. [Page 29.]

MAPI comment.--In its primary concern with the unemployment problem, the Report misses (or deliberately bypasses) an opportunity to recommend establishment of goals for the rate of inflation. Similarly, later in the Report it is pointed out that the Humphrey-Hawkins bill establishes "the goal of price stability as a high priority objective," but again there is no recommendation for a goal for decreasing the rate of inflation.

The Control of Inflation
--Prenotification

While the Report notes that the Committee has "long been on record as opposed to comprehensive wage-price controls and [does] not recommend them now," it goes on to say that:

> Legislation should be enacted authorizing the Council on Wage and Price Stability to require prenotification of planned price increases from selected industries and to delay for modest periods wage or price increases which could have serious inflationary effects on the economy. [Page 115.]

MAPI comment.--The combination of prenotification and delay of wage and price increases amounts to, in effect, the very wage and price controls that the Committee--and we, even more strongly--disavow. "An increase delayed is an increase denied," to paraphrase an old axiom. Further, experience shows that such controls do not work and, worse, are counterproductive and perverse in effect. Finally, as Representative Reuss points out, "the present nervous business climate is such that prenotification requirements may do more harm than good. . . ."

Tax-Based Incomes Policy

The Committee speaks of tax-based incomes policies (TIP) as "deserving serious consideration," and as "promising examples" of a direct attack on inflation. This includes the proposals of Henry Wallich and Arthur Okun.

MAPI comment.--While characterizing such proposals as relying on "market incentives rather than on coercion and control," this certainly is not true of the Wallich approach, which could impose severe penalties on a firm which raises its prices above the guideline after being forced to grant wage increases above the guideline as the result of collective bargaining negotiations. Further, both proposals would, of course, interfere with the price mechanisms of the marketplace. Finally, there are, of course, for both proposals the problems of determining the proper guideline, defining wages, etc., etc. We have no objection to further study being made of these and similar proposals, but let's go into those studies with open eyes and more guarded enthusiasm.

Indexing

Interestingly, in its discussion of indexing the Report speaks, somewhat favorably, only of "the indexing of the personal income tax," "changing the exemption level, bracket limits, and tax credits of the individual income tax at a rate equal to the rate of inflation," and the "[discontinuation] of taxing nominal capital gains."

MAPI comment.--This recognition of the impact of inflation on personal income, especially when subject to a progressive income tax structure, is laudable. However, no reference is made to the impact of inflation in depressing the level of the real earning power of the corporate system. The implications of the refusal of the federal government to recognize replacement costing for tax and regulatory purposes are explored in a recent study by George Terborgh, MAPI Economic Consultant, entitled "Corporate Earning Power in the Seventies: A Disaster." A copy of that study is attached to this statement.

Capital Gains

As noted above, the Report states that the practice of taxing nominal capital gains is "a capital levy that varies arbitrarily in response to the rate of inflation" and should be discontinued.

MAPI comment.--We applaud this finding of the Report and are attaching to this statement a current study expressing similar views, namely, "Inflation and the Taxation of Capital Gains," again by George Terborgh, MAPI Economic Consultant. This study concludes that it is only reasonable to ask that any country that goes in for taxing capital gain should see to it that the gains it levies upon are real. Once this reform is accomplished, it will be time to reconsider the structure of the tax itself.

Capital Formation

In the discussion of tax policy in the Report, other than for a reference to the impact of federal payroll taxes on employers, no mention is made of tax policies affecting capital formation.

MAPI comment.--An obvious and certain effect of the current depressed level of the real earning power of the corporate system will be a retardation of the growth and improvement of productive capacity. The Report is seriously remiss, in our opinion, in overlooking this. While the Minority Views on the Report discuss in some detail business tax changes, suggesting that business tax relief should be larger than that proposed by the Administration and that replacement cost depreciation and deeper corporate tax rate reduction would be most helpful, we do take issue with their statement that the ITC is possibly an inefficient use of tax reduction dollars, compared to a deeper cut in the corporate tax rate. It seems to us that misses the point. It is essential to the economic well-being of the nation that all of the provisions to increase capital formation put forth by the Administration deserve support, especially reductions in the corporate tax rate and liberalization and permanent extension of the 10 percent investment tax credit.

Our views on this matter are set forth in some detail in the Institute's formal testimony and oral comments on President Carter's Tax Proposals and Related Issues, March 6, 1978, before the House Committee on Ways and Means. At that time we testified that the federal tax system is dangerously tilted toward consumption and away from investment, and that this imbalance must be addressed and corrected. Also, MAPI pointed out (1) the hazards of piecemeal tax policy formulation; (2) the severe impact of inflation; (3) objectionable efforts to increase tax progressivity and income redistribution; (4) the overriding need for personal income tax relief; (5) the problem of setting federal tax policy without regard to the impact of state and local taxes; (6) the importance of tax relief for mandated capital spending (e.g., pollution abatement equipment); (7) the nuisance and cost of petty "reforms"; and (8) the dangers in U.S. taxation of foreign source income which departs from international norms. The full text of those documents is attached.

Foreign Trade

While the Report speaks of our deteriorating foreign trade position as a "source of serious concern," it goes on to say that, over time, a part of our trade deficit can be remedied by the speedy adoption of a national energy policy and that the remainder of the problem is "inherently temporary and external in origin."

MAPI comment.--We agree as to the "serious concern" but disagree as to the temporary and external nature of our problem. Evidently the views in the Report serve as the rationale for implicitly accepting the President's recommendations for the elimination of deferral of taxes on foreign source income, and the phase-out of Domestic International Sales Corporations (DISC). The fatal error of the proposal to terminate deferral is that it would unilaterally impose a tax burden on U.S. business which is not similarly imposed on its foreign-based competitors.

This cannot but make the U.S.-based taxpayer less competitive than before and, under certain circumstances, put the company out of business or out of certain product lines. As to the phase-out of DISC, this would simply eliminate an effective incentive contributing to export activity and domestic employment. This is hardly the means to correct trade and balance-of-payments deficits. The favorable impact of direct investment abroad on the U.S. balance of payments is spelled out in an advance draft of MAPI Capital Goods Review No. 108 (copy attached), and a discussion of our views on the tax matters contained in our testimony before the House Ways and Means Committee referred to earlier (also attached).

Again, MAPI wishes to express its appreciation to the Committee for this opportunity to present views and recommendations concerning "The 1978 Joint Economic Report."

Respectfully,

Charles Stewart

President

Enclosures

MACHINERY AND ALLIED PRODUCTS INSTITUTE

CHANGING THEORIES OF FISCAL POLICY

by

George Terborgh

It is always hazardous to assume that political actions are guided primarily by theoretical or philosophical principles. These do have some impact, varying from case to case, but in general the dominant motivation is political advantage. Certainly this is true of actions in the field of fiscal policy. Although it is customary for politicians to rationalize their decisions in this area by reference to prevailing theory, and to claim conformity thereto, their real motives are usually more practical.

This does not mean, however, that theory is of no consequence. Politicians are not immune to the contagion of widely held ideas, and when an orthodoxy develops on the proper role of fiscal policy they are likely to believe it themselves. Further--and more important--the fact that it <u>is</u> an orthodoxy can affect the calculus of political advantage. The public, or at least its more articulate elements, may be critical of departures from accepted doctrine, thus creating an objective pressure to reinforce subjective belief. While the conformity of political action to prevailing doctrine is often loose, and sometimes nonexistent, theory undoubtedly has some normative influence.

Over the past 50 years there has been a succession of dominant theories or schools of thought on federal fiscal policy. These are, in chronological order: (1) annual budget balancing; (2) pump priming; (3) anti-stagnation budgeting; (4) the stabilizing budget; (5) fiscal activism; and (6) the present theory (at the moment nameless).

While our principal interest here is in present theory, it will help to put it in perspective if we review briefly the history of its predecessors.

I

EARLIER PHILOSOPHIES OF FISCAL POLICY

1. ANNUAL BUDGET BALANCING

Prior to the mid-thirties, federal budget deficits (except in time of war) were generally regarded as deplorable, if not downright sinful. Save for this single exception, the conventional wisdom called for annual balancing regardless of the state of the economy.

That this view was bipartisan is demonstrated not only by President Hoover's valiant, if vain, struggle to maintain a budget balance during the great depression, but also by Mr. Roosevelt's castigation of the unwanted deficits in the campaign of 1932 as a proof of fiscal irresponsibility. Notwithstanding their apparent agreement in principle, however, both presidents were overwhelmed in practice by the exigencies of the depression. Federal deficits persisted from fiscal 1931 to the beginning of World War II (after which, of course, they fell under the wartime exception). For 10 consecutive years the earlier canons of fiscal orthodoxy were honored in the breach.

2. PUMP PRIMING

It is not to be expected that a government will live in self-confessed sin for 10 years in a row. Repetition dulls the sense of guilt; rationalizations develop. As Pope put it:

> Vice is a monster of so hideous a mien,
> As, to be hated, needs but to be seen;
> Yet seen too oft, familiar with her face,
> We first endure, then pity, then embrace.

The embrace in this case was not long in coming. The first rationalization of peacetime deficiteering appeared during the economic expansion of 1933-37 in the form of "pump priming" theory. As its name implies, this envisaged the depression economy as a dry pump that needed priming by the stimulus of federal deficits. It was, of course, a basically optimistic view of the situation, implying a need for only temporary stimulation. It assumed that once the economic pump "took hold" the inherent dynamism of the system would carry it upward to full prosperity. What was needed was an initial push.

This pleasant dream was shattered by the sharp recession of 1937-38, which interrupted the recovery in midcareer (the unemployment rate before the decline being still around 13 percent). Apparently the pump refused to stay primed. But why? It was not long before an explanation was forthcoming in the theories of economic maturity and secular stagnation unveiled before the Temporary National Economic Committee in 1939.

3. ANTI-STAGNATION BUDGETING

In contrast to the cheerful optimism of the pump-priming theorists, the new revelation proclaimed a dismal doctrine indeed. We quote a thumbnail sketch from an earlier work:

> Formerly youthful, vigorous, and expansive--the theory runs--the American economy has become mature. The frontier is gone. Population growth is tapering

> off. Our technology, ever increasing in complexity, gives less and less room for revolutionary inventions comparable in impact to the railroad, electric power, or the automobile in earlier times. The weakening of these dynamic factors leaves the economy with a dearth of opportunity for private investment, which is increasingly confined to the mere replacement of existing capital assets upon retirement. This replacement, and such limited expansion as remains, can be financed largely from the depreciation accruals and retained earnings of business enterprises, hence absorb little or no personal savings.
>
> Meanwhile these savings accumulate inexorably, unaffected by the attrition of investment opportunity, and pile up as idle funds for which there is no outlet in new physical capital, their accumulation setting in motion a downward spiral of income and production. The decline of investment for expansion which characterizes the mature economy thus precipitates chronic oversaving, and ushers in an era of secular stagnation and recurring crises from which there is no escape except through the intervention of government, which must either tax out of existence the excess savings that are poisoning the economy or absorb them itself. In short, the private economy has become a cripple and can survive only by reliance on the crutches of government support./1

This, in the view of these stagnationists, was the reason for the aborted recovery of 1933-37. It was, moreover, a portent of the future. Save for the redeeming power of government support, they foresaw only a succession of long and severe depressions, punctuated by brief and anemic recoveries. The fiscal-policy implications of these doctrines were painfully clear. Most of the time, the federal government would have to absorb excess savings with its own deficits. This meant to the stagnationists both the enlargement of federal expenditures (euphemistically called "public investment"), and tax reductions if necessary, in order to provide the necessary absorption.

The golden age of the stagnationists was from 1939 to World War II. True, they continued their gloomy prognostications throughout the war, and especially when the great game of postwar forecasting warmed up, but their following failed to match their frenzy. The climate was inhospitable. The war had snapped the economy out of the doldrums, carried production into new high ground, and virtually eliminated unemployment. It was followed, after a brief reconversion period, by a peacetime boom. This experience went far to dissipate the depression psychology that provided so fertile a soil in earlier years. Moreover, by the end

1/ The Bogey of Economic Maturity, MAPI, 1945, pp. 2-3.

of the war economists of other persuasion had subjected stagnationist doctrines to critical analysis./1 Buffeted by these adverse developments, the cult never regained its prewar position, but instead faded rapidly into obscurity.

4. THE STABILIZING BUDGET

The waning of stagnationist philosophy opened the way for other views on the economic role of federal fiscal policy. While no consensus emerged, there can be little doubt that the dominant school of thought until the appearance of "fiscal activism" in the early sixties was the "stabilizing-budget" concept launched in 1947 by the Committee for Economic Development./2

The basic idea of the stabilizing budget was to set tax rates at a level that would yield a "moderate" surplus at high employment (defined as 4 percent unemployment), and then to leave them alone except for periodic adjustments to maintain this calibration and except for extraordinary emergencies. The object was to balance the budget over the business cycle. It was not contemplated that the rates would be varied in response to ordinary cyclical swings in the economy. The contracyclical effect was to be achieved primarily through the working of the "built-in stabilizers" and through monetary policy.

In promulgating this concept the CED expressly repudiated the alternative of "managed compensatory budget policy," described as "the policy of adjusting tax rates and expenditure programs as often as necessary and to the extent necessary to keep employment and the national income steady at a high level." Such a policy had to be predicated on business forecasts, a fatal defect in the then-existing state of the forecasting art. Moreover, frequent changes in tax rates were disturbing to business, and if mistimed might have a destabilizing effect on the economy./3

5. FISCAL ACTIVISM

This concept of fiscal policy, sometimes called the "new economics," came into dominance in the early sixties, under the leadership of Walter Heller, then Chairman of President Kennedy's Council of Economic Advisers. It is best expounded in the Council's own words:

1/ For example, The Bogey of Economic Maturity, already cited.

2/ Taxes and the Budget: A Program for Prosperity in a Free Economy (Committee for Economic Development, New York, 1947).

3/ We should add that this capsule description of the stabilizing-budget concept is not offered as a complete account of the CED position on federal fiscal policy, which had other aspects as well.

> Built into the Federal fiscal system are several automatic defenses against recession and inflation. . . . Tax revenues change proportionally more than GNP. Furthermore, certain Federal expenditures, such as unemployment compensation payments, are automatically affected by the state of the economy. . . . These built-in stabilizers moderate the severity of cyclical swings. . . . But if the forces causing the downturn are strong and persistent, they may not suffice to prevent a large and prolonged recession. Furthermore, they are blindly symmetrical in their effects. When economic activity quickens after a slump, the rise in Federal revenues begins immediately and slows the recovery in employment and incomes. For these reasons, the task of economic stabilization cannot be left entirely to built-in stabilizers. Discretionary budget policy, e.g., changes in tax rates or expenditure programs, is indispensable--sometimes to reinforce, sometimes to offset, the effects of the stabilizers.
>
> To be effective, discretionary budget policy should be flexible. In order to promote economic stability, the Government should be able to change quickly tax rates or expenditure programs, and equally able to reverse its actions as circumstances change. . . . If moderate fiscal action can be taken quickly and can be speedily reversed when circumstances warrant, the dangers of overstimulating or overrestricting the economy are much smaller than if fiscal responses are sluggish and difficult to reverse./1

It should be said that the "fine-tuning" version of fiscal activism propounded in 1962 by the Council was never effectively implemented, nor could it have been without bypassing the slow and erratic procedures of congressional enactment. This was recognized at the outset by President Kennedy, who introduced in 1962 a proposal authorizing him to reduce personal income tax rates by 5 percentage points at his discretion, subject to congressional veto within 30 days. The scheme was so overwhelmingly rejected by the House Ways and Means Committee that no succeeding President has dared to make a similar request.

It should be said also that the life of activist theory was comparatively brief. A few years later the Council was backtracking:

> In principle, such fluctuations [in private demand] could be offset by expansionary fiscal and monetary policies if the course of demand could be perfectly

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1/ Economic Report, 1962, pp. 71-72.

> foreseen. But it can't and nobody is more aware of that fact of life than the Council of Economic Advisers. We have never claimed or attempted to engage in the practice known as "fine tuning." I freely plead guilty to the wish that our predictive techniques and our policy instruments were up to that high standard, . . . but in the present state of the arts, the application of fiscal and monetary policy offers us only limited protection against the impact of fluctuations in private demand./1

6. EFFECT OF EARLIER THEORIES

It is doubtful if the various fiscal theories that succeeded each other during the great depression of the thirties had much effect on actual budget results. As recalled earlier, the Hoover regime ran deficits notwithstanding its devotion to annually balanced budgets. The New Deal deficits of 1933-1937 were probably little affected by pump-priming theory, which served mainly to rationalize what the Administration was already doing. It is debatable also whether the mature economy doctrines had any significant impact on the deficits of 1939-40. Here too the role of theory was largely the rationalization of budgetary actions taken for other reasons.

To what extent was this true of the postwar stabilizing-budget doctrines? No one can say with certainty, of course, but there is reason to believe that their influence was appreciable, and possibly substantial. In the words of a former CED official, "In key respects the stabilizing-budget policy comes pretty close to explaining the practice of 1947-64. At least it comes closer than any competing theory of policy. . . . I would say that it was followed with many lapses and transgressions."/2

As for fiscal activism, we have already noted that it was never really implemented. The Council of Economic Advisers favored a stimulative tax cut in the summer of 1962, but the President declined to go along at that time. When the cut did come, it was for the fiscal year 1964, hardly an example of activism. In January 1967 President Johnson urged Congress to enact a restrictive tax increase for fiscal 1968 (an appeal renewed in August and November), only to have it deferred to fiscal 1969. Again, a poor example. Subsequent efforts to gear changes in the federal budget position to the alleged needs of the economy fared little better. Any resemblence to the theoretical requirements was largely coincidental.

1/ Arthur M. Okun (then Chairman, CEA), Issues in Preserving Prosperity, Economic Club of New York, March 6, 1968, pp. 3-4 (mimeo). The concept also came in for congressional criticism. See the statement by Wilbur Mills, then Chairman of the House Ways and Means Committee, The New Economics, MAPI, 1968, p. 169.

2/ Herbert Stein, then Vice President and Chief Economist (from correspondence).

II

PRESENT THEORY

In our earlier listing of fiscal-policy theories, we left the present one nameless. This for good reason: it is hard to label. Historically, it is a derivative of fiscal-activism theory; it is what remained after the flexible, or fine-tuning, approach was abandoned. Perhaps it can best be described as a sedated, or tranquilized, version of that approach.

This is obviously a change in the application of fiscal policy, not in its basic theory. The latter remains essentially the version propounded by the early activists. Since there is no difference in principle between frequent shifts in the federal budget position and once-a-year changes incorporated in the forthcoming budget (the prevailing pattern today), it has not been deemed necessary to rework the theory, and comparatively little has been done in that direction.

We observed earlier that there is often little relation between what theory calls for and what actually happens. Certainly it has been true of this modified version of fiscal activism. Presumably, it has shared the assumptions and expectations of its predecessor that its application would result in an irregular alternation of budget deficits and surpluses./1 Yet if we were to infer the theory from actual fiscal behavior, we would have to describe it as a theory of continuous deficiteering. The entire decade of the seventies (including 1978 and 1979) will show an unbroken string of deficits. If the string is extended through 1982, as now projected, it will complete a period of 22 consecutive years with only one surplus./2

Neo-Stagnationism?

The only one of the earlier fiscal-policy philosophies that could rationalize such behavior is the theory of secular stagnation. The stagnationists alone premised the necessity for almost continuous deficiteering, in keeping, of course, with their views on the chronic weakness of the private economy and the consequent need for sustained government support. What we have done over the past couple of decades is to apply stagnationist policy without espousing the theory that rationalized it. The theory died a generation ago, and it is safe to say that few of those responsible for subsequent deficiteering even gave it a thought. Yet the stagnationists could not have conceived in their wildest dreams a more faithful application of their policy prescription.

1/ An assumption shared, you will recall, by the earlier stabilizing-budget school, which contemplated a balance over the business cycle.

2/ Fiscal years, unified budget basis.

This is well exemplified by recent developments. We have now completed three full years of recovery from the recent recession and are approaching the point where the expansion of the economy, which has averaged 5.5 percent per annum over the interval (in real GNP), should be tapered down toward a more sustainable rate. Yet the budget for fiscal 1979 (starting October next) calls for a deficit of $60 billion. This during the fourth and fifth years of recovery. But that is not all. Deficits (hopefully diminishing) are expected to continue through 1982.

This projection of massive deficits into the advanced stages of recovery (and beyond) may be attributed by some to the cowardice and irresponsibility of politicians, but it is well to remember that the program has been vigorously supported by eminent fiscal-policy theorists, their thesis being, apparently, that the private sector lacks the energy and vitality to recover in the face of the "fiscal drag" from declining federal deficits./1 Having become addicted to the fiscal stimulant during the recession, in other words, it cannot kick the habit without traumatic consequences.

In one respect, this implicit stagnationism is more extreme than the original version. While the proponents of that version premised a dearth of investment opportunities in the private sector, and distilled their pessimism therefrom, they never held that recoveries from recessions required undiminished federal deficits all the way up to (and even into) the succeeding boom. Yet their current successors, most of whom strongly reject the idea of inadequate investment opportunities, appear to have adopted the thesis for the present recovery (through 1979 at least), if not, indeed, more generally.

Fuzzy Picture

As noted earlier, present fiscal-policy theory is poorly rationalized and hard to label. While fiscal behavior during its period of dominance has conformed to the expectations of the stagnationists, the fact that it has not been motivated by their doctrines leaves us guessing. What is the rationale for the continuous deficiteering we have indulged in over the past couple of decades? Or to come down to date, what is the rationale for running undiminished deficits into the fifth year of recovery? Why is it that the economy cannot do this time what it has repeatedly done before: recover in the face of an improving budget position?/2 If the private sector has become too weak to overcome "fiscal drag," what is the nature of its malady? We are not told.

1/ The "private sector" as used here is really the non-federal sector, including state and local governments.

2/ It did so in all previous postwar recoveries save the one following the minor recession of 1969-70, when a sizable deficit persisted throughout the move.

In the absence of answers to such questions, contemporary fiscal theory remains fuzzy. It would be a great service both to politicians and to the public if it were more clearly articulated.

III

CONCLUSION

As its title indicates, this essay is a quick review of the fiscal-policy philosophies, or schools of thought, that have successively attained dominance over the past half century. This is not the place for a systematic critique of these changing orthodoxies, which we have offered elsewhere./1 We should like, however, to close with a few observations on deficiteering in general.

It Has Been Oversold

There is a tendency among the proponents of deficiteering to regard it as a sure-fire panacea for whatever ails the economy. This is an illusion. We noted earlier that in the great depression of the thirties there were deficits in 10 consecutive peacetime years. They were, moreover, relatively large, averaging 2.6 percent of GNP, not far from the estimated average for fiscal years 1975-79. Yet the period ended with an unemployment rate of 15 percent. It took World War II to pull the economy out of the doldrums. Something was wrong with the system that counteracted and frustrated the fiscal stimulus. The same must be true of today's economy under the massive deficiteering of recent years. If it needs undiminished support into the fifth year of recovery, it must have maladies that do not respond to fiscal medicine.

One possibility rarely considered by fiscal theorists is that the maladies may be, in part, a side-effect of the medicine itself. Far from being a panacea, deficiteering can set up countervailing forces that reduce the overall, or net, stimulus to a fraction of the theoretical impact, and a variable fraction at that. Much depends, for example, on the way the deficit is financed. If it leads to a more rapid expansion of the money supply than would otherwise be appropriate, it can inject a stimulus (at the risk of inflation of course) without countervailing offsets. If, on the other hand, it is financed from the capital market, it raises interest rates above what they would be in its absence and diverts savings from other claimants, to the detriment of private capital formation, especially in interest-sensitive sectors. Moreover, it raises the threshold (required return) for equity commitments. This weakening of the investment sector of the economy runs counter to the strengthening of the consumption sector through the deficit and reduces the net stimulative

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1/ The New Economics, MAPI, 1968.

effect. While the reduction is likely to be small during recession and the early stages of recovery, it becomes increasingly substantial as the expansion develops. In the present situation, the deficits projected for the fourth and fifth years of recovery are likely to yield a low net-benefit ratio.

We are speaking here of the short-run benefit. Over the long run, sustained deficiteering can have a negative effect on the economy. By reducing the amount of savings available to the private sector, and with it the amount of private investment, it slows the secular growth of productivity and output to the detriment of all. This can be particularly serious in the case of the United States, which has one of the lowest investment-to-GNP ratios in the industrialized world.

Rethinking Needed

We have not mentioned the practical difficulties in applying current fiscal-policy theory--the inevitable reliance on economic forecasting a year or more ahead, the uncertainty as to what the economy would do in the absence of fiscal stimulation, the equal uncertainty about the size of the deficit appropriate to the given situation, etc. These and other application problems can be as important as the theory itself, but since the latter is our concern here, they are only noted in passing. One thing can be said with certainty, however: they can bedevil the implementation even of a correct theory.

As for contemporary fiscal-policy theorizing, it is often simplistic to the point of naivete. Not only has it been oversold to the public and to politicians; it has been overapplied in practice. If the economy needs all the fiscal stimulation it is scheduled to get in the years immediately ahead, something is wrong with it. Whatever the retardative factors--monetary policy, inflation, low real profits, high interest rates, depressed equity values, low business confidence, overregulation, adverse trade balance (the list could be extended)--they need separate diagnosis and treatment. They cannot be eliminated simply by running the fiscal pump full blast, particularly when this aggravates many of the maladies it seeks to cure.

We remarked earlier that the exponents of contemporary fiscal-policy theory would do the public a favor by clarifying it. We may add that they would do it an even greater favor by rethinking it.

CORPORATE EARNING POWER IN THE SEVENTIES: A DISASTER

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August 1977

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CORPORATE EARNING POWER IN THE SEVENTIES: A DISASTER

History is not given to sudden discontinuities, but the period of the seventies to date (1970-77), chosen for this analysis of corporate earning power, comes as close to one as we are likely to get. Certainly it is distinctive enough to justify separate treatment, its distinction being that real profitability has been at a disaster level throughout.

The reference to "real" profitability suggests that there are unreal or fictitious measures of earnings, and indeed there are. In fact the most commonly cited profits statistics are of this character. The reason is simple: they fail to adjust for the effect of inflation on the accounting of operating costs. Since this failure results in the understatement of these costs, the derivative profits are overstated, deceiving investors, politicians, academicians, and the public alike.

The present study attempts to gauge the magnitude of profit overstatement in the seventies and, for comparative purposes, over the preceding postwar period. A word on the line of march. Section I deals with the effect of inflation on the measurement of costs, and presents the record of profits before and after adjustment for this effect. Section II examines adjusted profit margins on both output and equity. Section III analyzes the failure of management to cope with inflation. Finally, Section IV considers the implications of this failure.

I. ADJUSTMENT OF PROFITS FOR INFLATION

The student of corporate earnings is offered these days two official profits series, both from the same source, the Department of Commerce. The first, and basic, series is derived (after several adjustments) from income tax data, which are based, with one exception, on historical costs./1 A second series is derived from the first by the application of the Capital Consumption Adjustment (CCA) and the Inventory Valuation Adjustment (IVA). These adjustments are the difference between the estimated replacement cost of the fixed assets and inventory consumed in production and the costs charged for income tax purposes.

Why the Adjustments?

The reason for the two adjustments is of course inflation. They are necessary because of the time difference between cost incurment

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1/ The exception is the allowance of LIFO inventory accounting to the extent actually practiced, a method believed to cover currently about a quarter of corporate inventory. While this is really a deferred historical-cost system, its immediate impact is broadly equivalent to true current costing.

and cost recovery. If all costs were recovered at the time of incurment, no adjustment would be required. But it is the nature of business operations that there is a lag between the two. This lag, which may be referred to as "cost lead time," varies all over the map, ranging from years (fixed-assets), to weeks or months (inventories). But whatever its duration, the effect of inflation is the same: the cost of replacing the assets consumed in production is higher than the historical-cost charges for the purpose. The latter provide only a partial replacement in real terms.

Since there can be no true profit until the assets consumed have been fully restored (or until full provision for their restoration has been made), the failure of historical costing to meet this requirement results in the overstatement of profits. What gets reported under this procedure is a mixture of true profits and unrecorded costs. It is the object of the Commerce adjustments to subtract out the latter./1

Adequacy of the Adjustments

While the two Commerce adjustments are generally acceptable so far as they go, they are incomplete. For they ignore the lead time of costs not charged into inventory. We refer to the category usually accounted as "expense"--selling, promotion, research and development, interest, rent, royalties, taxes (other than on income), insurance, contributions, general administration, etc. That such costs are important is sufficiently indicated by the fact that for nonfinancial corporations as a whole they constitute 25-30 percent of the total. They too have an average lead time of substantial magnitude, which calls, no less than the lead time of inventoried costs, for inflation adjustment.

Unfortunately, no one has figured out a practical way to derive the average cost lead time of expensed items, and we imply no criticism of Commerce on this score./2 It is well to remember, however, that its

1/ Since we are using Commerce adjustments in this study, we have stated the rationale for the specific-replacement-cost approach. It seeks fixed-asset and inventory consumption charges that will restore the amounts withdrawn in physical terms. In pursuit of this goal, it employs a multiplicity of self-duplicative price indexes. Those familiar with our writings on this subject will realize that we prefer, on both practical and theoretical grounds, to adjust for cost lead time by the application of a single index of the general price level. Conceptually, this calls for capital maintenance in terms of general purchasing power, rather than in physical quantities. Fortunately for our present purpose, the overall results of the two approaches are not far different. For a discussion of the issue, see The Case for the Single-Index Correction of Operating Profits, MAPI, October 1976.

2/ The depreciation adjustment is carried out by breaking down depreciable assets into year-of-origin groups, restating each group at current replacement cost, and computing depreciation on the restated amounts. The cost lead time for inventories is derived from turnover rates. This measure is of course unavailable for expenses.

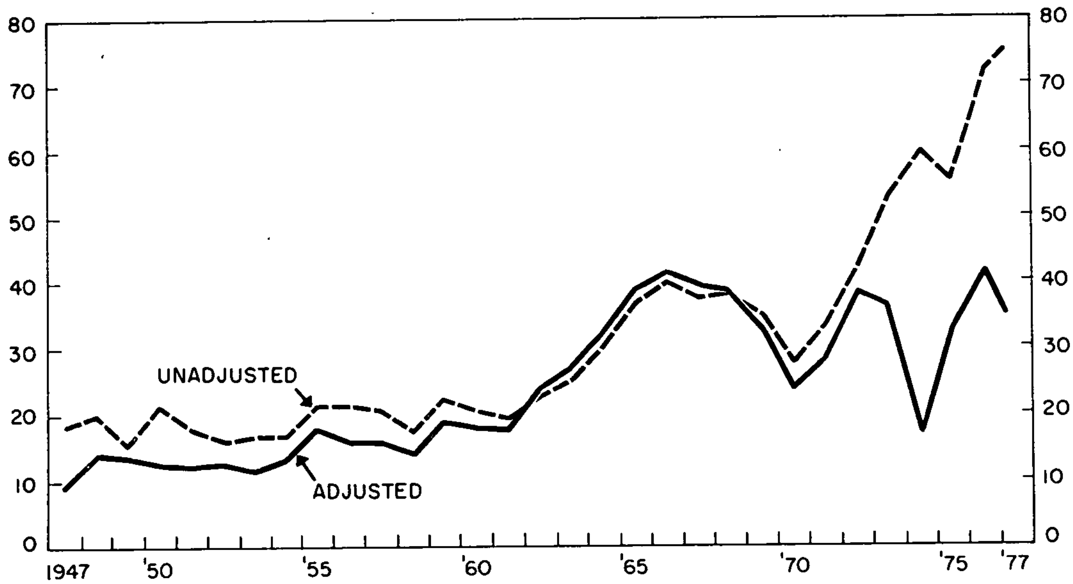
two adjustments yield a correction that is inadequate by an unknown, but certainly significant, amount, and that a full correction would yield adjusted profits even lower than those shown./1

The Results

With these preliminary explanations, we turn to the results of the Commerce adjustments, which appear below.

CHART 1

Adjusted and Unadjusted After-Tax Profits From the Domestic Operations of Nonfinancial Corporations, 1947-76/a
(Billions of dollars)



a/ Since the adjustments relate to physical-asset consumption only, and since there is relatively little of this in the financial sector, we shall deal throughout with nonfinancial corporations. The circled dots show the first quarter of 1977 at seasonally adjusted annual rates.

1/ There is another cause of undercorrection, though of much less importance, the use by Commerce of full-life straight-line depreciation as the basis for its inflation adjustment. The straight-line writeoff is in most applications a grievously retarded measure of capital consumption, the double-declining-balance method being in general more realistic. This is not the place to argue the issue, which we have done elsewhere. See Realistic Depreciation Policy, MAPI, 1954. For a correction of profits using double-declining-balance depreciation, see Inflation and Profits, MAPI, April 1977.

An interesting picture. The adjusted profits started out in 1947 at half the unadjusted, after which the two series gradually converged. They then ran along pretty much together until the late sixties, when accelerating inflation produced a divergence, explosive after 1972. Since that year, unadjusted profits have risen by more than 70 percent, while the latest figure for adjusted profits is actually off a little.

The substantial equivalence of the two in the early and middle sixties reflects in part the relatively low inflation rates of 1958-65, in part the increase in tax depreciation following the introduction of the Guideline Life System in 1962. The shortening of tax depreciation lives by that system, plus the availability of accelerated writeoff methods, kept tax allowances above the Commerce replacement-cost estimates for several years. The further boost in those allowances through the Asset Depreciation Range System of 1971 was soon overwhelmed by accelerating inflation, and by 1976 the CCA had grown to $16 billion./1

II. ADJUSTED PROFIT MARGINS

Chart 1 shows the absolute amounts of adjusted and unadjusted profits. To get an informative picture of what has happened to adjusted profits (with which we shall be exclusively concerned from now on), it is necessary to convert them into profit margins. Two such margins will be computed, one on gross product, one on adjusted net worth.

Margins on Gross Product

The first of these calculations appears on page 5.

From 1947-1969, profit margins ranged between 6 and 10 percent, averaging 7.75. From 1970-76, they ranged between roughly 2 and 5 percent, with an average of 4.25. By this measure, corporate earning power in this period was only 55 percent of its prior long-term average, and even in the most recent year (1976) it was no better than that. In the first quarter of 1977, it was only 44 percent as large.

Margins on Adjusted Net Worth

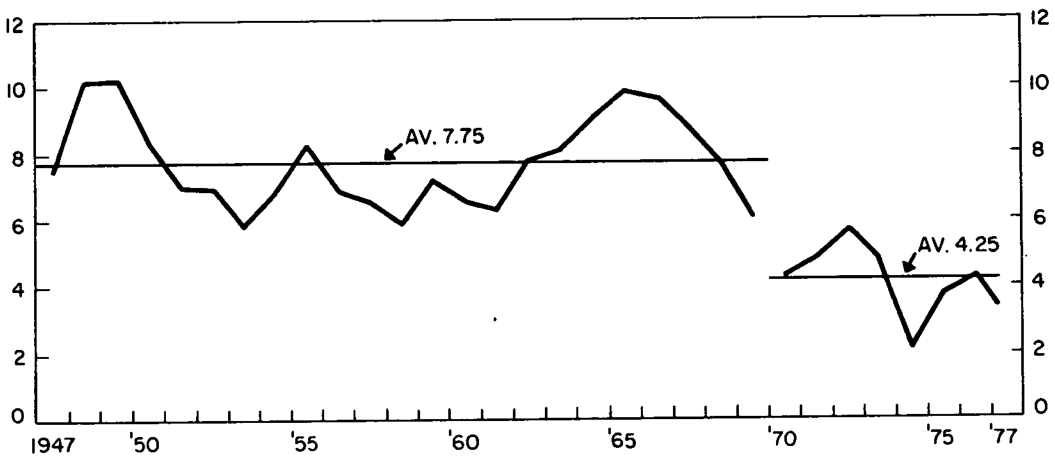
Suppose we look next at the second margin calculation, Chart 3 (also on page 5), which relates adjusted profits to adjusted net worth, that is to say, net worth with tangible assets (land, structures, equipment, and inventory) restated at estimated replacement cost.

The showing here is generally similar to the preceding one. Against a base-period average return of 5.90 percent, the 1970-76 period rates only 3.55, this time 60 percent of the base level. Again the 1976 figure is no better than the recent average. Worse still, the first quarter of 1977 is only 47 percent of base.

1/ It may be added that the CCA for book profits (not computed by Commerce) was at least $30 billion for that year, the difference reflecting the excess of tax over book depreciation.

CHART 2

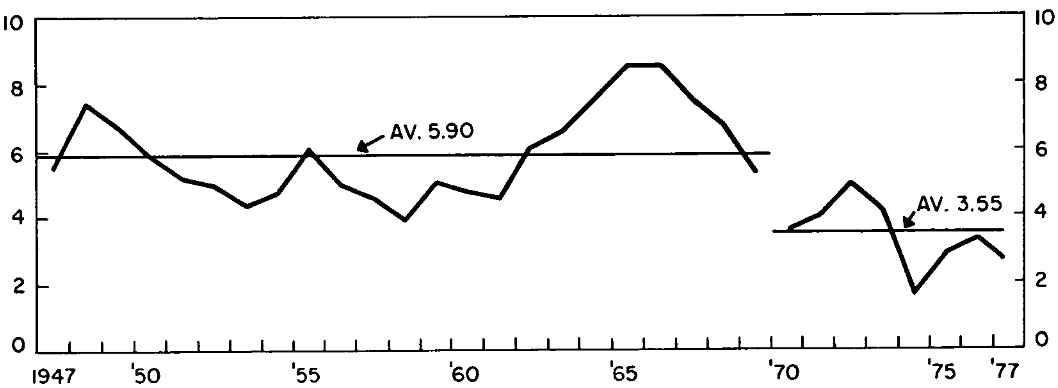
Adjusted Domestic After-Tax Profits of Nonfinancial Corporations as a Percentage of Their Domestic Gross Product/a



a/ It is customary to compute profit margins on sales rather than on gross product (value added), but the former is a duplicated figure, including purchases from outside the universe covered (here nonfinancial corporations) and transfers between enterprises within it. The gross product avoids distortions from shifts in the relative importance of these purchases and transfers.

CHART 3

Adjusted Domestic After-Tax Profits of Nonfinancial Corporations as a Percentage of Their Adjusted Domestic Net Worth/a



a/ Adjusted net worth is from the flow-of-funds reports (Federal Reserve Board), Balance Sheet of Nonfinancial Corporations, December 1976. Since the profits are from domestic production only, net worth was reduced by the excess of claims against foreign affiliates over obligations owed to them. Net worth is the average of opening and closing amounts. The 1976 and 1977 figures are partly estimated.

III. FAILURE OF MANAGEMENT TO COPE

It is evident that even after a decade of inflation American management (with some exceptions of course) has not yet learned to cope with it.

It is difficult in many situations to protect even nominal (historical-cost) profit margins in the face of inflation. The difficulty arises when price-setting takes place in advance of cost incurment. Under prevailing practice this is a fairly common phenomenon. There may be long-term fixed-price sales contracts outstanding; catalogs may be issued only annually or semi-annually; seasonal merchandise may be priced months in advance of delivery; long-cycle production may be quoted before work is started; etc. Unless such advance pricing is based on the costs that will be incurred later (as distinguished from those prevailing at the time of quotation), even historical-cost profit margins will be squeezed.

Overall, however, the protection of nominal margins is a minor problem compared with the protection of real margins. The lead of price determination over cost incurment varies widely from one industry to another. In many it is negligible, in some even negative. But the lead of cost incurment over sale, though likewise variable, not only averages far longer, but is almost universal. Correction for both leads is accomplished by pricing on replacement costs anticipated as of the time of sale. This is done by basing prospective profit margins on those costs.

It must be acknowledged, of course, that such a pricing policy may be impracticable for an individual company in a market where the competition is pricing on historical costs. The real remedy lies in the reform of policy across the board. If all competitors are targeting their prices on replacement costs, there is a better chance that they can make them stick.

It is probably fair to say that by and large American management has not even been trying to price on replacement costs. If it had been there should be by now some reflection of its efforts in the improvement of real profit margins. As we have seen, there is no such evidence in the record: real margins so far in the seventies have, if anything, been drifting downward.

Reasons for Not Trying

A major reason for this failure to try replacement-cost pricing is ignorance. Many managements--probably most of them in medium-sized and small companies--simply do not realize the phony character of the profits they are reporting. If their historical-cost margins fall in the target range, they think they are doing well, hence see no reason to alter their pricing policy. There is a second, and much smaller, group of managements that have been exposed to the gospel of current-cost pricing but reject it on principle. They still believe that a dollar is a dollar. Finally, there is a third group that accept the gospel on theoretical grounds, but for practical reasons do not apply it. Obviously none of these groups contributes to the restoration of real profit margins.

Among the practical reasons just referred to is the extraordinary difficulty of computing reliable replacement costs for individual companies, particularly in the case of fixed assets. This was forcefully illustrated by the results of the replacement-cost calculations mandated by the Securities and Exchange Commission (SEC) for the 1976 10-K reports of large corporations. There was the greatest diversity of method and approach (both left largely to the respondent), and much complaint about the cost of the operation and the uncertain validity of the results. The fact is that replacement costing is a headache, and most companies don't know how to do it.

The solution, in our opinion, is to give up the specific replacement-cost approach and correct for cost lead-time by the use of a single index of changes in the general purchasing power of the dollar. Not only would this vastly simplify the operation, it would facilitate the adoption of current costing for income tax purposes, a consummation devoutly to be wished./1

Effect of Disclosure

Many managements that accept current costing in principle are averse to the disclosure of current-cost profits in their financial statements. They may have substantial stock positions in their companies and fear the effect of disclosure on market prices. They may hold stock options, the value of which could be impaired. They may enjoy bonuses geared to present profit accounting, and so on. But even apart from self interest, they may feel that they owe it to outside stockholders to maintain this accounting, believing that they too would suffer from the disclosure of real profits.

Whether these fears are justified is an open question, long debated by securities analysts, accountants, and economists, though with little empirical evidence to go on. Fortunately, such evidence is now coming to hand. While the SEC forbade the formal restatement of profits by those participating in its 1976 project, the data on replacement costs in their 10-K filings and annual reports permit anyone else to do it, and securities analysts have been busy at it for months. Moreover, tabulations of sample companies have already been published./2

With what result? Notwithstanding a fantastic dispersion in the ratios of adjusted to unadjusted profits, the stock market response to the disclosure has been slight to negligible. Either the market has

1/ See Inflation and the Taxation of Business Income, MAPI, January 1976.
2/ See, for example, Business Week, The McGraw-Hill Publishing Co., June 29, 1977.

uncannily discounted the differing quality of reported profits, or it is relatively indifferent to this factor. In any event, management concern over the effects of disclosure appears to be exaggerated./1

If the SEC continues to mandate the estimation and reporting of replacement costs, the question of disclosure will become academic, for large companies at least. The adjusted earnings will be disclosed whether they like it or not. For those not subject to the mandate, the answer is different. If they fear the effect of disclosure on their stock prices, they can keep their estimated current costs an internal secret used only for pricing policy. The important thing, with or without disclosure, is that managements try to price on these costs. In the end, this is the only way they can cope with inflation.

Governmental Obstacles

Unfortunately, the federal government handicaps this effort by its adherence to historical costing for income tax purposes./2 Since the excess of current costs over tax costs is not deductible, it requires twice as much added revenue to build up current-cost profits as it would with deductibility. This doubles the difficulty of restoring real margins.

There is a second handicap imposed by the government. We refer to its propensity to publicize nominal profits and profit margins. While it uses adjusted pre-tax profits in the GNP accounts, it avoids the publication of adjusted after-tax profits./3 This means that if American management did manage to get its real profit margins up to normal levels, the nominal margins reported in official publications would appear abnormally, and embarrassingly, large. Notwithstanding their phony character, they would be used by politicians, labor leaders, and others to beat business over the head. If the government wants corporate management to cope with inflation, it had better switch to the publication of real profits.

After this recital of obstacles, it is evident that the generalization of efforts to price on current costs will be slow in coming. In the meantime American industry can be expected to continue with abnormally low real profit margins.

1/ An earlier tabulation of adjusted and unadjusted profits, this time by a different method of conversion, showed a comparable dispersion of results, with little stock market response. See Financial Accounting Standards Board, Research Report, May 1977.

2/ Except for the availability of LIFO inventory accounting when taken bookwise.

3/ See A Mystery in Federal Profit Reporting, MAPI, May 1976. Since this was written, two minor concessions have been made. Adjusted after-tax profits now appear in Business Conditions Digest, and in an inconspicuous addendum to one table on the GNP accounts. Elsewhere "profits after tax" are unadjusted.

IV. IMPLICATIONS

What if the real earning power of the corporate system continues at the depressed level that has characterized it so far in the seventies? The most obvious and certain effect will be a retardation of the growth and improvement of its productive capacity.

While the capital expenditures of nonfinancial corporations were well maintained in the early years of the seventies (before 1975) notwithstanding the low level of their real profits, this was accomplished by resort to unsustainable financing arrangements. Because the real retained earnings of the system averaged less than $7 billion a year over the full period 1970-76, and its net new stock issues less than $9 billion, most of its capital expansion was financed by borrowing, as a result of which its outstanding debt mounted at an average annual rate of roughly $60 billion.

This has resulted in a substantial rise in the overall debit-equity ratio on the historical-cost balance sheet of the system. While the ratio has remained fairly stable on its replacement-cost balance sheet, most credit appraisals (insofar as they turn on asset coverage) are based on the former. From their standpoint, therefore, creditworthiness has been impaired.

But this is only the tip of the iceberg. Far more important, as a rule, than the asset coverage of the loan principal is the earnings coverage of interest requirements. Here the deterioration has been drastic. The decline in the coverage multiple began in the second half of the sixties, reflecting falling profit margins (Charts 2 and 3), expanded borrowings, and rising interest rates; it then continued irregularly in the seventies./1 Note the following:

Earnings Coverage of Net Interest Payments,
Nonfinancial Corporations
(Multiples)

1965	11.8/a	1972	4.8
1966	10.6	1973	4.3
1967	8.7	1974	3.1
1968	8.1	1975	3.4
1969	6.1	1976	3.7
1970	4.0	1977 (1st q.)	3.4
1971	4.3		

a/ The 1965 figure is only slightly above the average for the first half of the decade (11.3). Prior to 1960 the multiples were uniformly higher than in 1965.

1/ The coverage multiple is adjusted pre-tax profits plus net interest payments, divided by these payments.

It is obvious that earnings-coverage multiples cannot continue indefinitely the decline of recent years. By the same token, the expansion of corporate capital cannot be indefinitely sustained by the inordinate borrowing that characterized the period. If the multiples do not improve, there will be increasing pressure on lenders and borrowers alike to cut back debt expansion, and with it the financing of new capital formation. To avoid this adverse development, it is vital to lift real corporate earnings from the depressed level prevailing so far in the seventies, and to raise real retained earnings from their even more depressed level. The higher earnings are necessary to increase the coverage of interest and facilitate further debt expansion; the higher retained earnings are required to reduce the need for such expansion.

The depressed level of real profits is bad not only for the corporations affected but for the nation as a whole. Despite the suspicion and disfavor that attach to profits in the eyes of many politicians and of a considerable part of the public, it is essential that they be large enough not only to motivate the expansion of investment, but to finance a substantial part of it. The present level falls short on both counts.

Would the Normalization of Real Profits Be Inflationary?

We should like in closing to comment briefly on a common objection to the restoration of real profit margins; namely, that it would be inflationary.

It is true, of course, that if nonfinancial corporations were suddenly to raise their real after-tax margin on gross product from the average of the seventies, 4.25 percent, to the base-period average of 7.75 percent (Chart 2), it would require an increase of 7 percent in the average of prices charged for that product. (Since the added revenue would not be shielded by added deductions, it would require this much to yield the 3.5 percentage-point increase in the after-tax margin.)

This 7 percent increase is misleading, however. For the added corporate taxes associated with the normalization of the real margin would permit an equal relief of personal taxes, either by their reduction or by the abatement of increases that would otherwise occur. This gain to personal disposable income would offset half of the price increase, leaving the net impact 3.5 percent.

Moreover, this would be a one-shot, nonrecurrent effect. Once accomplished, it would give no further impulse to inflation. Real inflation is generated by sustained and continuous forces, such, for example, as excessive monetary expansion or excessive wage increases, which can go on year after year./1 Without such forces, it would quickly come to a halt.

1/ See Unwinding the Present Inflation, MAPI, March 1977.

But this is not all. The restoration of real profit margins, even if attainable, would stretch over a period of years. It is not at all improbable that the gains in productivity during the transition period from the investment induced by the restoration would offset most or all of the price effects that would otherwise occur. In any event, the net impact on inflation would be small.

Conclusion

It would be pleasant to conclude this essay on an optimistic note, but we cannot, in honesty, do so. For reasons already set forth, the prospect for the normalization of real profits and profit margins is dismal. With the general disinclination of mangement even to try replacement-cost pricing, and the obdurate refusal of the federal government to recognize replacement costing for tax and regulatory purposes, the cards are stacked against success. Without it, the economy will continue to fall short of its growth potential, with serious consequences for production and employment alike. It is a spectacle to make angels weep.

INFLATION AND THE TAXATION OF CAPITAL GAINS

by
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March 1978

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INFLATION AND THE TAXATION OF CAPITAL GAINS

by

George Terborgh

The taxation of capital gains has long been one of the most controversial issues of fiscal policy, and not surprisingly, practice has differed widely from country to country. Many have exempted such gains entirely. Some have taxed them as ordinary income. Others (including the United States) have gone in for a mixed, or compromise, solution, with varying treatment for different categories of transactions, with concessionary rates for some, and with other special provisions./1

These differing approaches were debated and implemented before inflation became the chronic economic disease it now is, and their supporting rationalizations took little cognizance of this factor. It happens, however, that inflation has profound implications for capital gains taxation, implications that are only now beginning to be appreciated. It is the purpose of this essay to explore them.

Inflation Accounting

The persistence of rapidly advancing price levels since the mid-sixties has given rise to unprecedented interest in what has come to be known as "inflation accounting." Its object is to restate business accounts in such a way as to eliminate the distorting effects of inflation.

Unfortunately, efforts to develop such an accounting system have failed as yet to reach consensus. We have commented on this elsewhere:

> It would be gratifying to report that these several ventures in inflation accounting have arrived at reasonably consonant results. On the contrary, they present a "confusion of tongues" recalling the Tower of Babel. There are disagreements even on basic issues: whether inflation adjustments should be applied to all balance-sheet and income accounts, or to selected items only; whether the inflation-adjusted accounts should supersede the conventional historical-cost accounts, or be merely footnotes thereto; whether the adjustments should be effectuated by the use of a single index of the general purchasing power of money or of a multiplicity of indexes reflecting its purchasing power over specific items; whether the inflation-adjusted accounts should be recognized for income-tax purposes or in financial statements only. And so on./2

1/ Such a system has been in effect in this country since 1921. Prior to that year capital gains were taxed as ordinary income.
2/ Inflation and the Taxation of Business Income, MAPI, January 1976.

Whatever the position taken on these issues, there is no disagreement on the basic principle of inflation accounting. It is to correct for changes in the purchasing power of the dollar between the incurment of costs and their subsequent recovery, and between incurment of obligations and their subsequent repayment. Since our subject here is the effect of inflation on cost recovery, we shall confine the discussion to this aspect.

I. EFFECT OF COST LEAD TIME

The reason for the adjustment of historical (original) costs for inflation is the time difference between cost incurment and cost recovery. If all costs were recovered at the time of incurment, no adjustments would be required. But it is the nature of business operations that there is a lag between the two. This lag, which may be referred to as "cost lead time," varies all over the map, ranging from years (fixed assets), to weeks or months (inventories). But whatever its duration, the dollar shrinks over the interval, so that the cost dollars recovered (whether through product sales or asset disposals) are always smaller than the dollars of incurment.

It is obvious that the matching of unlike dollars can yield only distorted and unreliable results. To get the same dollars on both sides of the comparison, it is necessary either to convert the dollars of one side into those of the other, or to restate both in some common dollar differing from either. Since the first course is clearly simpler, involving only one conversion, and since it is obviously desirable to deal in present dollars, we shall discuss the restatement of costs at their equivalent in the dollars of recovery.

Application

The practical application of this principle to operating costs is rather difficult. If it were possible, the correct procedure would be to date the input or incurment of each item, and then to restate each of these dated costs at its equivalent in the dollars received for the product. The sum of the restated costs would then be comparable with the revenue from which they are recovered, and the operating profit (or loss) so determined would be correct.

Unfortunately from the standpoint of this ideal solution, conventional accounting records rarely provide incurment dates for individual items of cost, nor do they ordinarily identify such items with particular units of product. For the most part, costs accumulated during a given time period are offset against the revenues of the same period. This method of accounting obscures the lag of cost recovery behind cost incurment and precludes a direct computation of the lag. It is necessary, therefore, to deduce operating-cost lead time by indirect methods./1

1/ There is a major exception to this statement, the cost of fixed-asset consumption (depreciation). Here the acquisition dates of the depreciating assets are available from property records.

Fortunately, the problem of identifying costs with recoveries is much simpler for capital gains calculations. Here we ordinarily deal with the cost lead times of specific assets, for each of which both the acquisition date and the realization date are known, together with the amounts involved at each point. It is therefore relatively easy to restate the historical-cost "basis" of the asset (or the portion disposed of if less than the entirety) in the dollars of realization, and to compute the true gain from the restated amount. It is particularly easy if the taxing authority supplies an official index for the conversion, as we believe it should./1

II. EFFECT OF HISTORICAL-COST TAXATION

Having commented briefly on the theory of inflation accounting, and on its application to the measurement of capital gains, we can illustrate the effect of taxing these gains, as is now done, without adjustment for inflation.

It must be obvious, in the first place, that if the appreciation of an asset during the holding period is the same (in relative terms) as the rise in the general price index over the interval, the restatement of its historical-cost basis by the application of that index will yield an amount equal to the realization itself, hence neither gain nor loss. It is equally obvious that if the excess of this amount over the historical cost of the asset is subject to tax, the tax will come out of the real capital of the owner. It will constitute, in other words, a capital levy.

It may help to spell this out. The following table traces the effect of a 25 percent tax on the unadjusted capital gains from 10 different transactions./2 These involve the same asset, with the same cost, but different holding periods. Specifically, the asset is purchased for $1,000 in each of the years 1 to 10 and is sold in the year 11 at a price representing an appreciation of 10 percent a year. The general price index by which the historical cost is restated is also assumed to advance 10 percent a year.

1/ As noted earlier, one of the unsettled issues of inflation accounting is how changes in the purchasing power of the dollar should be measured --whether by a general price index or by a multiplicity of specific indexes. So far as tax administration is concerned, the use of a single index is almost essential. We may add, incidentally, that we favor the single-index approach for other purposes as well, on both theoretical and practical grounds. See The Single-Index Approach to Inflation Accounting, MAPI, October 1976.

2/ This rate is the present "alternative tax" on long gains. Where such gains are subject to a surtax under the "minimum tax" provisions of the Code, the combined rate can go much higher. See The Minimum Tax on Tax Preferences--The Back-Door Route to Federal Tax Increases, MAPI, March 1977.

Table 1

Nominal and Real Capital Gains From the Sale in Year Eleven of an Asset Purchased for $1,000 in Each of the Preceding 10 Years

	Historical-Cost Calculation					Adjustment for Inflation		
Year of Purchase	Cost in Dollars of the Year of Purchase	Realization in Year Eleven	Nominal Gain Before Tax (2)-(1)	Tax (at 25 Percent)	Nominal Gain After Tax (3)-(4)	Cost Restated in Year Eleven Dollars	Real Gain Before Tax (2)-(6)	Real Gain After the Tax on Nominal Gain (7)-(4)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	$1,000	$2,594	$1,594	$399	$1,195	$2,594	-0-	$-399
2	1,000	2,358	1,358	340	1,018	2,358	-0-	-340
3	1,000	2,144	1,144	286	858	2,144	-0-	-286
4	1,000	1,949	949	238	711	1,949	-0-	-238
5	1,000	1,772	772	193	579	1,772	-0-	-193
6	1,000	1,611	611	153	458	1,611	-0-	-153
7	1,000	1,464	464	117	347	1,464	-0-	-117
8	1,000	1,331	331	83	248	1,331	-0-	- 83
9	1,000	1,210	210	53	157	1,210	-0-	- 53
10	1,000	1,100	100	25	75	1,100	-0-	- 25
11	1,000	1,000	0	0	0	1,000	-0-	0

Note that the inflation adjustment converts nominal gains (Col. 3) into real after-tax losses (Col. 8). As indicated earlier, these losses measure the erosion of real capital by the tax.

This is, of course, a special case based on the assumption that the asset depreciation rate equals the inflation rate. The losses computed on this assumption are increased if the inflation rate exceeds the appreciation rate, and are diminished (or converted into gains) if it falls short thereof. The permutations are of course endless. But so long as there is any inflation over the holding period, the real after-tax losses are larger (or the gains smaller) than their nominal counterparts.

Not only are the permutations endless; the impact of historical-cost taxation can be utterly capricious. Suppose we modify the foregoing example by assuming that the asset has appreciated the same amount (100 percent) for all holding periods, the inflation rate remaining, as before, 10 percent per annum:

Table 2

Nominal and Real Capital Gains From the Sale for $2,000 in Year Eleven of an Asset Purchased for $1,000 in Each of the Preceding 10 Years

	Historical-Cost Calculation					Adjustment for Inflation		
Year of Purchase	Cost in Dollars of the Year of Purchase	Realization in Year Eleven	Nominal Gain Before Tax (2)-(1)	Tax (at 25 Percent)	Nominal Gain After Tax (3)-(4)	Cost Restated in Year Eleven Dollars/a	Real Gain Before Tax (2)-(6)	Real Gain After the Tax on Nominal Gain (7)-(4)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	$1,000	$2,000	$1,000	$250	$750	$2,594	$-594	$-844
2	1,000	2,000	1,000	250	750	2,358	-358	-608
3	1,000	2,000	1,000	250	750	2,144	-144	-394
4	1,000	2,000	1,000	250	750	1,949	51	-199
5	1,000	2,000	1,000	250	750	1,772	228	- 22
6	1,000	2,000	1,000	250	750	1,611	389	139
7	1,000	2,000	1,000	250	750	1,464	536	286
8	1,000	2,000	1,000	250	750	1,331	669	419
9	1,000	2,000	1,000	250	750	1,210	790	540
10	1,000	2,000	1,000	250	750	1,100	900	650
11	1,000	2,000	1,000	250	750	1,000	1,000	750

a/ From Table 1, Column 6.

Here the holder has made the same nominal gain throughout--he has doubled his money--and shows the same nominal gain after tax (Col. 5), but the real results range from a loss of $844 for the 10-year holding period to a gain of $650 for the 1-year period (Col. 8). Clearly the conventional results bear little relation to reality.

III. PUBLIC POLICY ASPECTS

The present inflation has lasted well over a decade (since 1965), and its cumulative amount as measured by general price indexes is approaching 100 percent. Over this interval there has been a varying--and in recent years huge--understatement of operating costs and a corresponding overstatement of operating profits (understatement of losses)./1 More relevant here, there has been a huge overstatement of gains (understatement of losses) from capital-asset disposals. No comprehensive figures are available, but it is certain that a substantial proportion of the capital gains taxes paid over these years has been assessed against fictitious gains reflecting simply the effect of inflation over the holding period.

We shall not address the question whether capital gains are properly taxable at all--as noted earlier, different countries have different views--but certainly it is reasonable to ask that any country that goes in for such taxation should see to it that the gains it levies upon are real. This includes, among others, the United States, where billions of dollars are collected every year on phantom gains.

The effect of this practice on the economy needs no emphasis. In an era of tight capital markets and underinvestment, the erosion of existing real capital through such taxation is clearly deleterious. At a time when an honest and explicit capital levy would be defeated hands down, it makes no sense to continue a disguised levy, particularly one not intended in the first place. (As noted earlier, the intention was to tax real gains.) Since the progress of inflation has frustrated this intention, it is manifestly in order to try to achieve the original objective by excluding from tax the phantom gains inflation has generated. This can be done, as we have seen, by restating the "basis" for capital gains calculations in the dollars of recovery.

Once this reform is accomplished, it will be time to reconsider the structure of the tax itself--the definition of capital gains, the types of assets covered, the distinction between long and short gains, the concessionary rates accorded long gains, etc. But the reform itself must have priority. Without it, no rational address to these and other issues is possible. How can a sensible tax policy be developed when capital gains as now computed represent an indeterminate mixture of reality and fantasy? The question answers itself.

1/ See Inflation and Profits, MAPI, April 1977, and Corporate Earning Power in the Seventies--A Disaster, MAPI, August 1977.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the

Machinery and Allied Products Institute

to the

House Committee on Ways and Means

on

President Carter's Tax Proposals
and Related Issues

Presented by

Charles W. Stewart, President

March 6, 1978

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Introduction

The Machinery and Allied Products Institute (MAPI) deeply appreciates this opportunity to appear once again before the distinguished Ways and Means Committee of the House of Representatives. As members of the Committee will recall, MAPI is the only national organization representing the capital goods and allied product industries of the United States. Our program focuses on original economic and management research and, within that context, places very high priority on research in the fields of capital formation, capital investment, productivity, and "real profits." In addressing these matters over the years, the Institute has given very substantial attention to U.S. tax policy, statutory enactment, and administration.

Affirmative Aspects of the Administration's Program

First, I wish to acknowledge our appreciation to the Administration, particularly the Treasury Department and its Secretary, W. Michael Blumenthal, for giving MAPI and other business organizations an opportunity in a real sense to comment and offer recommendations during the development of the Administration's program. I say that in behalf of the Institute and personally. Moreover, although MAPI is critical--sharply so--with respect to certain recommendations, it would be quite unfair if we did not commend the Administration with respect to certain proposals, notably significant improvement in the investment tax credit and a start in corporate rate reductions. We are reluctant to include in this commendatory evaluation the recommended reductions in the personal income tax rates because of their nature and their structure. We develop our support of these affirmative recommendations in more detail later in this statement.

Premises

Premises of the Administration's tax proposals.--This hearing on the Carter Administration's tax proposals, submitted to Congress initially on January 20, 1978, will necessarily be wide ranging because of the breadth of the Administration's tax package. The MAPI interest and concern are equally wide ranging. We begin with a discussion of certain premises which have been articulated by the Administration as a basis for its tax recommendations. Then we will state those premises which constitute the foundation for the Institute's views and recommendations. Certain comments will be offered as we go.

During the presidential campaign and after his inauguration, the President and his Cabinet members concerned with tax policy have laid down certain criteria or premises which they deem to be fundamental for federal tax action. Most frequently the statement of these criteria includes: (1) equity, (2) the need for simplification of the tax system, (3) encouragement of investment, and (4) a dollar of income should be taxed only once, implying an objection to double taxation, and a dollar of income should be taxed in the same way to the same degree regardless of its source. It has been said by Administration spokesmen that their ideal objective is to give equal weight to each of these criteria. These four criteria have been consistently referred to and more recently expanded upon to some extent as follows:

1. Achievement of greater progressivity, particularly in the individual tax structure, as expressly stated in the Economic Report of the President to the Congress dated January 20, 1978 (page 6), and in the 1978 Annual Report to the President of the Council of Economic Advisers dated January 27, 1978 (page 219);

2. A belated and insufficient recognition of the impact of inflation on taxation and tax policy, although this recognition is not translated effectively into recommendations;

3. Again, a belated recognition--but an incomplete one--of the interaction and total impact of various tax actions recently enacted, proposed, or clearly to be forthcoming; and

4. A more definitive expression or reflection of the Administration's concept of "equity" in terms of the proposed elimination or reduction of certain deductions, exemptions, and exclusions, including the reduction or removal of certain "perquisites."

It is fair to observe that the total set of criteria is in some respects self-contradictory, as for example the encouragement of investment and capital formation on the one hand and greater progressivity in the income tax structure on the other.

In reference to these stated criteria or premises, it is one thing to assert them but quite a different thing to define them and apply them and, in some instances as we have just pointed out, to reconcile them. We will deal with that in more detail later. We now turn to a statement of premises upon which the MAPI views on tax policy and on the President's recommendations are based.

The Foundation for MAPI Tax Policy and Related Recommendations

The central issue.--The federal tax system as a whole is skewed in a dangerous manner from the standpoint of the public interest toward consumption and against investment and capital formation. Relatively substantial action now and a continued program of action to correct this imbalance are critical. Capital formation, capital investment, increased productivity, and reward for excellence go to the heart of our economic system, and tax policy and administration should be formulated and administered accordingly.

Piecemeal tax policy formulation.--For an extended period of time MAPI has emphasized through appropriate government channels, and in communications to MAPI members, the business community in general, and the general public, the fact that American business and individual taxpayers have been "piecemealed to death" in the last year and in the current period by the Administration's recommendations bearing on the federal tax system. The massive tax increase involved in the social security legislation recently enacted, the tax aspects of the energy program proposed but not yet enacted, tax provisions recommended currently by the President in his message to the Congress, the significant "tax reforms" included in the 1976 Tax Reform Act and their implementation which is not yet complete, and tightened administrative rules and procedures of the Internal Revenue Service, which seem to represent an ongoing process, all must be examined together in order to develop intelligent and constructive tax recommendations and action. This overall approach has been followed only to a minimum degree, and the country will suffer unless a reconciliation of the various actions or recommendations I have referred to is realized.

Two examples, briefly stated, are in order. This Committee has recently held hearings on section 911 of the Internal Revenue Code as amended by the 1976 act involving taxation of Americans abroad. It was clear from the new proposal of the Treasury Department, as contrasted with the modifications to section 911 contained in the 1976 act, that the Administration, the Congress, and industry are painfully aware of the serious mistake represented by the 1976 modifications. The mistake in judgment and the tax impact from these modifications, which has been subject to legislative deferral, are discussed in more detail in the definitive portion of this statement. An even more serious example of a failure to put all of the pieces of the current tax proposals, recommendations, and actions on the table for examination in an interrelating manner and measurement of their total impact was the enactment of the Social Security Financing Amendments of 1977. This is believed to be the largest tax enactment in the history of the U.S. involving something like $230 billion in new taxes over a period of time. It is our understanding that the Congress has heard from the people in almost an unprecedented manner, protesting the incredible impact and burden created by these amendments over the years covered. Moreover, it appears that the reaction of the country has not been orchestrated; indeed, it has been spontaneous.

This reaction has resulted in consideration by the Ways and Means Committee on March 1 of a possible rollback in the social security tax increases previously legislated and although the preliminary vote, which was very close, did not call for such a rollback the issue is by no means dead. Proposed legislation has also been introduced on a bi-partisan basis which would call for a rollback. Because of the failure of the Administration to put the pieces together as I have described the process, the President has been placed in the position of having to try to compensate through parts of his current tax recommendations by tax reductions which he has said would help offset the impact created by the social security amendments. Unfortunately, although he has stated a recognition of this need, his proposals in the current tax package--particularly in the personal income tax structure--hardly make a dent in the impact of the social security amendments as you move up the income scale and as you take corporate taxes into consideration.

Severe impact of inflation.--Another premise upon which the Institute's views and recommendations are based is the overriding importance of recognizing the impact of inflation on tax policy and on corporate profits, depreciation, capital gains, etc.

Over the last two to three years, the Institute has published an extensive series of studies dealing with capital formation, "real profits," and the impact of inflation and related accounting and tax issues. A listing of these studies is attached together with copies of two key economic commentaries entitled "Corporate Earning Power in the 70s: A Disaster" and "Inflation and Profits," most recently revised in April 1977. These documents are submitted as a part of this statement for the record.

With due respect, we believe that the President's program gives no more than lip service to this impact. He refers to it in his recent economic message, and properly so, in terms of the effect of inflation forcing individuals into higher income tax brackets. The effect, of course, is double-edged because at the same time that individuals are forced into higher tax brackets by inflation, their real income is directly reduced by inflation. Moreover, inflation in the tax area has other deadly effects which have been documented by MAPI through the series of economic studies previously referred to.

Another example is in order which we shall develop in more detail subsequently. We refer to the impact of inflation on capital gains, which is treated to some extent in the President's recommendations, although the Administration has at least for the time being abandoned the notion of phasing out the capital gains treatment which has been long standing in the U.S. Code. It would be quite unfair to conclude that the President, the Administration, and the Congress are not at all concerned about inflation. Unfortunately, however, the President's tax recommendations do not reflect to any significant degree the inflationary impact. As to the dead hand of inflation on tax policy, profits, capital gains, etc., we are left almost entirely with rhetoric.

Further progressivity.--The federal tax system, as we have already pointed out, discriminates strongly in favor of consumption versus investment. As we have stated previously, our tax system is progressive, and the President has committed himself to a further escalation of progressivity. To this we take strong objection and our detailed comments will so reflect it. Moreover, implicit in certain of the President's recommendations is the goal of further redistribution of the wealth, and that same goal is central to the social security amendments of 1977 as well as to much of the President's current tax package. The President admits to an objective of further progressivity but is not so candid about the fact of the Administration's movement toward further redistribution of the wealth, both of which are related.

The redistribution of the wealth is being accomplished by a number of means, principally by the so-called transfer payments which make up the largest item in the federal budget. Those who pay in taxes for the transfer payments fall in the category of persons in good health who are working as contrasted with those who are considered to be "poor," the definition of which has moved up almost annually; those who are not poor but are not obliged to pay taxes; and those who are retired without significant taxable income. As David Brinkley, NBC's outstanding commentator, said in a recent broadcast, the persons who are contributing taxes to support the transfer payment system of this country receive no such transfer payments, only tax bills. They have not yet fully awakened to the load which they are carrying. And the situation is aggravated by the persistent trend toward removing individuals from the tax rolls even though they may not be poor but have been previously in lower income tax brackets.

Overriding need for personal income tax relief.--This brings us to a premise about which we feel most strongly. Although the Institute represents and is national spokesman for a very major sector of American business, namely, capital goods and allied products, we try to concern ourselves with national issues which affect the economy as a whole and the economic health of this country. If we were asked to single out one paramount need in the tax field--not to exclude the need for other vital moves to which we have already referred or will refer--our response would be major tax reform in the personal income tax structure to reduce what amounts to almost confiscatory taxation of middle income taxpayers, as broadly defined, in the light of inflation and the punitive nature of tax policy at all levels of government. This problem, of course, is not being faced up to by the Administration's tax proposals. Indeed, candidly, the President and other Administration spokesmen declare their objective to make it worse in terms of achieving further progressivity.

The notion of putting a very low ceiling on reduction in personal income tax rates in terms of annual income is ridiculous. Individuals, and families where two or more adults are employed, whose income reaches into the $30,000, $40,000, or even $50,000 brackets before federal, state, and local taxes are suffering a penalty under our present tax structure which is harshly burdensome and--if you wish to apply the concept of equity which the President lists among his criteria--totally unjustified. It is my considered judgment that the strong reaction by American taxpayers, primarily individuals, to the 1977 social security amendments is a symptom and a precursor of more to come from those individuals who are carrying, insofar as the personal income tax structure is concerned, such a heavy load.

To compound this gross inequity, these people are not properly represented in government forums. Their views, their pains, and their heavy burdens are not articulated before you in an adequate fashion, and this is also true in the states and in the counties. In drawing this conclusion or premise, I do not wish to abdicate my responsibility in behalf of the Institute as to other essential changes in our tax system. For example, we are strong advocates of the investment tax credit which MAPI has championed since the period when it was conceived, namely, the pre-inauguration planning of President-elect John F. Kennedy; significant reduction in the corporate rates; improvement in capital recovery allowances including the investment tax credit and other techniques; etc.

<u>State and local taxes</u>.--Another criterion which MAPI espouses is that federal tax policy should not be made in a vacuum insofar as the tax impact of state and local income taxes are concerned. In addition to the strong reaction to the social security amendments of 1977, there is a tide running in the country which is thoroughly documented in the press and in various state and local forums. This tide relates to the dramatically excessive burden of state and county real estate taxes. When the Administration and the Congress assess the soundness and the practicality of modifications in the federal tax structure, there is a duty to look at the total tax burden of American taxpayers, both individual and corporate, including state and local taxes of various types. When this burden is properly assessed in the aggregate, what I have said previously becomes even more valid, namely, that individual taxpayers in the $30,000, $40,000, and $50,000 brackets, when examined on an after-tax basis, are carrying extreme and unjustifiable burdens aggravated by inflation. As more relief is provided for very low income tax brackets and individuals in larger numbers are taken off the tax rolls altogether, it will be even more difficult to find a broader base than the people who are carrying so much of the tax burden in this country at the present time.

This brings me to a general comment regarding recommendations contained in the Administration's tax package on the proposed removal of the deductibility for federal tax purposes of state sales, gasoline, and personal property taxes. A travesty this would be and, from the standpoint of the economy, a most counterproductive move.

<u>Capital recovery of mandated expenditures for social programs</u>.--Another MAPI premise which is a bit more definitive: In this complex economic environment of the current period, and more particularly as we

wrestle as a country with many social goals as well as attempting to maintain a strong economy and our national security, sometimes we miss the forest for the trees. I refer to the critical need for increased capital recovery of mandated expenditures for environmental, safety, and similar purposes. It is fair to say that the present law makes a pass at providing some relief in this area, and the President's current recommendations include limited additional assistance from a tax standpoint.

I have no fundamental quarrel with objectives or the merits of federal and state programs of this type. On the other hand, as we point out in more detail in the detailed section of our statement, the billions of dollars which are involved at the federal level alone in meeting these requirements represent a siphoning off of funds which would be otherwise available for modernization and expansion of economic productive facilities. The objective which we urge is that the capital cost recovery system for such expenditures be as close to expensing as our budget, revenue loss, and other considerations permit. Neither the Executive Branch nor the Congress, and this applies not to this Administration alone, has fully come to grips with this problem. A sound program of solution is long overdue as we shall discuss in more detail later.

<u>Tax policy and "petty reforms"</u>.--Continuing to speak in general terms, we comment briefly at this point on a number of provisions recommended by the President in his tax package which verge on what I take the liberty of designating as "petty" suggestions. Without belaboring the point in this introduction, to even contemplate the possibility of having the difference between coach fare and first class fare for business travel be denied deductibility cries out for a stronger characterization than "petty." We have no plans to make a big issue about certain aspects of the disallowance of business entertaining expenses. I suspect that you will hear on certain of these matters from affected labor unions, restauranteurs, etc. But we do have the feeling that "symbolism" and "puritanism" may have their merits but they also are an open invitation to be "small." This is particularly true where under present rules a legitimate business purpose is established, is provable, and is not challenged by the vigilant type audit to which corporations and many corporate executives and other individuals are subjected. As you will observe from our detailed statement, we will not spend much time in this area, but I do not feel that I would be fully responsive to the Committee in terms of its desire to receive comments on the total tax package recommended to you by the President if we ignored these provisions completely.

<u>Preoccupation with rescinding deductions</u>.--Again referring to a rather general premise, we are troubled by the overreaching search in the Administration's tax recommendations for removal of various deductions or substantial modification of deductions. In theory, it is not too difficult to subscribe to the proposition that if the rate structure for individuals and corporations comes down substantially, there will be an opportunity for eliminating or modifying a wide range of deductions

which are included in the Code at the present time in order to provide some breathing space from the punitive impact of the total tax system. However, we do not see in the President's tax package any such substantial decreases in the rate structure, although at least as to the corporate side we commend the direction being undertaken. Hence, our reaction is very negative to the tightening of deductibility for medical and casualty losses; to the further tightening in the minimum tax; to the removal of the alternative computation privilege on capital gains; to the conversion of personal deductions to tax credits, creating further progressivity in the individual tax structure; to the elimination of the $5,000 death benefit exclusion, etc.

Foreign source income taxation.--The Institute has a clear and, we believe, sound premise which should govern taxation of foreign source income. We reject the premise of the Administration package that something is fundamentally wrong with tax assistance provisions for exports and tax deferral for unrepatriated earnings from U.S. foreign direct investment. The Administration's concept as to the latter is that there should be preserved in the tax system in the United States tax neutrality between treatment of income earned domestically and income earned abroad. This premise is faulty for the single reason that any tax policy has to be examined in relation to the real world of economic facts which are involved. The United States is committed to a strong world trade posture, and I sincerely believe that this commitment is governmental as well as private. As a general proposition, this is not disputable. The problem arises when government policy embraces the general concept of staking out and maintaining for the U.S. a strong world trade posture and then proceeds to attack it in practice. The sound premise, the one which we advocate and adhere to, is that U.S. foreign direct investment and related tax policy must be competitive abroad with competitor nations. Thus, the neutrality concept between U.S. source and foreign source income is neither appropriate nor sensible. There is a further rationalization which some of the advocates of destroying deferral treatment employ, namely, that deferral is "simply an export of jobs." We will deal with this subject later, but to call this notion simplistic and unreal is about as charitable as an experienced observer can be.

With regard to DISC, which is the principal export assistance tax program addressed by the President, once again the real premise should be competitiveness of U.S. products in world markets. It is difficult to find a single important competitor nation in world trade which does not provide many more techniques and devices, some on the table and some not, to assist their exporting industry. Why should we give up or continue to erode DISC, established and working in behalf of American exporting industries? Discussed in more detail later is the DISC relationship to job creation and maintenance.

Application of the Administration's Premises

At this point in our prefatory comments, we discuss the application of some of the premises of the Administration for their specific recommendations. Equity: There is little equity in our personal income tax structure and even less embodied in the structure of recommendations for reduction in personal income taxes as recommended by the President. Simplification: This concept is so overworked as a rationale for certain of the specific recommendations of the Administration that a perceptive analysis surfaces strained and misleading argumentation. To deny a thoroughly justified deduction on the grounds of simplification is ridiculous. If a deduction has merit, the mechanics perhaps can be simplified but deduction should not be denied solely on the grounds of simplification. Encouragement of investment: Certainly the changes in the investment tax credit, the proposed reductions in the corporate tax rate, and the recommendations as to small business are pro-investment and, as far as they go, we applaud them. But to eliminate the sum-of-the-digits option for the ADR system (incidentally, in the name of simplification); to kill deferral; to phase out DISC; to eliminate tax exempt industrial development bonds for pollution control facilities and industrial parks; to create more progressivism by the substitution of a personal credit for the personal deduction; and to reduce in the manner suggested itemized deductions are hardly supportive of investment and capital formation. To espouse taxing a dollar only once and yet recommend elimination of the deductibility of certain state taxes creates rather than eliminates double taxation, at least in a broad sense.

Thus, we find ourselves in the position of disbelief that a program of taxation can be triggered by a statement of lofty goals, followed by misapplication of those goals so as to create perverse effects rather than genuine achievement of the goals.

A Caveat

To conclude these introductory comments, we wish to enter a caveat, suggested briefly at an earlier point in this statement. Our reaction to the President's recommendations is clearly mixed. With respect to "tax reforms" suggested, it represents a somewhat toned down series of recommendations versus those espoused during the campaign and to some extent during the formative period of the President's tax proposals. There is in some respects recognition of the importance of capital formation and capital investment, a recognition which we must applaud as indicated at the beginning of this statement. Unfortunately, however, these pluses are substantially or more than offset by the other provisions to which we have taken objection in brief comments as related to certain fundamental premises, the President's and ours.

We leave the Committee, I am sure, with some feeling that we support the pro-business portions and to a limited extent, for the reasons indicated, those portions of the individual tax recommendations which relate to reduction in rates. However, we are quite negative as to most of the so-called revision or reform recommendations, and we abhor the acknowledged effort toward more progressivity in the individual tax structure.

This position in an overall sense is not taken lightly. We believe, however, that the result of rejecting certain tax recommendations, which theoretically would produce increased revenues and improve on pro-investment and pro-capital formation suggestions, would in the short and longer term--based on prior experience--produce a favorable effect on tax revenues even though that effect might not be immediate.

In addition, as we have previously pointed out, whatever may be the evaluation of the President's proposed budget and any reasonable expectation of congressional action, together we do not believe that they will approach the urgent need for a substantial--very substantial--reduction in government expenditures. These expenditures not only affect the ability of the Congress, at least in their view, to enact significant tax reductions, but they graphically reflect the escalating growth of federal government which creeps to state and local government enlargement. We are sympathetic with the concern expressed by the Chairman prior to these hearings and by other members of the Congress that we must introduce into our national goals a more disciplined and courageous restraint on expenditures. Further, we recognize the relationship between reduction in expenditures and enactment of tax changes and reductions which may have some negative effect, hopefully temporary, on tax revenues. This is not an easy problem, but we must make a start and the President's total package, looking at it in perspective, does not do the job in our considered opinion.

Congressional Response to the President's Recommendations

Finally, under no circumstances do we accept the proposition, which I think political realities have already rejected, that the "goodies" in the tax package cannot be afforded unless the "balance" of tax raising reforms are adopted in terms of the specifics recommended. The Congress can fashion a sensible, responsible and, on the whole, affirmative tax bill on its own. Moreover, I am confident that such a bill, although it will represent what the President may feel is a radical surgical procedure on his recommendations, will be signed by the President.

Definitive Comments and Recommendations

Having laid a proper foundation, we offer detailed comments and recommendations.

Capital Formation

Investment credit.--The Administration has proposed to make the investment credit permanent at 10 percent; to extend the credit to industrial structures; to change the credit limitation to become 90 percent of tax liability in any taxable year; and to allow a full 10 percent credit for pollution abatement facilities which qualify for 60-month amortization.

We agree with all the changes proposed for the investment credit, except that we recommend an enlargement of capital recovery allowances for federal mandated expenditures for pollution abatement facilities, new safety facilities, and similar noneconomic capital expenditures. We treat this matter in more detail in a separate section.

As we have contended for many years, the credit should be permanent so that businesses can plan on it on a long-range basis. Also, it is important that there not be disruptive artificial distortions of investment activity caused by changes in the credit level in attempts to manage the economy. The Institute has repeatedly documented the fact that the credit is not a desirable tool of countercyclical policy, and the record of efforts to use it for that purpose bears this out./1

Regarding investment credits for industrial structures, MAPI has consistently advocated this and applauds the Administration for its initiative in proposing such a change. It is conceded that investment by business in "bricks and mortar" has been lagging, whereas it is important to the achievement of our economic goals to have modern and more efficient plant as well as new equipment. An administrative benefit of the change would be to end much of the IRS-taxpayer wrangling about what is or is not "section 38" property. Extension of the credit as proposed should facilitate a worthwhile reallocation of resources, and we endorse the idea to the extent of net new incentive for plant investment. We do not agree that this change should be partly counterbalanced by the elimination of 150 percent declining balance depreciation for affected realty, as discussed elsewhere herein.

As to the increase in limitation, from all of the first $25,000 of taxes and 50 percent of taxes due above $25,000, to 90 percent of taxes across-the-board, we generally agree with the idea, for the reasons cited by the Treasury Department. The changes will increase the credit and its availability for many taxpayers and reduce the need for carryovers, thereby adding to financial support and simplification at the same time. Although we do not object strongly to cutting off the credit at 90 percent of liability, we do not agree with the reasoning to the effect that no taxpayer should be able to offset all liability using a "preference." This is the

1/ See, e.g., "The Investment Tax Credit as an Economic Control Device--Revisited," Capital Goods Review No. 92, MAPI, May 1973; and "The Investment Credit as an Economic Control Device," Capital Goods Review same thinking upon which the minimum tax is predicated, and the minimum tax is one of the worst-conceived instruments of taxation in the Code, as we have repeatedly indicated in presenting views and recommendations to Congress.

Mandated capital spending.--In view of the broad interest in increased business investment to increase productivity and improve the United States' competitive position in world trade, comments about statutorily mandated capital spending are quite important. By referring to mandated expenditures, we have in mind, principally, amounts required to be spent on basically nonproductive facilities for compliance with environmental controls and rules in connection with occupational safety and health. Since the enactment of major federal legislation in these areas in the early 1970s, the business community has spent billions of dollars on the preservation and improvement of the natural and workplace environments, both voluntarily and in response to requirements imposed at all levels of government. These expenditures are continuing at a very high level.

Although there is little question about the overall desirability of these programs, they have become a significant competing demand for the limited resources available for plant and equipment. Indeed, because these programs involve mandated spending, they actually, to some extent, have displaced the productive investment needed to achieve the nation's economic goals. This displacement is continuing and may increase as the requirements themselves become more stringent, and as new programs come on stream in such unrelated areas as energy conversion and conservation.

To demonstrate the magnitudes involved, recent figures developed by McGraw-Hill indicate that pollution control spending has now risen to a point in excess of 7 percent of total plant and equipment expenditures. Also, employee safety and health investment now is running above 2 percent of total plant and equipment expenditures, and appears to be on the increase in both absolute and percentage terms. The following data compiled by McGraw-Hill is revealing:

I

Expenditures for Air, Water, and Solid Waste Pollution Control As a Percent of Total Plant and Equipment Expenditures

	(1) Pollution Control (Billions of $)	(2) Total Expenditures (Billions of $)	(1) ÷ (2) Pollution Control As a Percent of Total (Percent)
1976 (Actual)	8.54	120.5	7.1
1977 (Estimated)*	9.76	137.0	7.1
1980 (Planned)	10.41	162.4	

II
Employee Safety and Health Investment As a Percent of Total Plant and Equipment Expenditures

	(1) Safety and Health Investment (Billions of $)	(2) Total Expenditures (Billions of $)	(1) ÷ (2) Safety and Health Investment As a Percent of Total (Percent)
1976 (Actual)	2.38	120.5	2.0
1977 (Estimated)*	2.89	137.0	2.1
1980 (Planned)	3.70	162.4	2.3

* Pollution control and safety and health expenditures for 1977 reported as "planned" by McGraw-Hill in survey issued in May 1977.

As borne out by the McGraw-Hill data above, expenditures for pollution control and occupational safety and health combined have reached nearly 10 percent of total plant and equipment spending. One effect has been to displace some amount of capital spending otherwise destined for productive fixed investment, as already noted, because the resources for that purpose--like most others--are limited. Another consequence of mandated expenditures which has received attention recently/1 has been to adversely affect output per unit of input, thereby further reducing the ability of business to generate resources for expenditures of any kind. According to the study just cited, new or increased requirements for pollution control and occupational safety and health, along with a rise in dishonesty and crime, have increasingly been reducing the growth rate in output per unit of input by very substantial amounts.

Our mention of these facts and data is relevant to the questions whether, how, and in what amounts to divert federal revenues to spur investment, including relief to be granted in the case of mandated expenditures. As our comments to follow will indicate, we feel rather strongly that the public commitment to a clean and safe natural and workplace environment, aimed at meeting high standards within a limited time frame, dictates that there be some public sharing of the costs involved. The federal income tax law is one medium through which such sharing can be achieved without major additional involvement by government itself in private decisions concerning mandated investment. Our position concerning tax relief in this area--which relief, in turn, should free resources for productive investment--is that cost recovery should be as fast as government can allow within budgetary constraints because the outlays are, by and large, a "dead weight" claim on assets and generate no significant revenue stream of their own.

1/ See "Effects of Selected Changes in the Institutional and Human Environment Upon Output Per Unit of Input," by Edward F. Denison of The Brookings Institution in Survey of Current Business, U.S. Department of Commerce, January 1978.

Furthermore, the qualification requirements should be as simple as possible consistent with protection of the revenues.

Regarding the investment tax credit, we see a definite benefit in allowing a full 10 percent credit for pollution abatement facilities also eligible for 60-month amortization. The one-half credit allowance enacted in 1976 for these facilities still does not make rapid amortization competitive with ADR depreciation plus a full investment credit, and the Administration's proposal would improve on the situation. As we have mentioned, pollution control outlays mandated by law now are a substantial part of total capital spending by manufacturers. These outlays do not contribute significantly to production, but do siphon away the funds available for equipment that does.

On a related point, we believe that Congress should review Code section 169, on rapid amortization of pollution control facilities, with a view to simplifying the certification procedures. If a taxpayer must become mired in bureaucratic "red tape" and redundant administrative procedures in order to use rapid amortization, then he may choose to avoid it, even if the resulting cash flow is improved by the extra increment of credit. This would be most unfortunate, and we urge the Committee to do what it can to streamline this area of administration by the cognizant agencies.

Concluding on this matter of certification, we recognize that there was some liberalization accomplished by the Tax Reform Act of 1976. However, we are concerned by the condition that pollution abatement facilities not lead to a "significant" increase in output of capacity; a "significant" extension of useful life; a "significant" reduction in total operating costs; or a "significant" alteration in the nature of a production process or facility. The test of significance is a change of 5 percent, which seems to us to leave very little margin for error. As we see it, a taxpayer faced with these burdensome expenditures should not be denied relief simply because of a relatively minor change in his circumstances which results from the addition of an abatement facility. Accordingly, we recommend that the test of significance be raised substantially. Any favorable "fall out" of investment in pollution control facilities should be welcomed, not penalized.

In another initiative, the Administration proposes to eliminate tax-exempt industrial development bonds (IDB) for pollution control facilities. As we see it, Treasury's reasoning in support of this proposal is weak, and loses sight of the need for exempt financing in this area. The Revenue and Expenditure Control Act of 1968 authorized this form of financing because it had become perfectly clear at that time that the federal government would become deeply involved in the environmental clean-up effort. As the Committee knows, the controls eventually put in place by means of the Clean Air Act Amendments of 1970 and the Federal Water Pollution Control Act of 1972 brought about some of the largest programs of relatively nonproductive capital spending ever required of private industry by government. These programs will continue and be intensified under schedules and deadlines set forth in the relevant statutes.

In view of the obvious public interest in having a relatively clean environment and in having basic industries with pollution problems remain competitive and profitable, it stands to reason that there must be some sharing of the costs of environmental clean-up. Exempt financing is one way Congress has approved to achieve this sharing, and we commend the Administration for its current initiative to extend a full investment tax credit to pollution abatement equipment which qualifies for rapid amortization. However, we do not believe that the investment credit proposal eliminates the need for exempt financing, even if our additional recommendation as to five-year amortization to ease up on the certification and qualification requirements is accepted.

Regarding Treasury's objections to IDBs for pollution control, we believe that the so-called "tax equity" argument is irrelevant if Congress decides that revenues should be yielded for this purpose. Also, we certainly have not heard any outcry of taxpayers that IDBs for pollution control are unfair. As to the alleged "economic" inefficiencies whereby exemption is said to encourage the "wrong types" of investment in pollution control equipment and to subsidize some industries relative to others, (1) the contention about "wrong types" of investment appears to be an unsubstantiated charge; and (2) there is nothing in the current law that restricts the access of any industry to this form of exempt financing.

With respect to the alleged higher costs of financing for state and local governments, we simply cannot take such a charge seriously when pollution control IDBs are only 6.6 percent of the tax-exempt market in dollar terms and have been declining almost steadily as a percentage of the total exempt market since 1973. Further on this point, Treasury surely is aware that general obligation bonds do not compete head-to-head for capital against IDBs. Moreover, if municipalities have been experiencing higher borrowing costs lately, it is no wonder inasmuch as short- and long-term rates for nearly all borrowers have been rising for nearly the last year. Also, any problem peculiar to municipalities may well be of their own making if their financial conditions are not sound. The market has, of course, become somewhat more cautious in the wake of difficulties experienced by certain local governments in establishing and maintaining their credit.

In sum, we urge the Committee to leave the IDB pollution control provision as it is for the reasons set forth above.

<u>Corporate tax rate reductions</u>.--The Administration has proposed to reduce corporate taxes from 20 percent to 18 percent on the first $25,000 of taxable income; from 22 percent to 20 percent on the second $25,000 of taxable income; and from 48 percent to 45 percent on taxable income above these levels, dropping to 44 percent after 1979.

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We agree with this proposed change because (1) it is a simple and straightforward method of reducing the tax burden for incorporated businesses; (2) nearly all corporations would derive some benefit from the tax cuts; and (3) as Treasury is aware, some corporate rate cuts should be instituted to parallel the planned rate cuts for individuals, in order to prevent some displacement of capital away from corporate investment. Congress should reject the contentions of some in its ranks that these proposed cuts are unwarranted due to low effective rates already allegedly experienced by business. As repeatedly pointed out by expert independent commentators, there is at least one annual study of this subject that seriously misstates the corporate tax burden by failing to consider foreign income taxes which have been paid or accrued and duly credited against U.S. liability.

We further agree with the Administration that the corporate rate cuts alone are not enough to spur fixed investment and should be coupled with other provisions specifically designed for that purpose. Also, we concur in the judgment that the rate cuts should be permanent. Finally, as pointed out in the Introduction to this statement, particularly when inflation is taken into consideration, further rate reductions or direct inflation adjustments will be necessary to offset taxation of unreal profits. However, since we are dealing with a limited package and revenue considerations must be weighed, timing of this further and critically necessary action is to be deferred in the absence of massive reductions in government spending.

"Simplifying ADR".--The Administration proposes to "simplify" the ADR system by (1) disregarding salvage value; (2) requiring use of the half-year convention; (3) eliminating the sum-of-the-years' digits (SYD) depreciation method; and (4) eliminating the annual reporting requirements but requiring taxpayers to answer survey questionnaires sent out from time to time with respect to their assets.

We concede that steps (1) and (2) above will accomplish bona fide simplification and perhaps (4) as well. Our only strong objection here is to the planned elimination of SYD depreciation and the option to use SYD in combination with the double-declining-balance (DDB) method. For many taxpayers, this change represents a sizable immediate and growing increase in tax liabilities. Inasmuch as users of SYD and the DDB-SYD combination understand what they are doing and have no trouble with it, there is no need for this "simplification" from their vantage point. Nor can we believe that IRS is incapable of understanding the simple arithmetic involved in this approach. For taxpayers who like the even simpler DDB and straight-line methods, they already have the option.

The only valid justification for eliminating SYD and DDB-SYD in combination, thereby raising taxes, would be to demonstrate that these methods do not approximate the run-off of service life of the assets for which they are used under current conditions plus an appropriate element of incentive. We doubt that this can be shown, and note that Treasury has not even attempted it. Both the ADR lives and the SYD and DDB-SYD combination depreciation methods help taxpayers to gain some relief from the debilitating effects of inflation on capital cost recovery using a historical cost basis. It is very untimely of Treasury to propose elimination of the SYD option, and we seriously question whether the only purpose is simplification.

Treasury estimates that its ADR proposal would have a negligible effect on tax liabilities. We disagree, based on comments to us by corporate taxpayers about the planned SYD change, and we urge that the item be dropped if the Administration really is interested in fixed investment and proper measures to induce and support capital formation. If SYD is to be eliminated and simplification genuinely is the only reason for taking that step, then we urge that DDB depreciation be increased to provide cost recovery in timing and amounts approximately equivalent to that under the DDB-SYD combination, or to a greater degree if considered appropriate.

Small business.--The Administration's tax proposal would allow, for small business, a special simplified depreciation system like the Asset Depreciation Range (ADR) system; liberalize the tax concessions for losses on small business investments; and ease the "subchapter S" rules.

We generally concur in the tax law changes proposed for small business. First, if small businesses have had inhibitions about use of the ADR system, then it is important that a simplified system be made available for their use. We assume, although the Treasury explanation is not entirely clear on this point, that the asset classes, guideline lives, and depreciation ranges for small businesses would be roughly the same as those in ADR itself. As to "subchapter S," we have no comment except to express our support for increased eligibility and liberalization of the loss rules. Regarding losses on small business investments, the liberalization proposed by the Administration for Code section 1244 is in order and our only question is whether the Committee could not move in a more aggressive way on behalf of venture capital.

Small-issue industrial development bonds.--Here, the Administration proposes to raise the small issue IDB exemption to $10 million but limit its use to "economically distressed" areas.

We endorse the idea of raising the small issue exemption, but frankly do not know why the use of these bonds should be restricted. These IDBs still serve their original purpose of facilitating industrial development even if most states now authorize them. If anything, the tax factor in plant siting has become less important with the spread of IDBs, but still gives an important assist to the financing of business facilities. We note further that the growth in nonpollution control IDB financings has been modest and could not be said to present any serious problem of revenue loss. If small-issue IDBs are directed only to "economically distressed" areas, they seem likely to be less useful to both businesses and local governments. Furthermore, a government agency will have to administer the provision to determine area eligibility, at some added cost and complication to everyone concerned.

In short, we urge the Committee to reconsider the IDB small-issue matter in respect of area eligibility and leave things as they are.

Foreign Source Income

Terminating "deferral".--The Administration proposes to impose current U.S. federal income taxes on unremitted earnings of controlled foreign corporations (CFC) by eliminating so-called "deferral" in three steps with full current taxation to begin in 1981. Losses of a CFC would be allowed to offset the U.S. source income of the shareholder. Also, foreign taxes of a CFC would be treated as imposed on the U.S. shareholder and be taken into account currently for foreign tax credit (FTC) purposes. The Treasury Department would be authorized to negotiate treaties in appropriate cases to provide that U.S. shareholders will not be taxed currently on certain CFC income from a treaty country.

On several other points, the Administration says that it will discourage discriminatory foreign taxes aimed at "soaking up" the difference between a foreign country's rate and that of the United States. This would be done by denying to the U.S. shareholder any FTC on the discriminatory tax. A concession to the current-taxation rule apparently would be made for "blocked" currency or other restrictions on remittance, but not if the restrictions apply solely to U.S. shareholders or are imposed solely on a shareholder-by-shareholder basis.

This proposal is potentially the most dangerous one in the Administration's package. The very caption, "Terminating Deferral," is pejorative and implies that the U.S. Government has a right to tax unremitted CFC income, whereas the proposal to do so is a radical departure from worldwide norms of taxing jurisdiction. Also, the proposal is transparently and unwisely protectionist in its orientation and purpose because it is partially intended to boost domestic investment and domestic tax revenues, whereas neither effect is likely to flow from the action contemplated. Moreover, the charge that "deferral" exports jobs is simplistic and specious.

To worsen matters, the Treasury Department (1) again waves the banner of "tax simplification" as a reason for such a change; (2) alleges that small companies will be able to do better against giant multinationals because small outfits do not invest much abroad and get the benefit of "deferral"; (3) suggests that there will not be any significant competitive effects; (4) implies confidently that low-tax countries will not attempt to preempt the revenue involved; (5) optimistically indicates that developing countries will beat a path to the Treasury's door to negotiate treaties with favorable concessions; and (6) states that it will deter discriminatory taxes and discriminatory restrictions on remittance by denying benefits to the taxpayer.

We think that the fatal error of this proposal lies in unilaterally imposing a tax burden on U.S. business which is not similarly imposed on its foreign-based competitors. There can be only one sure consequence of such an exercise, and that is that the U.S.-based taxpayer will come away from the experience relatively less competitive than before. Where a U.S.-based company can survive in a market only by manufacturing in the same low-tax jurisdiction in which all of its foreign-based competitors operate, the current tax proposal may, in fact, put the company out of business or out of certain product lines. As previously indicated, such a company will not bring the lost manufacturing jobs back to the United States, as is popularly supposed by the labor movement. Also, the related U.S. distribution and marketing employment related to the foreign-made goods will be lost, as will the jobs for U.S. manufacturing of components, subassemblies, and related goods which either go into or depend on the "foreign made" end product.

In ignoring this and in suggesting that the investment will be relocated stateside in other industries, we think Treasury is using non-sequiturs and bald speculation about both the impacts of this change and the behavior so induced. Indeed, Treasury even predicts a mild stimulus from this action it would take notwithstanding that it is adverse to many business taxpayers while directly benefiting none. Further, we think Treasury is internally inconsistent in part of its arguments for current taxation and against DISC. In questioning that DISC creates domestic employment, Treasury contends that one cannot be sure because he must translate the impact of DISC on the balance of trade into an impact on employment and then measure the labor intensity of exports versus imports. As if the "jobs" question were self-evident with "deferral," the Administration simply concludes that "deferral" exports jobs and gives no consideration at all to the domestic employment related to foreign investment.

We note Treasury's allegation that "deferral" discourages the repatriation of profits which would help domestic investment. The fact of the matter is that income from foreign investment is returned to the United States in very significant amounts. As demonstrated in an update of a MAPI study/1 soon to be published, U.S. direct investment abroad has been the single most important factor in reducing our balance-of-payments deficits over the past 15 years. For example, the surplus generated by such investment, which surplus averaged $1.8 billion per year during 1960-62, had risen by 1975-77 to an annual average of $8.4 billion. Moreover, in the period 1975-76, remittances as a percentage of U.S. earnings abroad ran at an annual average rate of nearly 56 percent, a pace which has not been at all unusual over the period from 1966 to 1976 and has often been exceeded.

Clearly, the remitted earnings from U.S. foreign direct investment--which, as just demonstrated, are high both in absolute amounts and in terms of payout percentage--benefit the domestic economy. More specifically, they help create jobs and support critical activities of the

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1/ The study being updated is entitled "The Favorable Impact of Direct Investments Abroad on the U.S. Balance of Payments--Spending More To Get More," Capital Goods Review No. 103, MAPI, June 1976.

corporate sector in the United States, including research and development, and various socioeconomic programs such as pollution abatement and improvement in occupational safety and health. Of course, too, these remittances, which rose from an annual average $3.4 billion in 1960-62 to $14.3 billion in 1975-77, generate substantial amounts of tax revenue in this country. In that connection, we would add that taxes on actual dividends make more sense to us than taxes on deemed dividends, if only because they are less likely to cause cash-flow embarrassment to the shareholder.

Further on "deferral" and remittances, deferral can truly be said to discourage repatriation of profits only if it can be known that profits would exist from foreign investment and be repatriated in the absence of deferral. Obviously, deferral discourages nothing in the case of profits from high-tax jurisdictions. In the case of low-taxed investments, situated where they are because of competitive factors, it is not valid to assume that profitable operations would continue or do nearly as well if deferral were terminated. Furthermore, decisions on repatriation of profits are not mainly tax-oriented even though good sense dictates that tax factors be considered.

On a final point, we object to Treasury's proposal to penalize taxpayers for actions of foreign governments which result in "soak up" taxes or blocked income on a discriminatory basis. As we see it, this is government-to-government business, even if no treaties are in effect, and the U.S.-based foreign investor should not be made a pawn in a dispute which it did not cause and cannot resolve. The entire "deferral" proposal is presented by Treasury with an unjustified attitude of hostility toward U.S. foreign investment, and the punitive intent shows through in provisions such as these.

DISC.--Domestic International Sales Corporations (DISC) would be phased out over a three-year period beginning in 1979 and ending in 1981. The phase-out would be accomplished by increasing the deemed distribution from the present 50 percent of profits attributable to incremental exports, to 66 2/3 percent for taxable years ending in 1979, to 83 1/3 percent in 1980, and to 100 percent (i.e., DISC repeal) after 1980. Accumulated past earnings of a DISC would continue to be tax-deferred as long as they remain invested in export-related assets.

We disagree with DISC repeal because we believe that the incentive contributes to export activity and domestic employment. Obviously, different persons reach different conclusions as to the extent of export activity and domestic jobs attributable to DISC because it is not easy to measure these effects and their causes in isolation. However, the undeniable fact is that DISC enhances the return on export activity beyond what it would be in the absence of the incentive. Under normal circumstances, the more attractive return should yield more of the business activity so favored and that, in turn, should result in additional employment.

If DISC is less potent than it could be, then Congress must recognize that the 1976 Tax Reform Act is part of the reason. On the other hand, the 1976 changes made the incentive incremental to satisfy those who did not want to subsidize activity that would occur with or without a subsidy. Consequently, those who wished to refine DISC in 1976 and were given their way should not be heard to complain now that the incentive does not work as efficiently as it should. Indeed, they could perhaps more constructively work for a larger deferral for incremental exports rather than none at all.

In our opinion, the timing of the repeal proposal could not be worse. This country now is suffering the worst trade deficit in its history, totaling $26.72 billion for 1977. Along with this, the U.S. dollar has been skidding to new lows against the value of other major currencies, with disruptive consequences here and abroad because of it all. If Congress is going to curb export incentives then it might better do so at a time of balance-of-payments surplus. Also, although we certainly do not object to the contemplated increases in Eximbank aid--indeed, we favor them--the boosts for Eximbank do not require elimination of DISC. Indeed, many major trading nations use tax incentives for exports along with loan subsidies. Evidently, they do not view the two approaches as substitutes for one another.

We should note, in that connection, that the elimination of DISC on a unilateral basis would not cause other countries to abandon their tax subsidies for exports. In fact, its repeal would deprive the U.S. Special Trade Representative of an item that otherwise could be bargained away in multilateral trade negotiations in return for other similar concessions. Considering that DISC was enacted in part as a response to such measures as foreign value-added-tax export rebates which give foreign exporters an obvious "edge" over our own, one wonders why Congress would abandon it without an appropriate quid pro quo, at the minimum. Our trading partners must be mystified by these proposed actions of self-denial. We note further that, in a recent television interview, Ambassador Strauss indicated that he personally opposes repeal of DISC.

For those persons who contend that flexible exchange rates have made an anachronism of DISC, we do not wholly agree. Although dollar devaluation is a very important factor in causing U.S. exports to become or remain competitive, exchange rates and export markets obviously are not in a "one to one" relationship because of structural considerations and all kinds of government intervention to delay, dampen, or defeat the consequences of relative exchange rate movement. Clearly, if there were a pure "float" of exchange rates, if there were no existing tariff and nontariff barriers to trade, and if export markets responded directly and perfectly to shifting currency values, there would be no special reason to have export subsidies of any kind. The real world bears no resemblance to this, and the Administration must realize this because it has not--to our knowledge--yet proposed to eliminate Eximbank, the Commerce Department program of export promotion, and other programs of export aid.

Finally, if DISC is to be repealed, then we feel that deferred taxes should be forgiven unconditionally. We doubt that investments in export assets would be influenced in future years by a continuation of "strings" attached to the existing deferral. At the same time, any recapture of deferred taxes would be inequitable and burdensome. If DISC is to go, there should be a "clean break."

Income earned abroad.--We would be remiss if we did not take this opportunity to urge again that the Committee straighten out the intolerable situation which threatens U.S. citizens who earn income abroad. Our complete statement on this subject was presented to the Committee in public hearings held on February 23, 1978, and we wish to review a few salient points at this time.

Preliminarily, it seems clear that Congress, the Executive Branch, and affected industry and U.S. employees abroad agree that the 1976 amendments to section 911 were a serious blunder. The only action to be taken is to resolve differences as to the mechanics of a solution, which must be a substantial correction. But let us not have another hasty action which will be incomplete and/or counterproductive.

In connection with the 1976 amendments to section 911, the business community, including MAPI, forewarned all who would listen concerning the consequences, but the self-styled "tax reformers" knew better and had their way. According to Treasury's Acting Assistant Secretary Lubick in his testimony before this Committee on February 23, 1978, the 1976 changes would more than double the U.S. tax liability of Americans claiming section 911 in 1977 and the increase intensifies as income levels exceed $15,000. This is rather severe to say the least, and tax increases of such a magnitude should not come into being unintentionally.

As we see the matter, to summarize, the way to rectify this situation is to extend promptly the moratorium on the 1976 changes through 1978 with a mandate from Congress to the Treasury Department as to the direction and the outline of a solution. Then, before the end of the current Congress, there should be enacted further amendments to section 911. We favor returning to a general $20,000 - $25,000 exclusion, but to have it be increased to reflect inflation since 1964. If that is unacceptable, we would favor on a next-best basis a list of specific types of deductions, to include cost of living, housing, education, home leave, rest and recuperation, and other appropriate overseas allowances in reasonable amounts. We also favor a liberalization of the moving expense deductions; the provisions with respect to gain on sale of a principal residence; and the rules as they bear on lodging in camp-style facilities.

Finally on this issue, we reemphasize the need for the Committee to be deliberate and to act with care to achieve a full solution.

Taxation of Individuals

Individual rates.--Marginal tax rates would be reduced for all taxpayers, with the lowest rate decreased from 14 percent to 12 percent and the highest rate decreased from 70 percent to 68 percent.

Although there is an appearance of uniformity surrounding this proposed tax reduction because the rates would be dropped two points at the top and the bottom, the largest percentage reductions would be at the lowest income levels, the next at middle income levels, and the least at upper income levels. Indeed, if one were just to look at the two percentage point rate cuts at the bottom and at the top, we assume that far more revenue would be yielded at the bottom than at the top because the rate cut is over 14 percent at the bottom and is only 2.8 percent at the upper end. The rate cuts, then, are an integral part of the overall scheme to redistribute income downward, and what we are looking at is not tax reduction but "tax reform."

We do not object in principle to providing tax relief where it is needed most. However, above the poverty level, "need" becomes a relative thing. As we have repeatedly testified before this Committee in recent years, taxes on individuals at every level of government have risen to undesirably high levels and have become especially burdensome for middle-income individuals and families. Notwithstanding this, it seems that recent rounds of tax reductions have largely disregarded, or punished in a relative sense, this productive sector of the economy as if they could always be expected to fend for themselves.

In our opinion, it is high time that tax cuts for individuals were designed to reach across-the-board. We should remind the Committee that, because of inflation, individuals have increasingly been subjected to nonlegislated tax increases at progressively higher rates on amounts that do not even represent real increases in income. The effects of this are more severe at the relatively higher income levels, and we urge the Committee to structure its rate cuts with this in mind.

A start should be made now toward correcting these defects of the system, and a substantial restructuring of tax reductions should be undertaken as soon as possible. The so-called middle income tax brackets should be more realistically defined upwards. In our opinion, a taxpayer revolt is not too far away unless this is done. Even more importantly, on the merits and in line with this country's tradition of rewarding the deserving and those who strive to achieve, a higher level of performance should no longer be ignored or defied.

Personal tax credit.--The Administration has proposed that a personal tax credit of $240 replace both the $750 personal deduction and the general tax credit. For each exemption that a taxpayer is allowed under present law, he would be allowed a $240 personal credit.

As we see this proposed change, it would accomplish some simplification but do so in a way that is rather redistributive of income. We do not disagree with the idea of having simplification, but we are skeptical that, on this issue, simplification is the primary objective. More specifically, the act of eliminating the exemption in favor of a credit is part and parcel of the Administration's attack on exclusions, exemptions, and deductions, with which we generally do not agree.

It must be recognized that the current rate of income tax progressivity results from a combination of factors, including the structure of rates, exemptions, deductions, and credits. We firmly believe that, whatever the situation may be for persons in a position to "shelter" income from taxes, the average middle- or upper-middle income individual is already in a position of near tax confiscation. We think that changes such as have been proposed in the case of the personal exemption are most burdensome to middle-income families (properly defined) where the bite of progressive taxation already is severe. Moreover, with social security about to spiral sharply upward for these same individuals, the proposal to replace the exemption with a credit seems poorly timed.

Although some changes may be in order for the personal exemption-general credit, it would suffice for now to adjust the amounts for inflation. Also, on inflation, we think the Administration would do well to keep in mind--while pondering the inequities of the current system and proposing remedies--that the present arrangement (1) inappropriately taxes increases in income which are inflationary; and (2) as if to compound this impropriety, does so at the top marginal rates of the taxpayer.

On one final point, we do not feel that persons above the "poverty level" (as defined) should be removed from the tax rolls as a result of changes such as the one under consideration. It appears that this would occur to some extent under the Administration's proposals, and we recommend that the Committee evaluate the proposals for their performance in this respect and provide a detailed analysis of the same in any bill subsequently reported that purports to raise the taxation threshold.

Deduction for state and local taxes.--For individuals who itemize deductions, the Administration proposes to repeal the deductions for state sales taxes, gasoline taxes, and personal property taxes not associated with business. Also payments for unemployment disability fund taxes would not be deductible. Taxes relating to a business activity would be deductible, according to Treasury, "under normal tax accounting principles." State and local income and real property taxes generally would be deductible in the year paid or incurred. However, if the taxes relate to the acquisition of a capital asset, they would have to be capitalized.

It is saddening that while taxpayers--particularly in the middle incomes--are staggering under the weight of heavy federal, state, and local taxes aggravated by inflation, the Administration would repeal existing deductions. We, of course, understand that the amounts of tax increase associated with the repealed deductions would not be huge (this being a relative term, particularly in respect to sales taxes, which, on "big ticket" purchases, can be quite large), perhaps costing the average individual affected by them not more than a few hundred dollars per annum at the start. However, the justification for any such hikes seems weak in view of the existing situation; the fact that the provisions in question have been in the law for many years; and the ameliorative effects they do in fact have. Furthermore, the arguments presented by Treasury in favor of its proposals are not convincing to us.

As Treasury is aware, the deductions for all state and local taxes now covered, for persons who itemize, are intended to assure that the aggregate marginal rate of federal income taxes is not confiscatory. Although a federal income tax credit on a dollar-for-dollar basis would probably be more effective to prevent double-or-more taxation at successive levels of government, the deductions do manage to provide some amount of relief not only with respect to income taxes but also for other types of tax. If the deductions for sales, gas, and personal property taxes are repealed, the Administration will simply have worsened the duplicative taxing which the deductions are intended to avoid. Further, it should be remembered that most of these taxes have increased substantially since the deductions were first legislated, and that the state sales taxes have become very nearly universal and are at rather high levels.

Further as to sales taxes, they have become one of the most important mechanisms for financing government at the state level. The federal government certainly does the states no favor by, in effect, raising the cost of sales taxes to taxpayers. If it is the intent of the federal government to pressure states into increased reliance on income taxes and reduced reliance on sales taxes, then that intent should have been expressed. In that regard, we think it would be more appropriate for the Treasury Department to remain neutral by maintaining the deductions for each type of state tax.

On another point, we see no mention by Treasury of the impact of its proposal on the sale of goods subject to state sales tax. If sales taxes are, in effect, raised by repeal of the itemized federal deduction--and in some cases substantially, e.g., for purchase of an automobile, appliance, home furnishings, apparel, etc.--the cost of goods to purchasers also rises, however inconspicuous that may be. We wonder whether the proposal is not both inflationary and likely to dampen economic activity to some extent. In a sense, although different jurisdictions are involved, this action would create "double taxation" which the Administration purports to abhor.

In regard to state gasoline taxes, Treasury implies that the itemized deduction encourages energy waste and that repeal would foster conservation. To the contrary, we believe that in the short run, there is only so much that people can do to curtail further energy usage without economic disruption and hardship. In our opinion, the near-doubling of fuel prices since 1973 has induced substantial conservation, and repeal of the state tax deduction would not contribute to the cause at this point in time. Nor, in our opinion, does continuation of the deduction cause profligate consumption of energy, if indeed it has any effect at all. What the gas tax deduction does provide is some relief from overlapping taxation by successive levels of government, and we feel that the deduction should be continued.

On another point, it seems to us that the error rate in computing state and local tax deductions argues more eloquently for simplification of the computations than for repeal. Moreover, anyone unable to use the tables provided for this purpose probably has errors all through his return and should use the standard deduction; find a competent return preparer; or be given a simpler table to use. It is not necessary to repeal deductions just because some persons can neither follow instructions nor subtract accurately. Simplification does not appear to us to be a bona fide objective in this case.

Concerning the existing tables, Treasury states that there is no direct relationship between the amount of the deduction and the state taxes actually paid. This implies that the taxpayer cobbles up a number out of thin air. In the first place, the tables exist because of the administrative problem in keeping records to document entitlement to the deduction. The tables represent in other words a legitimate effort to simplify taxation in this area in much the same way that guideline lives are applied for depreciable assets by business taxpayers. Beyond that, the amounts claimed are, in fact, related to the amount of taxes paid unless the taxpayer makes an error or commits fraud. If there is too much error, use of this deductible should be simplified further. As for fraud, we believe it is very infrequent.

On one other item, we object to Treasury's proposal to capitalize business taxes "related" to the acquisition of a capital asset. MAPI has encountered many complaints of taxpayers about IRS agents who endeavor to capitalize everything remotely associated with capital. Only recently, in December of 1977, the Institute sent to the Revenue Service a detailed protest (copy attached) covering areas where agents appear to be raising taxes on audit through arbitrary capitalization practices. We realize that such things as sales taxes on building materials for a business structure are part of the "cost" incurred in constructing the asset. However, Treasury does not contend that the income taxes are not being paid at all or that state taxes are being deducted twice. Consequently, it appears that capital-related business taxes are simply another "timing" item for which Treasury seeks to better its position.

On the other side of this is the taxpayer who is being asked to wait 10, 20, or more years to recover the tax "cost" of his capital. Instead of deducting these taxes currently in dollars of the same value as are paid to the state tax collector, a business would have to deduct these amounts at a later time when they are worth much less. This would present obvious cash flow problems to the hapless taxpayer and would erect yet another tax impediment to capital formation.

We urge the Committee to consider this proposal not as a refinement of tax accounting, but as another potential deterrent to fixed investment. With the subject matter thus in perspective, it seems clear that the proposal should be rejected.

Medical care and casualty loss deductions.--Under the Administration proposal, medical care expenses and casualty and theft losses would be deductible only to the extent that, in the aggregate, they exceed 10 percent of adjusted gross income. A casualty or theft loss would be taken into account only to the extent that it exceeds $100. Treasury complains that taxpayers often make errors in computing these deductions.

One way to reduce the error rate in the taking of deductions by taxpayers is, of course, to repeal the deductions. Without even blushing, Treasury proposes such action as to various state tax deductions. Here, in an area where government has previously shown some limited amount of compassion for persons afflicted by illness or penalized by other misfortune, Treasury would elevate the deduction threshold to eliminate the deductions for 11.1 million, or 83 percent, of the taxpayers now claiming them. The item would truly become one which is available only in the worst of personal catastrophes. After estimating that some amounts currently deductible would continue to be deductible, Treasury observes that "[a]ll other taxpayers will be spared the administrative burden. . . ." This is another example of the Administration's misapplying a tax policy criterion.

This proposal very nearly needs no comment at all. It reveals to all who see it that the tax collector's concern for his mission and for improvement of the revenues--although conscientiously pursued, which we do not concede in this case--must be kept in check. The fact of the matter is that people do not plan for sickness, disease, casualty, and theft as carefully as they should because all such happenings are to a greater or lesser extent unpredictable. Even those persons who plan ahead by insuring are incurring costs for coverage that usually is incomplete, and may or may not be used at all. Whether the cost is incurred in the form of cash outlays for insurance or cash outlays for payments to recover from sickness or loss, it reduces the ability of the taxpayer to pay tribute to the government. Moreover, the applicable tax policy, we think, should be--as it always has been--to allow some reduction of tax burden where this occurs. To raise federal taxes in this connection strikes us as being insensitive, and the rationale is not straightforward.

As for the error rate, both the medical care and casualty loss deductions are not complex to start with but could be simplified by, for example, eliminating the deduction "floors" and/or giving better definition to what does and does not qualify. To cure error by, in effect, repealing something is like curing arthritis by amputation. Neither repeal nor amputation makes any sense to us under the circumstances.

Fringe Benefits

Travel and entertainment.--The Administration proposes to disallow deductions for expenses of entertainment which are not taxed to the recipient as compensation. However, 50 percent of currently deductible entertainment expenses for food and beverages would remain deductible. Also, the value of meals provided by an employer to an employee on the employer's premises and for his convenience, upon a clear and strong showing of business necessity, would continue to be excluded from the employee's income.

Costs of business travel away from home would continue to be deductible, subject to certain limitations for foreign conventions and first class air fare (discussed elsewhere), but not if the only purpose of the trip was to entertain the traveler.

The Treasury Department has gone to great length to document its case against entertainment expenses, showing how unfair they can be and how those interested in beating the government and other taxpayers can easily do so. We take no issue with Treasury's purpose of eliminating any abuses which clearly exist. On the other hand, there _is_ such a thing as legitimate business entertainment, and it should not be disallowed as a deduction. The answer, then, is not to disallow everything, but to tighten up the rules of allowability and substantiation if necessary. A step in this direction was taken in the Revenue Act of 1962, and we suggest this approach as being more rational than blanket disallowance.

Regarding business meals, we agree that abuses, if any, should be curtailed, but it is not clear to us that the "50 percent" proposal is the only or the best answer. For one thing, it would complicate the bookkeeping for this item. Obviously, too, it would impose a tax burden in situations where the business meals are legitimate and not intended to gain a "free lunch" at the expense of others. Again, this is an area where existing requirements, including substantiation, could be tightened, and we urge that Congress investigate that approach instead if there is some problem.

Incidentally, we anticipate that affected unions and restauranteurs and their representatives will give the 50 percent proposal a thorough going-over. Further, we doubt that any econometric model developed for government by theoreticians to show the allegedly minimal impacts of the proposal will be acceptable to these interests.

Foreign conventions.--The proposals of the Administration would disallow deductions for expenses of attending conventions or other meetings outside the United States and possessions unless it is reasonable for the meeting to be where it is because of the membership or specific purposes of the organization. Subsistence would be limited to 125 percent of the government per diem for the area.

Our detailed views on this subject were submitted to the Committee in public hearings held in October 1977.

Although MAPI's approach to this issue may not be shared by certain other trade organizations and similar groups which sponsor meetings, we generally approve of the Administration's proposal, except as it deals with first-class air fare (discussed elsewhere) and the government per diem. In our opinion, the per diem requirement is unwise because the cost of meals and lodging may exceed the amounts in question, but not be discretionary with the person attending the meeting. For example, the sponsoring organization may need to use a particular hotel to satisfy certain meeting room or other requirements. We do not see that the meeting attendee should be penalized in such a case, or that the sponsoring organization should be pressured into settling for inferior facilities.

On another point, hardly anyone who has studied the 1976 Tax Reform Act provisions on "foreign conventions" understands just what types of meetings are intended to be covered, aside from seminars held by trade and professional associations. For example, we suspect that trade shows and company-sponsored meetings for their management personnel are not embraced by the rules, but there continues to be some doubt. The Committee may wish to reconsider this question.

First class air fare.--The Administration proposes to disallow deductions for the portion of air fare attributable to first class. The disallowance would apply to the costs of regularly scheduled, commercial air transportation to the extent that they exceed the amount of the lowest priced, generally available fare for regularly scheduled flights between the same points at the same time of day. A fare would not be considered "generally available" if it involves stand-by status, requires advance purchase, or requires that the person stay at his destination for a specified period of time. Air transportation that is noncommercial or not regularly scheduled would not be affected.

We oppose this proposal because it is arbitrary, if not petty,/1 and rests on the simplistic reasoning that the primary difference between a first class seat and a coach seat is "personal indulgence." MAPI has had some experience in surveying corporations about their practices in this area and can assure the Committee that such first-class travel policies as still exist generally have a business purpose that is not exactly hedonistic. For example, many companies require coach-class travel unless unusual circumstances justify first class. The unusual circumstances may include flights of long duration or a physical disability of the traveler. Also, in some cases, a physical characteristic (not a disability) of the traveling employee may justify the larger seats or more ample legroom of first class.

Whatever may be said of individuals who travel first class for reasons of personal indulgence, the reasons just mentioned which may warrant first-class seating for business travel are quite different. For example, one need only travel once non-stop between this country and the Far East or some similarly distant location to know that it is a long and tiring experience. If a person is on vacation, that is one thing; if he must transact business and the schedule is tight, as it generally is, that is quite another matter. Those who must make such trips frequently on business can derive some respite from the ordeal by traveling first class. We are not about to say that these employees do not deserve the added relief provided in first-class seating. Nor do we consider it wasteful of a business to authorize such travel for employees who may perform their tasks more efficiently or be better able to tolerate heavy travel schedules as a result.

1/ Because of the inherent characteristics of this silly recommendation, we are somewhat embarrassed to dignify it by a definitive response, particularly as a part of a statement addressed to so many important tax policy matters.

As already indicated, this proposal strikes us as being rather petty. If Treasury begins disallowing first class air fare, where will this kind of thing all end? For example, will business travelers next be denied deductions for first class hotels and first class restaurants? Will "coach class" limitations be placed on all types of business expenses which presumably involve an element of personal benefit? Just administering "refinements" such as these would involve costs far in excess of any benefits. We hope that the Committee will avoid tax revision of this kind, about which the distinguished Chairman of the Senate Finance Committee, according to the press, has already expressed his disapproval.

Since there is no practical way to circumscribe first-class air travel to restrict the deductions to business travelers who "deserve" that class of travel, in view of the myriad facts which might apply, we urge that the entire proposal be scrapped.

Employee death benefits.--The Administration would eliminate the exclusion for up to $5,000 of death benefits paid by employers to their employees. Where the status of a benefit as a death benefit or gift is not clear from the terms of the arrangement under which payment is made, the payment would be treated as a death benefit in any case in which it is occasioned by the death of an employee and deducted by the employer. If the employee is a more-than-10 percent owner of the employer organization or is an officer, any payment occasioned by the employee's death will be treated as a death benefit whether or not deducted by the employer. Death benefits would be includible in gross income of the recipient.

We object to this proposal because it appears to be an attack on an exclusion without care for the reasons it was established in the first instance. The death benefit exclusion is intended to provide limited tax forgiveness in instances of personal tragedy, and we believe it is appropriate tax policy. In our opinion, the survivors of a deceased employee who receive a stipend occasioned by the employee's death, from which amount the recipients may need to pay for last rites for the deceased and out of which amount the recipients may have to continue through a difficult period of adjustment resulting from loss of a wage earner, should be relieved of tax on some portion of the payment. We are surprised by the insensitivity of the Administration in seeking authority to demand greater tax payments from persons afflicted with illness; confronted with casualties; and, in this particular situation, faced with the ultimate loss.

The death benefits exclusion has been around at the $5,000 level for some time now and should be increased to reflect inflation since enactment. If the Committee is not disposed to do this, then we suggest that the provision be left alone.

Minimum Tax and
"Tax Shelters"

Minimum tax for individuals.--The Administration would eliminate from the minimum tax provisions for individuals the deduction from preference income of half the taxpayer's regular tax liability before imposing the 15 percent minimum tax. The minimum tax applies to so-called "tax preferences."

MAPI strongly opposes both the minimum tax itself and the specific recommendation of the Carter Administration. As to the minimum tax, we believe it to be conceptually unsound because, among other things, it serves by indirection to undo tax policy which was enacted to eliminate or reduce tax disincentives to specific kinds of economic activity. Congress should enact or repeal tax incentives by acting on them frontally and not via surreptitious devices like the minimum tax for which congressional accountability is obscured. The minimum tax directly cuts into and increasingly interferes with a number of tax provisions, not the least being the excluded portion of capital gains, which otherwise favor savings and investment. It is inconsistent of the Administration, we think, to profess concern for investment; to propose to help investment through the tax system; and to "jack up" the minimum tax at the same time. Our more detailed thoughts on this objectionable levy are contained in a 1976 MAPI pamphlet entitled The Minimum Tax on Tax Preferences--The Back-Door Route to Federal Tax Increases, a copy of which is enclosed for the hearing record.

Regarding the specific recommendation, it is not faithful to the original purpose of the minimum tax, which was to exact some tax from persons who manage to reduce their liability otherwise to zero or close to it. The minimum tax, until 1976, always had a deduction for regular taxes paid because persons with regular tax liability were, to that extent, contributing to the cost of government. In gradually whittling down the dollar exclusion from the minimum tax and the deduction for taxes paid, the opponents of tax incentives are turning the minimum tax into a straight add-on to regular tax liability--the equivalent of a surtax, but obscured. The value of the so-called tax preferences is slowly being eliminated as the exclusion and deductions themselves are cut back. Indeed, some proponents of tax change point with pride to the fact that they have already succeeded in gutting the excluded portion of capital gains for some individuals impacted by the minimum tax. Paradoxically, these same persons act perplexed about the present rate of investment which seems inadequate to achieve this country's economic goals.

In our opinion, the minimum tax should be repealed and any further congressional adjustments to tax incentives should be direct. At the least, in the current context, the Administration's recommendation regarding the deduction for one-half of taxes paid should be disregarded.

Real estate depreciation.--The Administration proposes a number of changes for real estate depreciation aimed at raising taxes. Among those of concern to business taxpayers are ones which would require the use of straight-line depreciation and eliminate component depreciation. A new option for useful lives would be to elect guideline lives pursuant to the findings of a 1974 Treasury study, and to depreciate buildings based on zero salvage value.

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We take no issue with the guideline option just mentioned. However, we object to the real estate depreciation proposal in those of its provisions which are intended to raise taxes. It appears to us that the Treasury Department is so aggravated by the marketing of tax shelters in the real estate area that it has come to doubt all depreciation practice. As we have often contended and Treasury now seems to recognize in its proposal to extend the investment tax credit (ITC), industrial structures are different from the types of buildings generally used in tax shelter syndication. If the Administration must eradicate tax shelters, it should take care not to interfere with fixed investment in industrial property or it will be at cross-purposes with its own objective of spurring investment in the nation's industrial plant. Indeed, it seems to us that the Administration's real estate depreciation proposal is, in fact, at cross-purposes with its ITC proposal as it applies to factory buildings.

On straight-line depreciation, we do not agree that accelerated methods for real estate are unrealistic, especially under current inflationary conditions. Treasury supports its position by reference to office buildings which hold their value well in the early years. However, it should be noted that a building which holds its value in nominal terms still is declining in real value due to inflation. Also, we believe that any structure under normal, constant use will demonstrate a loss of service life in a decelerating pattern rather than on a level decline. We have no reason to think that buildings differ from other assets in this respect even though technological obsolescence may be a less significant factor.

Further on this point, we do not accept the Treasury contention that technological change is relatively unimportant for buildings, particularly in the case of industrial structures. Also, we certainly do not accept the Treasury assertion that, with reasonable maintenance, "there is no physical reason that most buildings cannot remain in service for hundreds of years. . . ." Even if this statement were literally true, it would not be accurate in an economic sense. In order to provide economically useful service to the taxpayer claiming depreciation on the structure--which is the subject at issue--it is unlikely in our opinion that most buildings could remain in service anywhere near that long, even with reasonable maintenance. As to the "social, cultural, and political" reasons cited by Treasury as the most common reasons for abandoning a structure, we should point out that these factors do have economic consequences.

As to component depreciation, it actually is a more thorough approach than the use of guidelines. In another part of the tax package, Treasury would repeal individual taxpayers' itemized deductions for certain state taxes because the tables do not necessarily approximate actual experience. Here, in real estate depreciation, Treasury wants tables--to which we do not object--and criticizes taxpayers who fragment their structures into a number of parts in order to achieve a more accurate depreciation for an entire building. Seemingly, the only common thread of logic among the Administration's proposals in some of these areas is that they would raise taxes and simplify administration for IRS.

We feel that the Committee should give close attention to both the straight-line item and component depreciation to determine whether the proposals are conducive to fixed investment or contrary to it. Also, if shelters are the "problem" and the Committee is sympathetic to the Administration's position, then we suggest that exceptions to the restrictive changes be considered for industrial structures.

Capital gains: Repeal of alternative tax.--The Administration proposes to repeal the alternative tax on capital gains. Under this provision, an individual taxpayer may elect to pay a 25 percent alternative tax on the first $50,000 of net capital gain. An individual normally chooses this alternative rate only if his marginal tax rate exceeds 50 percent. If the taxpayer elects the alternative tax, he must forego regular income averaging which, in some cases, he may elect in lieu of the alternative tax where income averaging results in less of a tax burden.

MAPI opposes this proposed change because it is the grudging vestigial remains of what began as a questionable attack by the Administration on the special tax treatment of capital gains generally. The original idea was defective in that it failed to recognize the importance to U.S. economic goals of minimizing the interference of federal income taxation with capital formation. In a more limited way, elimination of the alternative tax has the same shortcomings, because the Administration still is insisting on higher taxes for capital gains even though the impact would be more focused. The alternative tax, at one time in the past, did not have a $50,000 ceiling. Adding the ceiling was a mistake, in our judgment, and repeal would compound the error.

The near-sightedness of this proposal comes into clear view when one considers that the tax burden on capital gains already is rising in an insidious way without any congressional action at all because of inflation. For example, an individual who acquired a capital asset for $1,000 in 1970 and disposes of it for $1,500 in 1978 has, in all likelihood, enjoyed no economic gain whatsoever because of deterioration of the currency due to inflation over the period in question. (For a fuller explanation of the effects of historical cost taxation in a period of inflation, see attached materials.) When the tax collector demands that tax be paid on the nominal gain, as presently must be done, he forces the individual to pay the amount out of capital itself. It is no wonder that this country is underinvesting when Congress will allow such a defect in the system to continue and erode the capital base upon which the economy rests.

To complicate an already bad situation, the Administration's proposal would increase the overall burden on capital. We submit that the Administration's thinking in general about capital gains is not consistent with its own objectives for the economy. Moreover, it is incredible to us that higher tax impediments to fixed investment have been rationalized in the name of "simplification." To accomplish simplification at such a disproportionate cost would be unwise, and demonstrates to us a distressing lack of perspective about taxes and investment. Incidentally, we feel the same way about the Administration's proposal to "simplify" the tax law by imposing current taxation of unremitted earnings of controlled foreign corporations, discussed elsewhere.

Our only recommendation at this time is that the Committee disregard the proposal to repeal the alternative tax and reorient its thinking to changes in the taxation of capital gains which will lessen the income tax burden associated with savings and investment. It is about time that Congress came to grips with and stopped the taxation of capital for businesses and individuals. Any serious consideration given to contrary proposals such as repeal of the alternative tax is, in our view, out of order.

Other Matters

Unemployment compensation benefits.--Under this proposal, benefits in the nature of unemployment compensation paid pursuant to government programs, including trade readjustment allowances, would be includible in the income of taxpayers with adjusted gross income from all sources (including unemployment compensation) in excess of $20,000 if the recipient is single and $25,000 if married.

This proposal is another of the series of similar ones offered by the Administration in attacking exclusions, exemptions, and deductions on the ground that they confer more benefit on high-bracket individuals than low-bracket persons. As we understand the conventional wisdom of the Administration on this subject, lower-income individuals ideally should pay little or no taxes and receive most of the benefits provided directly or indirectly through the income tax system to individuals. Higher-income persons ideally should foot the bill and receive relatively little of the government's largesse. In order to get from the present situation to the "ideal," wholesale curtailment of exclusions, exemptions, and deductions is thought to be justified. We disagree with this objective and the means for obtaining it.

First of all, we are distressed by these proposals to siphon taxes from individuals faced with hardship or loss. Not only would taxes be raised in the event of sickness, casualties, or the death of loved ones, but, in the instant proposal, taxes would be raised for those who are out of work. Presumably, the existing tax concessions to be repealed or reduced would be made up to some extent for some taxpayers by others which have been offered. However, the direct tax benefits for hardship situations would be curtailed. We cannot align ourselves with provisions such as these if only because we believe that the tax collector should show more compassion.

As to the unemployment compensation benefits, we do not favor the proposal because it fails to recognize that employed persons, even with working spouses, usually exist at a standard of living--including fixed obligations--which cannot be altered quickly to accommodate the loss of income attendant upon unemployment. This is as true of persons with income above $25,000 as it is of persons less well situated, and it seems to us unreasonable for the Administration to be taxing away what, in fact, may be needed for a person's mortgage and automobile payments, other notes, utility bills, tuition payments, regular living expenses, and other obligations and necessities, while he is at a disability to pay for them, much less to pay taxes. It is to us irrelevant that the exclusion may be worth more to someone with taxes at 70 percent than to someone with taxes at 14 percent. Indeed, a productive individual who pays federal taxes at high rates is entitled to some benefit when things go awry, and we do not think he must constantly support others with no return in his own moments of need.

The Administration proposal should be scrapped and the present arrangement left in place. Imposition of a dollar limitation on benefits --which would be quickly eroded by inflation--would be the first step toward repeal of the exclusion altogether, and that should not be allowed to happen.

Communications tax repeal.--The Administration proposes to phase out the existing 4 percent communications excise tax by reducing the tax one percentage point a year so that the tax would be gone by 1982.

We agree with this proposal to complete the overhaul of the excise tax system which was instituted by the Excise Tax Reduction Act of 1965. In that connection, we note that the Administration contemplates that the tax reduction will be reflected in "lower prices" of communications services paid by business firms. Although we most certainly hope that lower prices will result from elimination of the tax, it must be recognized that the providers of communications services have costs of their own that will continue to mount. Accordingly, repeal of the tax may lower prices, but do so only temporarily. We should add that any rate increases of the service providers must be approved by the respective regulatory commissions, so assertions that these companies will arbitrarily move to "fill the gap" are fallacious. Of course, the state governments could impose sales taxes to replace the federal excise tax, but this hopefully will not occur.

We commend the Administration for proposing elimination of this undesirable and unnecessary tax on communications.

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Again, MAPI wishes to express its appreciation to the Committee for this opportunity to present views and recommendations concerning the Carter Administration's tax proposals and related tax policy issues.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

EFFECT OF HISTORICAL-COST TAXATION OF CAPITAL GAINS*

The following table traces the effect of a 25 percent tax on the unadjusted capital gains from 10 different transactions. These involve the same asset, with the same cost, but different holding periods. Specifically, the asset is purchased for $1,000 in each of the years 1 to 10 and is sold in the year 11 at a price representing an appreciation of 10 percent a year. The general price index by which the historical cost is restated is also assumed to advance 10 percent a year.

Nominal and Real Capital Gains From the Sale in Year Eleven of an Asset Purchased for $1,000 in Each of the Preceding 10 Years

	Historical-Cost Calculation					Adjustment for Inflation		
Year of Purchase	Cost in Dollars of the Year of Purchase	Realization in Year Eleven	Nominal Gain Before Tax	Tax (at 25 Percent)	Nominal Gain After Tax	Cost Restated in Year Eleven Dollars	Real Gain Before Tax	Real Gain After Tax on Nominal Gain
			(2)-(1)		(3)-(4)		(2)-(6)	(7)-(4)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1	$1,000	$2,594	$1,594	$399	$1,195	$2,594	-0-	$-399
2	1,000	2,358	1,358	340	1,118	2,358	-0-	-340
3	1,000	2,144	1,144	286	858	2,144	-0-	-286
4	1,000	1,949	949	238	711	1,949	-0-	-238
5	1,000	1,772	772	193	579	1,772	-0-	-193
6	1,000	1,611	611	153	458	1,611	-0-	-153
7	1,000	1,464	464	117	347	1,464	-0-	-117
8	1,000	1,331	331	83	248	1,331	-0-	- 83
9	1,000	1,210	210	53	157	1,210	-0-	- 53
10	1,000	1,100	100	25	75	1,100	-0-	- 25
11	1,000	1,000	0	0	0	1,000	-0-	0

* Excerpted from a study scheduled for publication in the near future, entitled "Inflation and the Taxation of Capital Gains," by George Terborgh, MAPI Economic Consultant.

Note that the inflation adjustment converts nominal gains (Col. 3) into real after-tax losses (Col. 8). As indicated earlier, these losses measure the erosion of real capital by the tax.

This is, of course, a special case based on the assumption that the asset appreciation rate equals the inflation rate. The losses computed on this assumption are increased if the inflation rate exceeds the appreciation rate, and are diminished (or converted into gains) if it falls short thereof. The permutations are of course endless. But so long as there is any inflation over the holding period, the real after-tax losses are larger (or the gains smaller) than their nominal counterparts.

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MACHINERY AND ALLIED PRODUCTS INSTITUTE

EXCERPTS FROM ORAL SUPPLEMENT

Statement of
Machinery and Allied Products Institute
to the
House Committee on Ways and Means
on
President Carter's Tax Proposals
and Related Issues

Presented by
Charles W. Stewart, President

March 6, 1978

Mr. Stewart. Thank you. We always welcome the opportunity to appear before this Committee.

I will restrict my remarks to the time limit suggested and, therefore, we can't hit more than certain highlights.

First, I acknowledge the fact that the Treasury Department and the Administration as a whole have certainly given an opportunity to business to express its views. Also, MAPI commends those provisions referred to by previous commentators, such as the investment tax credit improvement, corporate rate reduction, and some relief for small business.

We are not as enthusiastic about the proposed personal income tax changes because they introduce a further element of progressivity in the Tax Code.

As an overall piece of legislation, if we were asked to accept the package or nothing, we would be obliged, I think, to say that we are in opposition. However, I believe the Congress will not accept this approach to enacting legislation and will fashion its own bill in a responsible way.

I want to say a word about one of the big problems in the making of federal tax policy, and this is not in disagreement with Mr. Jones' comment about introducing social security directly into this dialogue. One of the problems confronting American industry, and I believe the individual taxpayer, has been a failure by government to bring the various pieces of proposed tax policy together in order to assess the total. Each item is separately considered and only after the fact, as in the case of social security, does there seem to be the kind of overall view which is needed.

To put it in brief terms, we think the country is being piecemealed to death by this technique of developing tax policy in such areas as social security, energy, the reform act of 1976 which has not been fully implenented, the proposals of the President currently, etc.

Within the time limits, I want to emphasize a few key points. I agree with everything that has been said about DISC and deferral. Let me add a few comments.

First, there seems to be an impression created by the advocates of rescinding deferral that money is sitting overseas hidden, tax protected indefinitely and, therefore, not properly treated in terms of our total tax structure.

We looked at the figures and we find that the single most favorable contributor to our balance of payments in the current picture and for some recent years is repatriated earnings from foreign affiliates of United States companies. It is also interesting to point out that in 1975-77, the surplus generated by the investments and repatriation of earnings produced a surplus of extraordinary amounts. There is an annual average over the period 1975-77 of $8.4 billion.

Another interesting aspect of the deferral situation is the fact that well over 50 percent of earnings abroad by U.S. affiliates and associated companies have been for many years remitted to the United States. So this implication or charge that the money is hidden overseas, a la Switzerland, and never gets taxed should be reexamined on the facts.

I want to talk about the premises on which the Administration package is presented. Equity, simplification and, as the third item was repeatedly stated, inducements to better and more investments.

At one point in the President's economic message, he added the criterion of increased progressivity. We oppose that. In this case, the Administration has been very candid and has pointed to three parts of the total tax package which do, in fact, increase progressivity.

I want to make a point which is not commonly made by corporate witnesses. I firmly believe that if you had to select one crucial part of our tax policy which needs mending, you would be obliged as citizens and legislators to look at the individual income tax structure. I refer particularly to how the transfer payments and other burdens are being carried by those in the brackets that fall between the low income taxpayers, many of whom have recently been taken off the tax rolls, and the people in the so-called rich brackets.

In my judgment, taking into consideration inflation, the extent to which taxpayers have been forced up into higher rate structures, the individual income tax structure of the United States is in horrible shape. We will suffer as a total economy, and business will suffer if it is not corrected.

I realize things can't be done all at once, from the revenue standpoint.

In looking at the Administration's proposals on exclusions and deductions, we feel that some of them are petty; some of them will be counterproductive; and, in some cases, I would presume to say they are silly.

An example of a silly one is the proposal to remove the tax deductibility of the difference in cost between coach and first class travel.

I want to hit quickly a subject which is not being given as much attention as I think it should be, namely, capital cost recovery for federal and state mandated expenditures for pollution controls. There is some improvement in this area as proposed by the President but not enough. The problem lies in the conditions for qualification for five-year amortization of such mandated expenditures. The present rule that if from the expenditure you have a substantially favorable economic fallout, the expenditure is disqualified. We feel that the country ought to adopt a policy as close to the expensing of those expenditures as possible.

There is a modification proposed in the minimum tax; we oppose the minimum tax as such. We think it is a very, very deceptive part of the Code. It is constantly growing in terms of tax preferences in the minimum tax basket, so to speak.

Inflation, inflation, inflation--what inflation is doing to profits, what it is doing to the after-tax, real take-home pay of individuals, we have documented for years and some of the documentation is attached to our statement.

I close on the proposition that there are some important affirmative provisions in this package. There are some very bad and counterproductive ones. I am confident, as I said earlier, that this Committee, the House, the Senate Finance Committee, and the Senate will work its way in terms of a new approach.

Thank you.

* * *

The Chairman. Mr. Jones, you indicated that you felt the $25 billion reduction was about the right level. As you know, the Committee, in its budget recommendation, settled on that figure. I had urged a somewhat lower figure, but that is partly based upon the process over here where whatever figure we settle on, it will probably be increased before we finish.

But you took a strong position in opposition to going higher than $25 billion; is that right?

Reg Jones. That is right.

The Chairman. Do other members of the panel disagree with that or agree with it?

* * *

Mr. Stewart. I agree in general terms. What is the makeup of the reduction, however, is very much in dispute.

* * *

Mr. Burke. I would like to ask the gentlemen on the panel about the disadvantage domestic industry has on social security tax compared to competitors abroad and how you feel about it. In the steel industry the tax on the employer and employee is approximately $1,500 higher per worker a year, in the auto industry about $1,150 higher per year, footwear approximately $700, in the textile industry approximately $800. In most of the manufacturing jobs in the country it is about $800 more.

Why don't you gentlemen support a bill to reduce the social security taxes and take the funds from general revenue as 60 other nations of the world do and put us in a far better competitive position than at the present time when it is costing a loss of jobs and closing down of steel mills, laying off of auto workers, closing down textile mills and footwear and other labor intensive jobs?

Mr. Stewart. Very briefly, first of all, we forewarned the Congress and the Administration about the impact of the proposed social security tax amendments of 1977 when they were being considered. I am very much aware of the state of the economics of the industries you refer to.

Congress should correct the overkill from the 1977 social security amendments, which correction I think is essential but not necessarily as part of the tax bill at this juncture, or in lieu of a provision of the proposed tax bill at this time. We don't think it necessarily follows you have to go to general revenues.

We presented--and I won't take the time of the Committee at this point to discuss it--an alternative approach to improving the integrity of the social security system which would not have cost $230 billion in new taxes. So I am sympathetic with your general point but don't necessarily believe that to make the necessary correction you have to go to the general revenues.

* * *

Mr. Burke. A $12.5 billion cut in this country and you are saying no to it, to all the small businesses with 30,000 of them going out of business last year? When I first came to business this was an average of about 10,000 or 11,000 a year. Now we have about 30,000 small business. Where will we get the money for Government? How long can multinationals enjoy the privilege we have? How long can we stand the huge deficit in trade we have? In the past month it has not come down. It is about time we came in with answers for jobs here in America and domestic industry.

Mr. Stewart. I think everyone on this panel, with possibly one exception--I don't mean that critically--has endorsed the improvements in the investment tax credit and the improvements in the corporate income tax structure which is just a start. Also I have pointedly suggested that perhaps the most serious problem that we have in the tax policy of the United States is the burden that the middle income tax brackets are suffering under. And I am talking about a group of people who are much larger in number than some would define as middle income.

Mr. Reese referred to "displacements of labor by modern equipment." I think you know, sir, as well as anyone in this room, that one of the problems of New England industry was the fact, because of a capital shortage and a combination of things, including imports, the strength of that base for American industry was very severely hurt. One of the problems, in due respect, was that this section of the country had obsolete plants and equipment.

Mr. Burke. It is obsolete because they are getting murdered by the social security tax. They are paying a 50 percent tax on the employer and 50 percent on the employee. They will never have capital formation. As far as lack of capital, that is not true. There is plenty of capital in New England, but it is going overseas by some of our biggest banks. That is where the money originated from but they are now using it elsewhere. We have to do something about the social security taxes and it is about time big business recognized it.

Mr. Stewart. We recognize it, sir.

Mr. Burke. You will have nobody in this country going to work. Do you think people are going to work with the take-out pay, 12.26 taken out of every dollar next year? According to the Joint Committee on Economics, they figure it will cost 1 million 300 thousand jobs, the increase last year. Where do you think the money will come from to pay for those?

Mr. Stewart. Business didn't support the social security tax bill in the form it was passed or in the form of the President's recommendations. We thought it was an overkill. We told Congress that. We pointed out the burden of the social security system at that time before the amendments were enacted. The Congress, not big business, not small business--and there is a good deal more than big business represented at this table--passed that bill and the President signed it.

* * *

Mr. Duncan. How do other major countries treat foreign earned income?

Mr. Stewart. They don't tax it for the most part.

Reg Jones. No nation taxes foreign source income before it is repatriated and two nations never tax it even when it is repatriated.

Mr. Duncan. Heretofore you talked about capital formation and it may be in some of your statements, but is capital formation still of critical concern to you people?

Reg Jones. Very much so. Capital formation is lagging in this recovery. It is half the rate it has been in every post-war recovery period.

Mr. Stewart. Certain provisions in the bill are anti-capital formation. I am referring to the President's proposal, not a bill.

* * *

Mr. Duncan. Mr. Reese, since other competitive trading partners do give incentives to their manufacturers for exports, what would you suggest if DISC isn't working? You must have an alternative because in order to sell we must be able to compete fairly.

Mr. Reese. I would agree. First, I think we are challenging the current practice of the European nations in GATT on refunding their value-added tax just as they challenge our DISC. I think we should aggressively pursue that policy.

Second, I think we should have loan programs that will help small businesses get into the export business and help them to increase their exports.

* * *

Mr. Stewart. May I add a word in response to one question that was raised?

First of all, one of the things that people who live in world trade know is that small companies sometimes do not have the personnel and resources to put in place a strong export program, but they are benefited by any measure--DISC or otherwise--that enlarges export opportunities. They are also benefited, these smaller companies, because many are suppliers to large companies. They may make components. Before the aerospace depression on the West Coast there were hundreds of small companies with high technology who were principal suppliers to the major aerospace companies. When you think in terms of the small company, sometimes that small company exports through providing components to a larger company that has a foreign marketing system.

You asked a question about how many new companies got into exports or how many companies newly got into exports. One should bear in mind in that connection the point I have just made; there is this linkage between a large company and a smaller supplier. Also, companies can make a new entry in exports, as one might say, by adding product lines that they did not have before. So this is not a monolithic witness table of people who are thinking only in terms of large companies. Incidentally, I should correct one point which the Chairman made, this panel is not just heavy industry. GE manufactures many products that are not heavy industry as do many of our member companies.

* * *

Mr. Burleson. Mr. Stewart, did I understand you to say that more than 50 percent of the revenues generated overseas is returned to the United States subject to taxation?

Mr. Stewart. That is correct, and a few years back it was 60 percent. It is coming down somewhat but not much. Over half for a long period of time has been repatriated, as you put it, and subjected to tax when it entered the United States. The notion that I was trying to put to rest is that all of these earnings are insulated indefinitely abroad from U.S. taxation. It just isn't true. What happens when the earnings come back? Not only are they subject to U.S. tax but net after-tax earnings are put into domestic business and they provide jobs and enable companies to buy equipment and so on.

I know of a number of companies during the worst part of the recession, which was one of our worst in the last two or three decades, that would have been in the red if it had not been for their foreign operations and their repatriated earnings.

* * *

Mr. Gradison. I think, Mr. Chairman, this brings to our attention the reality we had an income tax written for a period of same prices. We have had inflation for a long time with us and it has only been in the last 15 years as we have moved into substantially higher numbers where the conflict--written for tax stable prices and the best interest of the taxpayer and economy begins to conflict with each other.

Mr. Stewart. My organization has done extensive research in this field and I will be glad to send you some of the studies.

I think what we have now is a highly discriminatory form of indexing. The government employee, federal government employee and, to some extent, local government employees receive cost-of-living adjustments on an automatic basis; social security recipients and railroad retirement people receive such adjustments. Many union contracts include provisions for it. So we really have a situation in terms of the standard of equity which is very bad. I have sympathy for the point Mr. Jones was making. It is almost a vicious circle. You adjust to inflation by indexing. Does that, in turn, cause more inflation?

We have looked at it very hard, have published on it and believe it continues to need study. One step taken by the SEC, which is not out of line with the thesis you are proposing, is to require information on a replacement cost basis in filings with the Securities and Exchange Commission. They went the wrong mechanical route, we think, in terms of inflation.

Abroad, the British have been into this field and published extensively. So I think you raised a very sensitive point, and I am terribly disturbed about the discriminatory action which has been taken as I described it. We have part of the country protected and another part completely unprotected.

* * *

Mr. Vanik. Where would you be if the private sector had $35 billion available to it in the money market, $25 or $30 billion available in the money market that will be soaked up by federal borrowing? What a tremendous depressant that is to cost of capital. Don't you believe--what do you suppose would happen to the economy in the country if we made this kind of decision? Don't you think it would move upwards if for the first time we developed some sanity about what we are doing?

[Suppose we] do nothing except renew what we must renew in order to prevent tax increases from flowing or that would otherwise result. We can't increase our taxes but we should not be decreasing the level of government receipts.

Mr. Stewart. Are you suggesting that the Congress and Administration would be agreeable to and could find ways to reduce expenditures to achieve that?

Mr. Vanik. I don't know. I know you will tell me that we can't probably reduce $60 billion in deficits. Most realize we can reduce something but can't make that kind of a cut in government spending, and it may not be desirable at this time.

My point is if we don't throw out any further tax increases, if we renew what we must renew, those expiring this year, there would be, the deficits would be reduced to $35 billion. Now, imagine that, a $35 billion shortfall in our receipts over our expenditures. Falling down to that level, what would that do to the economy? I am sure the dollar would be better. It would reflect itself in the confidence of Americans in the system.

What the world and Americans are concerned about and the reason they are running abroad with their investments is they are worrying about the depreciation of their currency and what decreases that is the management of our government affairs.

We have a chance to narrow the deficit, bring it down to $35 billion. Can you with your economist minds tell me whether that would not of itself propel some sense of recovery because I don't see anything really substantial happening with one or two points on the tax rate or $4 a week in increased spending on the part of the average citizen. I think that will be lost in the first week.

* * *

Mr. Schulze. I think if the camel goes under the tent, I think if we could get [rollover from the sale of a small business], we would encourage sole proprietorships because they would see the long-range advantages of it and I think it would augur well for the whole business community.

Mr. Stewart. May I respond?

Mr. Schulze. Yes, but I would like before you do to ask you to send me copies of your studies.

Mr. Stewart. First, in my oral testimony and more so in my written testimony I argued the proposition, not to the exclusion of other tax actions, that we have, in my opinion, a developing crisis in the personal income tax structure. The transfer system in the budget and in government is the largest single item in the budget. The rich don't contribute much to those transfer payments in terms of total revenue, the poor certainly don't, the people that have been taken off the tax rolls certainly don't. The people that are carrying the burden of the immense governmental system we have, notably the transfer system, are the people that are healthy and working. But through inflation the double-edged effect of being brought up to higher rates, and also suffering the devaluation of the dollar in terms of what it will buy, is crucifying millions of people who are supporting this country through the tax system.

In my opinion, although I represent an organization that is a business organization, I think very seriously this country has got to face up to that situation as an overriding problem.

Our feeling, as I expressed in the statement and orally, is that we ought to go as far as our total economic structure permits us to give those people tax relief. They are not getting it in the proposal sent up here for comment.

I also suggested that we need a massive change, hopefully consistent with running the country and keeping our economic system in shape. We need a massive improvement in the capital recovery of mandated noneconomic expenses by companies paying for pollution equipment, and so on.

The Administration's bill does not do that job. I think in all fairness we have strong feelings about the need. The question is the economic timing and how much can you do at once and I think the panel was trying to be constructive in that sense rather than being defensive.

Mr. Schulze. I do believe we need more adequacy.

Mr. Stewart. The personal income tax brackets I am talking about, with due respect to Mr. Reese, are not represented in Washington.

Mr. Schulze. I would like to change the subject a little bit. You gentlemen as a group could be categorized as captains of industry and I would like to have your personal experiences with the three-martini lunch. I would like to know if any of you have ever attended a lunch where someone, or whether any of you, have personally ever had three martinis at lunch?

* * *

Mr. Stewart. The three-martini lunch is a symbol, it is nothing more than that. It seems to have certain political appeal. I understand from the press that on one occasion at Sans Souci, the elite restaurant in this town, Secretary Blumenthal was there and a famous cartoonist ordered three martinis delivered to his table. I think it is nothing more than a symbol. I characterized these provisions on removing deductions as being petty. I think you could use a stronger word, slightly stronger, at least as applied to the proposal on coach and first class fare; it is silly.

Senator Long has argued, as I understand it, that if you carry that thinking to its logical extension, you go to an airplane, you travel coach or pay the difference, arrive at the destination airport, you can't use anything but a bus because the cab would be disallowed. When you get to the hotel you would ask for a third-class room and then order cheap whiskey for a drink before a cafeteria dinner. This business of using the tax system as a regulatory system in this kind of petty detail just leaves me with a very, very sour note.

* * *

Mr. Schulze. One step further---

Mr. Frenzel. Would you yield?

On the taxi ride from the airport to home would you allow half of a cab?

Mr. Stewart. We might come to that.

Mr. Schulze. Do any of you personally own a yacht?

* * *

Mr. Stewart. No. I think the auditors took care of that. We are not dealing with people who are outrageously engaged in certain self-indulgence, without the IRS taking a look, and contrary to some beliefs some of their auditors, or most of them, are very good and very vigilant.

As a matter of fact, on the airplane situation, in my organization we have a rule that you ride coach unless it is a long trip, say across country, to the Far East or whatever, and unless you cannot get a coach seat on a plane that is reasonably convenient. We don't need the government to tell us that is a sound idea.

* * *

Mr. Corman. One of the Secretaries brought up this question, one of the theories was if the tax cut was too high people would be automating and eliminating labor but that piece of it [unemployment taxes] is a dollar per month per employee. Would you believe that much would cause you to make a decision to automate somebody out of a job?

* * *

Mr. Stewart. You used the term "automating somebody out of a job." This floats around without evidence. Businesses have confronted this situation. Unfortunately, there was a bad situation in the New England area; that is, the plant and equipment went to pot. We had multi-story inefficient buildings. It is not limited to New England. It is true of other industrial areas. In order to be able to compete internationally and domestically, companies had to spend major money to modernize them. We know something about this subject because that is our business--supplying capital goods and allied equipment. A company in these days, domestically and internationally, must be competitive from the standpoint of its facilities.

One of the reasons Japan has the capacity to give our steel mills a bad time is they built integrated steel mills from scratch and have strong government subsidy. I think it is a bogey, a catch phrase.

* * *

Cong. Jones. Let me ask you in your comments on DISC, Mr. Jones, one of the problems, as I think you pointed out, is nobody can say whether it is a variable exchange rate or whether it has been DISC responsible for the increase in exports.

However, I agree that we should not unilaterally do away with DISC and that we ought to get something for it in a negotiated agreement at Geneva.

My question to you is, do you have any practical advice to this Committee, if that is in fact the opinion of this Committee, as to how we can write a DISC provision that would be contingent upon getting something at Geneva for it? What kind of advice can you give us in that area?

Reg Jones. It appears in GATT negotiations, because of the way it is written, that the rebate of taxes is something we won't be able to knock out. Your Chairman of this Committee often talked of the feasibility of a value-added tax in the United States. We have had concern on this front. It is like opening Pandora's Box. It is a source of new income and could go to a host of new uses and where do you put a limit on it. Until we do have a value-added tax system in lieu of the current system, we feel that DISC is probably the only alternative we do have.

The fact that these other nations in GATT discussions have made such an issue of it we think is added evidence of its effacacy and value to U.S. exporters. These other nations would not be so desirous of seeing it outlawed if they didn't see it as very efficient in helping us.

I don't see how we are going to get a quid pro quo unless they are willing to drop their rebates.

Mr. Stewart. One of the problems in terms of the United States international negotiation effort is that the United States is inclined in negotiation to put things on the table, to look at what we are doing in a kind of open way. Foreign countries, with due respect, don't operate that way. Many of the incentives, inducements, hand holding, or whatever you wish to call it, that is accorded by foreign competitor nations--I mean major ones--don't even get to the surface.

A classic example has been the U.K.'s attitude toward turbines. I don't believe there is anything in writing that the British have to buy turbines from the British. But they don't buy them from anybody else. We have hard-ball played by the other teams, and we play soft ball.

As far as DISC is concerned, you have just gone through the process of making the DISC system incremental. We felt that was a mistake but Congress in its wisdom chose to do it. Why don't we give DISC a chance to determine for you whether the incremental system works. If it works you may have better proof than we are able to offer now with regard to the importance of DISC, although I think our case is strong.

The basic thing to keep in mind is that foreign governments which have heavy reliance on exports, percentagewise much greater than ours, although we should be moving ahead, will do almost anything to help a major company get a major order.

I recall a time when De Gaulle went to Mexico to help the French get an order and he succeeded. Let's not kid ourselves about the proposition that we are going to GATT and get some very beneficial trade-offs.

* * *

Mr. Waggonner. Is there any of you who believe we should have no tax cut?

Reg Jones. No, Congressman Waggonner. My point, and I believe many members of the panel feel the same way, we are not sitting on the edge of a decision, but we have had a recovery in terms of month of tenure and duration which has been longer than that of any other recovery. We feel some stimulus is necessary to maintain the economic momentum, otherwise, we believe in 1979 we can begin to see the start of a slide downhill. That would have a greater impact on tax revenues, in our opinion, than this amount of stimulus.

Mr. Waggonner. Do any of you disagree with that basic position?

Mr. Stewart. I would like to supplement. I am baffled as to how we will get the reduction in the deficit. Suppose the premise is we do not reduce taxes, we in effect take no action at this time. That leaves us where we are with that deficit. The response of Mr. Vanik to my question, are we going to get $30 billion reduced in spending, was no. Where does the reduction come from?

Mr. Waggonner. Are you asking me?

Mr. Stewart. Yes, sir.

Mr. Waggonner. Where does the tax reduction come from?

Mr. Stewart. Where does the deficit reduction come from?

Mr. Waggonner. I say assuming, the assumption is if we don't cut taxes we have more money that we can identify as revenue thereby Treasury borrowing is less. That is a fundamental assumption that causes that and Treasury on that basis says that $15 to $20 million less would be needed under those conditions. Treasury and OMB. Do you take issue with that?

Mr. Stewart. Yes, because I don't think you can get to the point of a $30 to $40 billion reduction without cutting spending to that extent.

*   *   *

Mr. Pickle. Then next year and the next year we can anticipate a contingent series of tax cuts for stimulus purposes from now on. Is that too broad an assumption?

Reg Jones. You can anticipate a continuation of tax cuts in lieu of going to some kind of indexing system as long as we have inflation, otherwise the percentage of gross national product that goes to government will inevitably increase.

Mr. Stewart. Your options are not very good. One of the things that the economic side of the Administration is concerned about is what might be described as anticipatory pricing and anticipatory wage increases because people have been accustomed to the history of inflation and some buyers don't like escalation clauses. The result is that companies are being put in a bind with reference to their pricing policy.

I am not talking about any illegal activity; I am just talking company by company. I think that is one situation that is happening and it flows from the severe impact of inflation. And if you take the individual tax structure, inflation has increased taxes every year for the average taxpayer without any congressional action.

So when you turn that coin over you have a bad situation, just as bad, if not more so, than the one that concerns you.

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MACHINERY AND ALLIED PRODUCTS INSTITUTE

Advanced Draft
Capital Goods Review No. 108

THE FAVORABLE IMPACT OF DIRECT INVESTMENT ABROAD ON THE U.S. BALANCE OF PAYMENTS: Spending More To Get More

The central issue in public policy debates about the economic impact of U.S. direct investment abroad continues to be its effect on the U.S. balance of payments. Because of the importance of U.S. direct investment abroad, we considered the subject in an earlier Capital Goods Review. It has even more relevance today in light of the Administration's proposal to tax foreign earnings when earned instead of awaiting their repatriation to this country. Accordingly, we are reissuing the article, updating it to cover the period through the third quarter of 1977. While certain components of the balance of payments have undergone substantial change, this updated Review serves only to reenforce our earlier conclusions.

Paramount among those conclusions is that U.S. direct investment abroad has been the single most important factor in reducing our balance-of-payments deficits over the past 15 years. The surplus generated by such investment, which averaged $1.8 billion per year during 1960-62, had risen by 1975-77 to an annual average $9.2 billion. This goes far to demolish the myth that foreign earnings are held overseas in order to insulate them from U.S. taxes.

It should also be noted, in this same connection, that the remitted earnings from these investments, which constitute an important part of the total net earnings of many companies, create jobs and support critical activities of the corporate sector in the United States, including research and development, and various socio-economic programs such as pollution abatement and improvement in safety and health. Further, when remitted, earnings derived from foreign operations are of course subject to U.S. tax.

Trends in the Overall Balance of Payments

By way of providing a broad setting against which to consider the role of direct investment abroad in the balance of payments, we will first look at movements in the overall balance and in major balance-of-payments sectors before undertaking a closer examination of the performance of the direct investment sector.

Table 1 shows movements in major items in the U.S. balance-of-payments accounts since 1960. Three-year annual averages are used in order to smooth out erratic annual movements. A 2-3/4 year annual average is used for 1975-77--data for the last quarter of 1977 are not yet available. The balance-of-payments definition used in Table 1 (line 21) is "balance on current and long-term capital account" otherwise termed the "basic balance."/1

There was a steady and substantial deterioration in the overall U.S. balance throughout the 1960s, and the annual average deficit reached a then record high of $6.1 billion in 1969-71. There was a small improvement during 1972-74 following the initial devaluation of the dollar. However, the deficit rose sharply to a new record $13.6 billion (annual average) from 1975 through the first three quarters of 1977. Major factors accounting for the increase in the deficit have been a sharply deteriorating trade balance, a steep rise in capital outflows, and huge increases in remittances abroad of earnings from foreign investments in this country./2 These have been offset in part by the enormous increases in income from U.S. investment abroad, the rise in long-term capital inflows, and the reduction in the deficit in military transactions.

Performance of the Government
Versus Private Sectors

Viewing the balance of payments from another perspective, it is interesting to consider the proportions of the overall deficit attributable

1/ This appears to be the most meaningful of the three definitions formerly used by the U.S. Department of Commerce. The other two definitions included short-term (including "hot") money flows and were considered particularly inappropriate in a world of fluctuating currencies.

Following the recommendation of an advisory committee, which undertook a study of the balance-of-payments accounts, the government discontinued publication of overall balances, on the basis that they were subject to incorrect interpretation. Nonetheless, the use of this particular measure appears appropriate, in our view, for considering our general balance-of-payments performance and the relative contributions of major balance-of-payments sectors.

However, there is one minor difference in the Table 1 figures from those formerly compiled by the Commerce Department. In this connection, see footnote d to Table 1.

2/ Income receipts on U.S. direct investment abroad and payments on foreign direct investment in this country (lines 10 and 18 of Table 1, respectively) include dividends, interest, branch earnings, and fees and royalties from direct investments. (For the treatment of branch earnings, see footnote 1 on page 5.)

to the government and private sectors./1 The items in Table 1 can be classified reasonably well into these two categories and the results of such a classification are shown in Table 2.

It can be seen from Table 2 that the government sector more than accounted for the deficits which occurred during 1960-74 as the private sector generated sizable surpluses throughout the period under review. Since 1975, it has accounted for almost two-thirds of the deficit. The private sector moved into a deficit position during the latter period but the government sector deficit was almost twice as great. This is not surprising. The major government activity in the international area is the extension of grants and loans for military security or economic development purposes in areas which are not attractive to the private sector because they are not profitable.

It is clear at the same time that the continuation of large government programs is vitally dependent upon the private sector's ability to generate sufficient surpluses to finance these activities. Otherwise, we will continue to confront substantial devaluations of the dollar with potentially serious adverse effects both for the U.S. and world economies.

The Private Sector in Closer Focus

It can be seen from Table 2 that despite the favorable performance of the private sector during most of the period under review, it has not been sufficient to finance the large increases in government spending abroad since 1960. What is worse, it has now moved into a deficit position, thereby adding to the overall deficit and greatly complicating the country's efforts to restore balance to its international accounts. By way of considering the reasons for the recent deterioration in the private sector balance, Table 3 shows, on a somewhat consolidated basis, those private sector items in Table 1.

Clearly, a major factor underlying the large adverse shift in the private sector balance has been the sharp deterioration in the merchandise trade balance. Between 1963-65 and 1975-77, the merchandise trade balance showed an adverse swing of more than $13 billion and while there were also increased net outflows resulting from foreign investment

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1/ Admittedly, this is a somewhat simplistic approach, considering the interdependence of the two sectors. For example, government capital outflows no doubt provide significant support for U.S. exports. Indeed, because of the mutual interdependence of many of the individual items in the accounts, one must be cautious in interpreting developments in individual sectors. Nonetheless, a broad review of the general order of magnitude and direction of change of major sectors over an extended period provides, in most cases, sufficient evidence of performance, notwithstanding the interdependence.

in this country's private sector (see line 7 of Table 3), the deterioration in the foreign merchandise trade balance was clearly the major factor./1

Role of Direct Private Investment

The single major component in the balance of payments which has shown a favorable swing ($7-1/2 billion since 1960-62) is the surplus on private U.S. direct investment abroad (line 4 of Table 3). Income remittances from U.S. direct investment abroad exceeded capital outflows into such investment by an annual average $1.8 billion during 1960-62, and this had risen to $9.2 billion from 1975 through the first three quarters of 1977.

The balance on other long-term investment abroad also rose strongly through 1974, but moved into a deficit position during the 1975-77 period. This was attributable to an extraordinary increase in capital outflows which outstripped by a wide margin the large rise in income from such investment. The enormous rise in outflows was accounted for primarily by increased foreign bond issues in the U.S. The increase in bond issues reflected favorable borrowing conditions in this country in 1975 and 1976 and the termination in 1974 of the interest equalization tax which had effectively excluded many foreign borrowers from U.S. bond markets.

In view of the role of U.S. direct investment abroad as the single most important income earner in the balance-of-payments accounts, it appears useful to consider developments in this sector in greater detail. This is done in Tables 4 and 5, which show direct investment broken down by major geographic region and major industry sector, respectively./2

1/ It might seem surprising at first glance that the trade balance continued to show large adverse swings after 1971 in view of the declining value of the dollar which should have substantially improved the world competitive position of U.S. producers. Several factors were responsible. The initial impact of a depreciated dollar in making imports more expensive and exports cheaper in dollar terms was to worsen the terms of trade with adverse short-term effects. Only as trade patterns changed in response to the new exchange rates was there a net favorable impact. Unfortunately, the favorable effect of changing trade patterns was more than offset by the huge increase in the price of imported oil late in 1973.

Following a large surplus in 1975, which can be attributed primarily to the U.S. recession and the accompanying slowdown in imports, a deficit of more than $9 billion was incurred in 1976 and it approximated $27 billion last year. This reflected primarily the renewed U.S. expansion which has substantially exceeded that in most other industrial countries. While this deficit is expected to be reduced in 1979, if not this year, continued deficits are anticipated over the foreseeable future.

2/ Table 5 extends only through 1976, because industry data for 1977 are not presently available.

Both tables show there has been a substantial surplus on direct investment account since 1960, and the surplus has widened sharply as rising outflows into foreign investment have been accompanied by substantially greater remittances to this country from direct investments abroad. There was a slight decline in the surplus during 1966-68, but it rose substantially in 1969-71, experienced a particularly steep rise during 1972-74, and has almost matched that level since 1975.

Performance of Industries

Industry performance by sector.--As can be seen in Table 5, petroleum accounted for more than three-fifths of the huge increase in the annual average direct investment surplus during 1972-74. The average annual surplus for petroleum increased to more than $5-1/2 billion from roughly $900 million in 1969-71, while that for total direct investment rose to more than $8-1/2 billion from $3 billion. However, during 1975-76 the petroleum sector balance declined steeply, while the overall balance showed only a small decline as there were further large increases in the nonpetroleum sectors.

The unusually large surplus in the petroleum sector in 1972-74 is explained in part by a major accounting adjustment associated with the partial foreign takeover of a U.S. Middle Eastern oil affiliate. Another factor of central importance, however, was the steep rise in profits resulting from the increase in Arab oil prices in late 1973. Remittances from foreign oil affiliates in the form of dividends, interest, branch earnings,/1 fees, and royalties rose from $3 billion in 1972 to $5-1/2 billion by 1974. More important, there was a shift from net capital outflows of $1.3 billion into petroleum investments abroad in 1972 to a net repatriation of direct investment capital totaling more than $5 billion by 1974. Much of this was probably related to the financing of intercompany petroleum trade during a period of soaring petroleum prices.

Turning to other sectors, both manufacturing and other nonpetroleum industries showed a generally rising trend in the surplus on direct investment account throughout the period under review. Since the late 1960s, however, the increases have been substantially greater in manufacturing, and the 1975-76 balance was 3-1/2 times that in 1969-71. In the case of all sectors, recent increases--especially those since 1971--can be attributed importantly to accelerating inflation which led to a corresponding acceleration in both remittances and outflows. In addition, the devaluation of the dollar in terms of foreign currencies has been an important factor inflating the dollar value of most foreign currency payments and receipts.

1/ The accounting treatment of branch operations abroad deserves some comment, especially since this is a common mode of operation for the petroleum companies. Total branch earnings are counted as remittances to the United States. Those earnings not actually remitted are treated as capital outflows. Balance-of-payments surpluses are not affected by this approach, but both remittances and outflows are overstated on that account.

Industry performance by region.--The regions contributing most to the favorable balance through a large part of the period reviewed were Latin America and Asia-Africa-Oceania (Table 4). In the case of Europe, outflows exceeded remittances during most of the 1960s. The European deficit is somewhat misleading, however, in that it was more than accounted for by petroleum.

Most of the overseas earnings in the petroleum industry are generated in the producing sector rather than in refining or marketing. Taking all areas combined, the petroleum sector accounted, on average, for more than two-fifths of the favorable balance on direct investment account during the period reviewed in Table 5. However, half the favorable balance in Latin America has typically been accounted for by petroleum, while that sector accounted for some three-fourths to more than four-fifths of the balance in Asia-Africa-Oceania during 1960-74 (the rate declined to one-third during 1975-76). On the other hand, in Europe where refining and marketing operations are of substantially greater relative importance, the petroleum sector balance has been negative throughout the period under review. Capital outflows have been almost four times the level of remitted earnings which, although increasing throughout the period, remain relatively small.

The geographic patterns for manufacturing and other sectors have differed notably from those for petroleum.

Manufacturing surpluses have been large and trended generally upward in both Europe and Canada. They have increased much more rapidly in Europe, however, and during 1975-76 comprised more than one-half the total manufacturing surplus for all areas as compared with less than one-fourth in Canada. In Latin America manufacturing surpluses were small during most of the period since 1960 and moved irregularly, showing little trend as rising remittances were generally offset by increased capital outflows. However, in 1975-76 the surpluses increased sharply, due primarily to a large reduction in capital outflows. A similar pattern held true for Asia-Africa-Oceania in the early years of the period. However, the surpluses have increased sharply since the late 1960s as remittances have shown large increases while outflows have exhibited relatively little change.

The surplus on direct investment in other nonpetroleum sectors has also risen notably both in Europe and in Asia-Africa-Oceania. In the case of Europe, three-fifths of the 1975-76 surplus is attributable to the trade, finance, and insurance sectors. Surpluses have also been substantial in Latin America but they have shown relatively little change over the period as increased remittances have been matched by the rise in capital outflows.

The surplus for "other" nonpetroleum sectors in Europe in 1975-76 was more than one-third that for all areas. It represented more than one-fourth of the total in Asia-Africa-Oceania, but only some 15 percent in Latin America.

Relation of Direct Investment Surpluses to Capital Outflows and the Level of Investment

A major factor in relative changes of the direct investment surpluses among major areas and industry sectors is the differential changes in the level of direct investment from one area and one sector to another./1 Investment levels are influenced importantly by the volume of investment capital flowing abroad and the level of reinvested earnings which are the two major components accounting for increases in fixed investment. The expansion in earnings accompanying increases in the value of direct investment permits more funds to be remitted to the U.S. and also makes available additional funds for reinvestment, thereby expanding further the earnings base. This explains the cumulative long-term favorable impact of rising direct investment outflows on the balance of payments.

The cumulative outflow of U.S. direct investment capital into European manufacturing was three-fifths of the total outflow into manufacturing abroad during 1960-76. These heavy capital outflows account for the rise in the level of U.S. investments in Europe from one-third of total manufacturing investment abroad in 1960 to almost one-half in 1976. The corresponding rise in manufacturing earnings over this period permitted a rapid increase in earnings remittances to the U.S. As a consequence, the increase in total remittances (interest, dividends, branch earnings,/2 and direct investment fees and royalties) substantially outstripped the rise in outflows, accounting for the rapid rise in the surplus on direct investment account. The surplus rose from less than 10 percent of the total surplus from manufacturing investments abroad in 1960-62 to more than half of the total in 1975-76.

A sharply contrasting picture is shown for Canada. The value of U.S. manufacturing investments in Canada was more than two-fifths of total manufacturing investment abroad in 1960. However, capital outflows into Canadian manufacturing investments during 1960-76 were little more than one-eighth of total such outflows. As a consequence, the value of manufacturing investment in Canada declined to one-fourth of total such investments abroad by 1976; earnings on these investments rose very slowly; there was a correspondingly slow growth in remittances as well as reinvestments; and despite (or rather because of) the low level of capital outflows, the surplus on the manufacturing investment account grew so slowly that the Canadian share of the surplus on all manufacturing investment abroad declined from roughly two-thirds in 1960-62 to less than one-fourth by 1975-76.

1/ In the case of the petroleum sector, other factors are predominant as discussed earlier.

2/ See footnote 1 on page 5.

A similar pattern is shown in other, nonpetroleum sectors. Capital outflows into investments in Europe represented more than three-fifths of total such outflows during 1960-76 and the value of these European investments rose from one-tenth to almost three-tenths of total such investments abroad. As a consequence, notwithstanding the heavy outflow of capital, the surplus deriving from direct investment in European industry other than manufacturing and petroleum, rose from one-tenth of the surplus on total such investment abroad in 1960-62 to more than one-third by 1975-76.

As for Latin America, direct investment outflows into these economic sectors were little more than one-fourth total outflows to all areas, and the value of investments declined from two-fifths to roughly one-fourth total such investment abroad between 1960 and 1976. As a result, the surplus declined from two-thirds of the total surplus on direct foreign investment in these sectors in 1960-62 to well under one-fifth in 1975-76.

Conclusion

This review shows clearly the key role of the U.S. direct investment sector in reducing the U.S. balance-of-payments deficits over the past 15 years. In the absence of these investments, our deficits would have been greater by several billion dollars.

It is also clear that the cumulative long-term impact of rising direct investment outflows on the balance of payments is highly favorable since they generate a substantially greater increase in earnings and remittances. The finding that the U.S. surplus on direct investment abroad rose from an annual average $1.8 billion during 1960-62 to $9.2 billion from 1975 through the first three quarters of last year despite the rise in direct investment outflows from $1.6 billion to $5.2 billion is nothing short of dramatic.

These figures should go far to demolish the myth that the bulk of earnings from U.S. direct investment abroad are insulated from U.S. taxes. On the contrary, they are returned to the U.S., adding to the U.S. tax base, creating jobs, and supporting a variety of domestic corporate programs, including research and development, pollution abatement, and improvement in safety and health./1

Unfortunately, the Administration's proposal to tax foreign earnings when earned instead of awaiting their repatriation to the U.S. is based on that myth. It should be noted, in addition, that where a

1/ Not only has the dollar volume of remittances risen sharply, but the proportion of earnings returned to the U.S. has consistently exceeded 50 percent, averaging 56 percent during 1972-76 and even higher (65 percent) during 1966-71.

U.S.-based company can survive in a market only by manufacturing in the same low-tax jurisdiction in which all of its foreign-based competitors operate, removal of tax deferral may only put the company out of business or out of certain product lines. At least some foreign earnings must be left abroad for use in modernizing plant and equipment in order to maintain the competitiveness of U.S. industry against that of other countries participating in those same markets. These reinvested earnings should not be taxed at discriminatory rates, thereby putting the U.S. company at a competitive disadvantage with other local producers.

The conclusion is obvious. Measures that would restrict U.S. capital outflows or discourage reinvestment of foreign earnings would impact adversely on the U.S. international competitive position, and would, over the longer run, have a highly adverse balance-of-payments effect. To that extent such measures would clearly be self-defeating.

TABLE 1

U.S. Balance of Payments--Major International Transactions, Annual Averages
(millions of dollars)

		1960-62	1963-65	1966-68	1969-71	1972-74	1975 - 1st 3 qtrs. 1977 /e
1	Merchandise Trade Balance /a	5,025	5,659	2,751	317	-3,623	-8,234
2	Services	-1,010	-1,084	-1,254	-1,486	-2,150	-948
3	Military Transactions	-2,599	-2,186	-3,101	-3,192	-2,664	-696
4	Remittances, Pensions & Other Transfers	-675	-925	-1,195	-1,521	-1,781	-1,884
5	Long-Term U.S. Capital Outflows	-5,524	-7,758	-8,171	-9,387	-9,630	-21,174
6	Direct Investment	-1,642	-2,591	-3,176	-3,995	-2,592	-5,223
7	Other Private	-1,036	-1,647	-1,107	-1,692	-2,560	-9,126
8	Government (Including U.S. Government Grants Exclusive of Military Grants)	-2,846	-3,520	-3,888	-3,700	-4,478	-6,825
9	Receipts of Income on U.S. Investment Abroad	4,589	6,348	7,630	10,465	17,053	24,620
10	Direct Investment /b	3,406	4,623	5,137	7,004	11,292	14,441
11	Other Private Receipts	781	1,233	1,824	2,550	4,878	8,896
12	U.S. Government Receipts	402	492	669	911	883	1,283
13	Long-Term Foreign Capital Inflows	513	348	2,859	3,570	6,112	6,684
14	Direct Investment	115	16	221	562	1,988	1,893
15	Other Private /c	267	68	2,578	3,246	3,371	1,836
16	Government /d	131	264	60	-238	753	2,955
17	Payments of Income on Foreign Investment in U.S.	-1,105	-1,570	-2,515	-4,914	-8,754	-11,971
18	Direct Investment /b	-245	-307	-449	-603	-725	-1,460
19	Other Private Payments	-544	-815	-1,450	-3,096	-4,435	-5,807
20	U.S. Government Payments	-316	-448	-616	-1,215	-3,594	-4,704
21	Balance on Current and Long-Term Capital Account	-786	-1,168	-2,996	-6,148	-5,437	-13,603

a/ There was a break in the "merchandise trade balance" series beginning in 1970. Both exports and imports were revised to incorporate the results of the U.S.-Canadian trade reconciliation conducted by the U.S.-Canada Trade Statistics Committee. (Reconciliations are not available for years prior to 1970.) The net effect was to increase the 1970 surplus by $0.4 billion and to reduce the 1974 deficit by $0.8 billion.

b/ Includes direct investment fees and royalties.

c/ Includes foreign purchase of U.S. securities other than U.S. Treasury securities and change in long-term liabilities to foreigners reported by U.S. concerns.

d/ U.S. government liabilities to other than foreign official agencies. The "basic balance" as formerly published by the Commerce Department included nonliquid liabilities only. However, liquid liabilities represent only a minor part of the total.

e/ Seasonally adjusted annual rate.

Source: U.S. Department of Commerce.

TABLE 2

U.S. Balance of Payments--Government Versus Private Sector, Annual Averages /a
(millions of dollars)

	1960-62	1963-65	1966-68	1969-71	1972-74	1975 - 1st 3 qtrs. 1977/b
Government	-5,458	-5,701	-7,281	-7,904	-9,753	-8,886
Private	4,672	4,533	4,285	1,756	4,316	-4,717
Balance on Current and Long-Term Capital Account	-786	-1,168	-2,996	-6,148	-5,437	-13,603

a/ The government sector includes lines 3, 8, 12, 16, and 20 and the government portion of Line 4 in Table 1.
b/ Seasonally adjusted annual rate.

Source: U.S. Department of Commerce.

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TABLE 3

U.S. Balance of Payments--Private Sector Transactions, Annual Averages /a
(millions of dollars)

		1960-62	1963-65	1966-68	1969-71	1972-74	1975 - 1st 3 qtrs. 1977 /b
1	Merchandise trade balance	5,025	5,659	2,751	317	-3,623	-8,234
2	Services	-1,010	-1,084	-1,254	-1,486	-2,150	-948
3	Private remittances, pensions & other transfers	-445	-622	-790	-1,051	-1,128	-985
	Income from U.S. private investment abroad less capital outflow into private investment						
4	Direct investment	1,764	2,032	1,961	3,009	8,700	9,218
5	Other private	-255	-414	717	858	2,318	-230
	Payments on foreign private investment in U.S. less capital inflow into private investment						
6	Direct investment	-130	-291	-228	-41	1,263	433
7	Other private	-277	-747	1,128	150	-1,064	-3,971
8	Balance on current and long-term private capital account	4,672	4,533	4,285	1,756	4,316	-4,717

a/ The data of this table are taken from Table 1; Line 3 = the private portion of line 4 in Table 1.
b/ Seasonally adjusted annual rate.

Source: U.S. Department of Commerce.

TABLE 4

U.S. Balance of Payments--Transactions Relating
to U.S. Direct Private Investment Abroad
--Major World Areas, Annual Averages
(millions of dollars)

	1960-62	1963-65	1966-68	1969-71	1972-74	1975 - 1st 3 qtrs. 1977 /c
EUROPE						
Remittances	727	1,071	1,257	1,993	3,485	5,006
Capital Outflows	-851	-1,264	-1,418	-1,767	-2,667	-2,858
Balance	-124	-193	-161	226	818	2,148
CANADA						
Remittances	563	785	962	1,095	1,429	1,877
Capital Outflows	-356	-542	-580	-470	-533	-20
Balance	207	243	382	625	896	1,857
LATIN AMERICA /a						
Remittances	959	1,184	1,319	1,366	1,780	2,283
Capital Outflows	-132	-207	-440	-553	-1,045	-624
Balance	827	977	879	813	735	1,659
ASIA-AFRICA-OCEANIA						
Remittances	1,130	1,536	1,497	2,166	4,193	4,623
Capital Outflows	-272	-539	-644	-833	2,103	-2,033
Balance	858	997	853	1,333	6,296	2,590
OTHER /b						
Remittances	27	47	102	384	405	261
Capital Outflows	-31	-39	-94	-372	-450	312
Balance	-4	8	8	12	-45	573
ALL AREAS						
Remittances	3,406	4,623	5,137	7,004	11,292	14,050
Capital Outflows	-1,642	-2,591	-3,176	-3,995	-2,592	-5,223
Balance	1,764	2,032	1,961	3,009	8,700	8,827

a/ Includes all Western Hemisphere countries other than Canada and the U.S.
b/ Includes primarily transactions with shipping, finance, and insurance companies whose activities cannot be assigned to any particular world area.
c/ Not adjusted for seasonal variation.

Source: U.S. Department of Commerce.

TABLE 5

U.S. Balance of Payments--Transactions Relating to U.S. Direct Private Investment Abroad--Major Industry Sectors, Annual Averages /a
(millions of dollars)

	1960-62	1963-65	1966-68	1969-71	1972-74	1975-76/b
MANUFACTURING						
Remittances	1,051	1,436	1,711	2,415	3,925	4,902
Capital Outflows	-673	-1,093	-1,260	-1,346	-1,962	-1,114
Balance	378	343	451	1,069	1,963	3,788
PETROLEUM						
Remittances	1,444	1,935	1,674	2,304	4,188	3,892
Capital Outflows	-609	-872	-1,005	-1,377	1,373	-2,664
Balance	835	1,063	669	927	5,561	1,228
OTHER						
Remittances	911	1,252	1,752	2,285	3,179	4,586
Capital Outflows	-360	-626	-911	-1,272	-2,003	-1,652
Balance	551	626	841	1,013	1,176	2,934
ALL SECTORS						
Remittances	3,406	4,623	5,137	7,004	11,292	13,380
Capital Outflows	-1,642	-2,591	-3,176	-3,995	-2,592	-5,430
Balance	1,764	2,032	1,961	3,009	8,700	7,950

a/ Only preliminary figures for interest and dividend remittances, branch earnings, and capital outflows are available for individual categories prior to 1966. Data showing direct investment royalties and fees are not available on an individual basis prior to 1966. Royalties and fees were estimated based on 1966-74 patterns. These estimates together with the preliminary data were adjusted to the revised figures for all sectors combined which are available for these years.

b/ Industry sector figures are not available for 1977.

Source: U.S. Department of Commerce.

The 1978 Economic Report of the President: Philosophy vs. Implementation

Statement by
The National Association of Manufacturers
to the
Joint Economic Committee of the Congress
March 1978

The period from March 1975 to the present has again proved the amazing resilience of the U.S. market economy. From the low of the worst recession since the 1930's the economy has bounced back at a rate and in a way that seems sustainable. This recovery should reaffirm faith in the inherent strength of our free market system. This indeed seems to be true in the case of President Carter; he has said the Administration will rely principally on the private sector to lead the continuing economic expansion, to create new jobs for the growing labor force, and to raise incomes. It is this expression of economic philosophy and many other such expressions and the apparent contradiction of this economic philosophy by Administration policies that will be discussed in this statement.

But, before going into policy questions, it may be well to examine the economic recovery and outline briefly where the economy stands at present and what the outlook seems to be.

An Overview of the Expansion and Present State of the Economy

We have now completed three years of economic recovery and expansion. Rather than being pleased with the economic recovery we instead see much dissatisfaction. Rather than being reassured as to the durability of the current business expansion we hear many doubts as to whether the recovery can be maintained. The major complaints about the economy are as follows. First, it is often said that the recovery is highly irregular, that it is proceeding in fits and starts. This leads to repeated alarms as to whether we are approaching the next cyclical downturn. Second, the current recovery is often described as incomplete--the unemloyment rate is said to be too high. Next, it is said that the state of business confidence is too low, thus depressing the rate of investment spending. Fourth, it is said that business expenditures in this recovery are below the levels needed to provide the necessary capital for future growth. Finally, it is argued that this economic recuperation has been plagued by continuing inflation. The present inflation rate is below the double digit rates of 1973-74 rate. It is disturbing, though, to think that this rate may continue and it is even more disturbing to think that it may accelerate.

Let us address each one of these complaints and in the process examine their significance for the business outlook.

Those who contend the economic recovery is irregular cite as evidence the widely fluctuating quarterly growth rates of real gross national product. If one instead looks at the quarterly growth rate of real final sales one gets a picture of a much more stable economy. The difference between real gross national product and real final sales is, of course, net additions to business inventories. As business inventories are being increased production exceeds final sales and as inventories are depleted final sales exceed production.

A glance at column 1 of table 1 seems to confirm the impression of many leaders that the economy is proceeding in fits and starts. Indeed, in the past three years the growth rate of production has varied between a high of 11.2 percent to a low of

0.9 percent. (We ignore the negative growth of the first quarter of 1975 because this was the final quarter of the recession.) The high growth to low growth ratio is slightly more than 12 to 1. If we instead look at the growth of final sales the economy is much steadier. The growth rate of final sales has varied between 7.1 percent and 3.5 percent. This is a ratio of slightly more than 2 to 1.

In 1976 when real GNP fell from 8.8 percent growth in the first quarter to 1.9 percent growth in the fourth quarter, real final sales increased from 3.6 percent growth to 6.0 percent growth. The same pattern held again in 1977. The real GNP growth rate fell throughout the year but the real final sales growth rate increased from 3.8 percent in the first quarter to 6.5 percent in the fourth quarter.

The erratic growth of production reflects the accumulation and decumulation of inventories. As businesses attempt to avoid holding inadequate or excessive inventories they adjust their production schedules. This production adjustment produces the erratic behavior in real GNP. Final sales, however, indicate demand for goods and services by end users. This underlying demand, which provides the underlying support for the economy, has been very stable and has shown no sign of slowing down. The periodic alarms that the expansion is tapering off and that we are passing the cyclical peak are, hence, suspect.

A further lament about the current recovery is that the unemployment rate is much too high. In the present expansion we have been confronted by a peculiar economic paradox. The growth of the number of employed persons has been phenomenal yet the decline of the number of unemployed persons has been slow and the unemployment rate has persisted at what seems to be a very high level.

If we examine table 2 we see that the U.S. economy has shown an amazing ability to create jobs. In the past three years 7.7 million people have been added to the roles of the employed. In the past year alone, well over 3 million additional people found jobs. Even with this vast increase in employment the number of persons unemployed has decreased by only 1.6 million since the second quarter of 1975.

These statistics should tell us a few things. First, the U.S. economy still has the vigor to provide productive and meaningful employment to an overwhelming majority of its citizens.

Second, these numbers indicate that the continued resistence of the unemployment rate to rapid reduction in the past three years is due to persistent high unemployment among certain demographic groups, most notably blacks and teenagers. The solution of unemployment among these groups will require dealing with the structural causes. Structural employment problems are of great importance to the health of society and they must be effectively addressed. In any case, the economy has shown the ability to create new jobs and there does not appear to be a systematic deterioration in the ability of the American economy to continue to create new jobs.

The yellow flag of depressed business confidence is often raised these days as a signal of slower future growth and depressed economic conditions. It is often times said that business confidence must be bolstered to assure high business fixed investment so as to speed up the expansion or at least to keep it going. Closer analysis of the situation reveals a different story.

What is described as "a lack of business confidence" can just as well be called a high degree of caution in the business community. The events of the past five years would undoubtably lead any rational individual to be cautious. The Arab oil embargo, excessive government regulation and economic intervention, the steepest economic slump since the 1930's, the uncertain energy policy, and the high and fluctuating inflation rate and interest rate are just some of the factors that have caused economic decision makers to appraise the future with reservations. This high degree of business caution can indeed have some very positive effects. In past business cycles overly optimistic business expectations have led to excessively expansive inventory and fixed investment policies. When these excessive investments were later found to be unwarranted cutbacks have occurred and a downturn has resulted. Thus, when business confidence appears to be unanimous or nearly so, a downturn is probably not far off.

Many people claim that as a product of the low business confidence fixed investment has failed to reach levels adequate to sustain the business expansion. They contend that the low level of business investment seriously impairs the long run growth prospects of society and that by not augmenting existing capacity threatens to touch off future inflation as demand expands. A more thorough analysis of the situation fails to confirm such fears. In past periods of rising investment after a recession, the capital goods boom has been the final phase of the expansion and has soon been followed by another downturn. The absence so far of an investment boom should be taken as evidence that the present business expansion still has a ways to go.

Chart 1 sheds further light on the question of fixed business investment. If we ignore the five years immediately following the war this chart seems to fall into two distinct periods. In the 1950-64 period the ratio of real fixed investment to real GNP averaged about 9.1 percent. This ratio jumped to a higher plateau for the period 1965-1974, and averaged about 10.3 percent. In 1975 this ratio fell back to the 1950-64 pattern and has remained there since. In light of this phenomena the question arises as to whether this decline is a cause for concern or whether it merely represents a decline to a more natural level.

It appears that the decline of this ratio does not represent a catastrophic and unprecedented falling off. The economic record of the 1950-64 period, which had an investment pattern similar to the one we are now entering, was by almost any economic criterion better than the economic circumstances of the 1965-74 period, which had a higher fixed investment to GNP ratio. The inflation rate in 1950-64 was 1.8 percent as compared to 5.1 percent in 1965-74. Also, the annual rate of growth of productivity was 3.1 percent in the earlier period and 1.7 percent in the latter period. Hence, there does not seem to be any clear reason to assume that the economy is in trouble because of some supposed insufficiency of capital.

The final complaint we hear about the present expansion concerns the inflation rate. From a high of 12.2 percent in 1974 the rate of inflation seems to have settled down to the 6 to 7 percent range. Fears abound that inflation may accelerate from this point.

Inflation has behaved peculiarly in the past five years. Traditional economic analysis told us that as excess capacity and labor occurred prices would fall. But experience indicates differently. From 1973 to 1975 capacity utilization in manufacturing fell from 92 to 74 percent and the unemployment rate rose from 4.9 to 8.5 percent, yet, inflation persisted at very high levels. We had stagflation. Recently economists have discovered that there are rigidities in wage and price decisions that tend to limit the tendency of wages and prices to fall during recession. But these rigidities do not operate on the up side. As industrial capacity and the labor supply become tight there is a tendency for inflation to accelerate.

Recent analysis indicates that the natural rate of unemployment is about 6.0 percent.* In other words, the inflation rate will begin to accelerate when unemployment approaches 6.0 percent. This prospect is particularly troublesome because there is political pressure to reduce the unemployment rate to 4.0 percent. The 4 percent rate of unemployment was a valid and attainable goal in earlier periods but due to demographic changes it is now unreasonably low and, therefore, can only be attained with higher inflation. Even in the late 1960's, whenever unemployment fell below 4 percent we had an accelerating inflation. The equilbrium unemployment rate at that time appears to have been about 5 percent. Now for demographic reasons, it is even higher.

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*See Phillip Cagan, "The Reduction of Inflation and the Magnitude of Unemployment", American Enterprise Institute Studies of Contemporary Economic Problems.

A strategy designed to reduce the unemployment rate well below. 6 percent could be successful only temporarily. It would inevitably set off an accelerating inflation, followed by stagflation, and leading to recession.

To sum up this brief review of the expansion one can say that the economy has made great strides and still appears to have the strength to continue. The economy has provided an unprecedented number of new jobs, the underlying growth in real final demand is stable and growing, the inflation rate has been brought down to a manageable level, and fixed investment does not show signs of over-expanding and, hence, leading to another recession. It appears that the economy can continue upon this moderate growth path -- provided overeagerness to do even better does not lead to government policies that reanimate inflation. Although the present economic expansion does not show any signs of tapering off, there are some ominous signs that it could end in an inflationary explosion if inappropraite economic policies are adhered to.

THE SIGNIFICANCE OF THIS ECONOMIC POSTURE FOR GOVERNMENT POLICY IS OBVIOUS. THERE ARE DANGERS TO OUR ECONOMIC FUTURE, BUT THE NATURE OF THOSE DANGERS IS WIDELY MISCONCEIVED. WE DO NOT HAVE AN INHERENTLY WEAK AND FALTERING ECONOMY THAT IS IN NEED OF CONTINUED STIMULATION--THROUGH LARGE FEDERAL BUDGET DEFICITS AND RAPID EXPANSION OF THE MONEY SUPPLY. WE DO HAVE AN ECONOMY THAT IS HIGHLY

SENSITIVE TO INFLATION AND WE ARE IN GRAVE DANGER OF A SERIOUS SETBACK THROUGH A RENEWED ACCELERATION OF THE UPWARD TREND IN THE PRICE LEVEL.

This is the fundamental conclusion that we would like to convey to the Joint Economic Committee and to all economic policy makers in government.

The Administration's Economic Philosophy and Policy

This Nation, since its inception, has adhered to the free enterprise form of economic organization. Our system is based on maximum freedom of economic decision-makers. We permit consumers to make their own choice as to the goods and services they desire to purchase. The dictates of consumers indicate what products producers will supply in order to earn a profit. If consumers desire less of a product, profits decline and producers shift their capital to other more profitable lines. If the consumer desires more of a product, sales in that industry increase and profits rise. This serves as a signal to enterpreneurs to enter that line of business. Thus, through freedom of consumer purchasing choice and freedom of business investment choice the demands of society are satisfied.

The key to our system is, as mentioned above, maximum freedom of choice. Unfortunately, in recent decades there has been increasing government intervention in our economic system.

Increased intervention can only be obtained with a reduction in the individual's freedom of choice. The rise of government economic intervention is evidenced by the deluge of federal rules and regulations business must now comply with. Further evidence of the government's economic intervention is seen by the ever expanding federal budget. Federal outlays have increased by more than 250 percent in the last ten years. The Federal government has operated at a deficit for 17 of the last 18 years. Federal spending now comprises more than 22 percent of gross national product. This means that over a fifth of the economic activity in this country is the result of decisions made by the Federal government. The Federal government's economic role is so massive that its fiscal decisions have major impacts on the national economy and on individual industries. Indeed, its spending and taxing authority is used to fine tune the economy -- although experience in recent years has demonstrated that this is a losing strategy. Fortunately, President Carter has recognized the hazards of increasing government economic intervention. In his annual report he outlined a broad economic philosophy that promises to enhance the freedom of private economic decision makers.

There are three major themes in the President's report that should be reassuring. First he has said he will rely on the private sector to engineer the continuation of the economic recovery. He has said that the Nation should "rely on the private economy to lead the economic expansion, to create new jobs for the growing labor force, and to raise incomes." A second encouraging theme is President Carter's decision to reduce the Federal government's share of the gross national product. He has committed his administration to balancing the budget and reducing the Federal GNP share to under 21 percent. Finally, he has indicated his administration will mount a balanced attack on the Nation's two most publicized economic ills, inflation and unemployment. President Carter evidently recognizes the intimate relationship between inflation and unemployment, and thus the need to fight both at once rather than fight one at the expense of the other.

The economic philosophy outlined by the President in these themes is indeed reassuring and encouraging. Our Nation needs an unfettered market system if it is to continue to respond to consumer demands. But words and actions sometimes differ. This seems to be true in the case of President Carter. Many of the policies President Carter has recommended do not seem completely consistent with his stated philosophy.

He has spoken of counting on a strong private sector to lead the economic expansion, yet he has proposed an inflation deceleration program that involves government in private wage and price setting decisions. The private sector requires maximum freedom if it is to develop the vigor needed to lead the economy. Business will be hesitant in expanding production, creating new jobs, and investing in new facilities if it is uncertain of the price it will be permitted to charge in order to earn a return on its investment.

If the deceleration program is conceived as a substitute for the other things government must do to curb inflation, then it will be a flat failure. If, while the voluntary controls are in effect the Administration attempts to stimulate the economy to, for example, reduce the unemployment rate, then disastorous results will occur. Another round of accelerating inflation will burst upon the economic scene and stagflation and recession will occur. The best course of action for the Administration to follow if it is determined to slow inflation would be to renounce all incomes policies, whether voluntary or mandatory, and adopt responsible fiscal and monetary policies.

There is nothing the business community fears more than a new experiment with wage and price controls. The Administration's "deceleration" program appears to fall well short of what is ordinarily thought of as controls. But any such program is in danger, on the one hand, of degenerating into a purely cosmetic operation and, on the other hand, of expanding into a program of government pressures on private parties that becomes mandatory control in all but name.

The President has also said he will rely on the private sector as the primary creator of new jobs. This statement came several months after he endorsed the increase in the minimum wage, an action that will make it increasingly difficult for the unskilled and the young to find jobs. The increase in the minumum wage raises the cost of hiring marginally efficient workers. Firms that would have hired these workers at a lower wage will now be reluctant to do so. It is peculiar that a President should ask the private sector to take the lead in creating new jobs and then make it more difficult for business to provide work for the demographic groups that need jobs the most.

The private sector can not be expected to lead the economy when its hands are tied with wage and price restraints and artificially mandated wage rates.

The second major economic theme expressed by the President in the annual report is his decision to balance the budget and reduce the federal share of the gross national product. Again, this is a sound bit of economic philosophy. The federal share of the gross national product has grown to the point that it now consumes over 22 percent. The budget has been in deficit for 17 of the last 18 years and as a result has strained the resources of the economy. Although these are serious problems and require immediate remedy one must wonder about the President's commitment to these goals.

The President appears to have set the private sector as a straw man. He says he will balance the budget "if the private sector grows at an adequate rate." But many of his policies threaten to create economic uncertainties and tie the hands of the private sector so that it does not have the freedom to grow. Without an adequately growing private sector the President feels he does not have to balance the budget. Rather than establish a goal that appears to be unattainable it may be better to set a less ambitious but at least achievable goal.

In his economic report and in several public statements President Carter has said he will fight a balanced war on inflation and unemployment. This kind of a commitment is long overdue. Economic theories popular a decade ago argued that a reduction in one could only be gotten at the expense of the other. It was said that an increase in inflation would reduce the unemployment rate. Recently, however, the opposite occurred. We experienced an acceleration of inflation and an accompanying rise in the unemployment rate.

Even though the President has made this verbal commitment he has also strongly endorsed the Humphrey-Hawkins bill. This bill emphasizes reducing unemployment over fighting inflation. Although the bill does warn against policies that might exacerbate inflation, it nevertheless presents a very real inflationary danger. The full employment goal set in this bill is at an unrealistically low 4 percent. The 4 percent full employment rate is a carryover from an earlier and much different period. Recent analysis has indicated that the current full employment rate is 6 percent. In other words, the inflation rate will begin to rise from the presently established 6 to 7 percent rate when unemployment gets down so low as 6 percent. We should already be cautious because the unemployment rate is currently approaching the minimum level. Pressure on the President to achieve the unrealistically low unemployment goal established by Humphrey-Hawkins could produce massive government make work programs and increase federal spending. Such policies would prohibit the

President from balancing the budget and worsen our inflationary troubles.

Reduced government spending should be the Administration's primary tool in balancing the budget. The President's efforts to hold spending down are commendable. In his 1978 budget he has held the growth in real federal spending to about 2 percent. Although this is praiseworthy there are other economizing measures that could be made to curtail the oversized federal bureaucracy. Particlar endeavors should be made in the area of reducing regulation.

Business today is overwhelmed by the volume of regulation that it must comply with. Compliance with myriad rules and the filing of countless forms increases the cost of all firms and reduces the productivity of many smaller firms. There is also a serious question as to the cost/benefit effectiveness of many of these regulations. The Council on Wage and Price Stability has in many cases found that the cost of a rule outweighs the benefits derived. By eliminating these regulations and paring the agencies involved, the Carter administration can increase business efficiency and reduce the expense of doing business, and at the same time, take a monumental step toward balancing its own budget.

There are many parts of the President's budget that are laudable. One such part is his tax cut package. There is a need for general tax reductions for both business and individuals to offset at least partially the effects of inflation on tax liabilities and of the coming Social Security tax hikes. The proposed corporate

rate reduction is desirable and sound. The tax reduction proposal could be improved though if a flat 18 percent tax rate were enacted on the first $100,000 and 44 percent on all income above $100,000. The permanent extension of the 10% investment tax credit is also a sound idea. It would lend increased stability to the tax credit and enhance its effect on financial planning. Raising the credit which can be taken in any one year from 90% of taxes otherwise due, from the current 50 percent, would make the credit more usable. The extension of the credit to capital structures would also be a desirable step.

The individual tax cuts are desirable but their impact does not focus sufficiently on middle and upper income taxpayers who provide much of the private savings which finances productive investment. The combined effects of a conversion to a $240 personal tax credit, repeal or limitation of various itemized deductions and higher social security taxes would more than offset the favorable impact of the tax cuts.

The proposal to end "deferral" of tax on foreign-source income is an unfortunate feature of the tax package. Unilateral imposition of a tax by the United States on undistributed foreign subsidiary earnings would increase the overall tax burden of U.S. firms competing in foreign markets. Such a proposal would only benefit foreign-based firms and foreign government revenues. Such a tax would reduce the incentive for U.S. firms to establish foreign subsidiaries. As foreign based U.S. subsidiaries increased the dividend remittances to their U.S. parents the coffers of foreign governments would be increased through the imposition of profits remittance taxes or "withholding" taxes when funds leave their country. The net effect of this would be an undesirable impact on U.S. trade. The establishment of foreign subsidiaries increases the demand for U.S. exports. These exports are usually in the form of components, semi-processed goods or raw materials for the foreign subsidiary. Less investment overseas would thus harm U.S. exports.

The proposal to eliminate DISC, like the proposal to end "deferral" would be injurious to U.S. exports. The DISC provision has been helpful in encouraging many firms to go into the export market and in encouraging others to expand their exports by enhancing their ability to overcome trade barriers erected by other nations. In light of the gigantic U.S. trade deficit the timing of this proposal is particularly bad. Rather than eliminate DISC it should be expanded to help abate our trade deficit.

Last, the President's proposal to limit business meal expenses and the end of the deductability of other business expenses ignores the extent to which such activities are a necessary part of doing business for many firms. Such limitations would attempt to dictate to managers how they should spend available funds in the development of new or increased business. The Administration's "meat-axe" approach to alleged abuses is unjustified. Such abuses are the proper subject for better enforcement and compliance procedures, not restrictive legislation.

<u>Summary Remarks</u>

Hopefully, this statement has indicated that our economy has come a long way since the depths of the past recession. The economy also appears to have the inherent vitality to continue on an upward course. Furthermore, much of the credit for the economic progress must go to our effective and efficiently operating free market system. But this recovery and continued economic expansion could very easily be truncated if improper economic philosophy is advocated or if inappropriate economic policies are followed.

The Administration has cleared the first hurdle. The President has proclaimed his faith in the free enterprise system. He has announced his reliance on the private sector and he has devoted himself to reducing the relative size of the federal sector in an effort to increase the freedom and influence of the private sector. Unfortunately it seems that the second hurdle has proven to be the stumbling block. His policies do not always accord with that philosophy. Many of his actions constrain the private sector and weaken its ability to lead the economy. He also has not taken strong enough measures to reduce federal spending and, therefore, the size of the federal sector. Finally, he has in some cases endorsed unrealistic goals that could worsen the economic environment. Continuation of these policies and concerted efforts to achieve these unrealistic goals could cut short the expansion and quite possibly cast us into another round of inflation and recession.

Adopting policies that conform to his stated economic philosophy will augment the underlying strength of the private sector, permit continuation of the expansion, and lead to a healthier and more stable economy.

Table 1

Growth Rates in Real Gross National Product
and Real Final Sales--Quarterly
(Annual Rate of Increase)

	(1) Real GNP	(2) Real Final Sales
1975 I	-9.6%	3.1%
II	6.4	7.1
III	11.2	4.3
IV	2.9	4.3
1976 I	8.8	3.6
II	4.8	4.2
III	4.1	3.5
IV	.9	6.0
1977 I	7.7	3.8
II	6.3	5.0
III	4.9	4.6
IV	4.2	6.5

Source: Computed from data of U.S. Department of Commerce.

Table 2

Employment and Unemployment
(Quarterly)

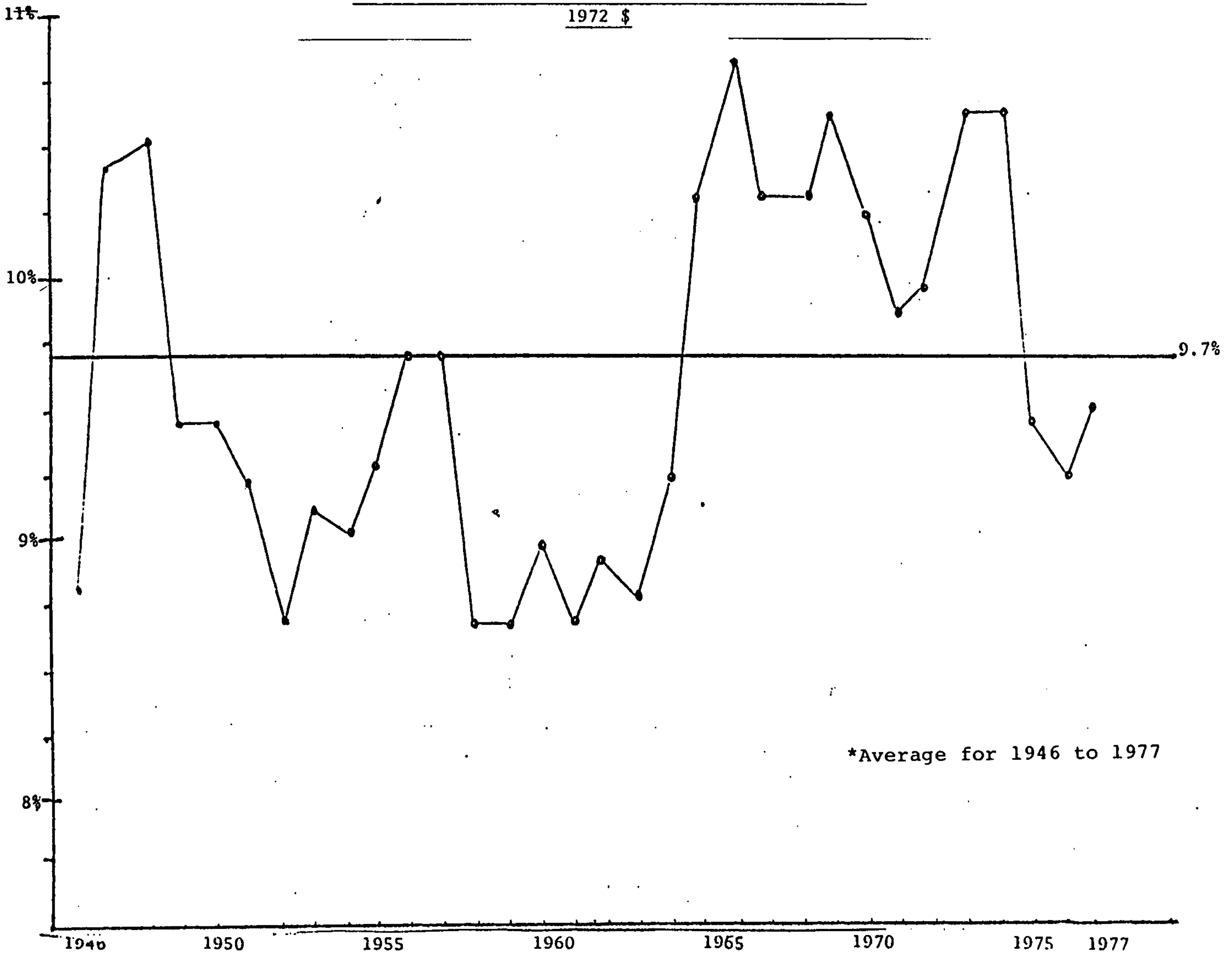
		Number of Persons Employed (a) (millions)	Number of Persons Unemployed (millions)	Unemployment Rate (Percent)
1975	I	84.4	7.6	8.2%
	II	84.3	8.2	8.9
	III	85.0	7.9	8.5
	IV	85.3	7.7	8.3
1976	I	86.6	7.2	7.7
	II	87.4	7.1	7.5
	III	87.8	7.4	7.7
	IV	88.2	7.5	7.8
1977	I	88.9	7.2	7.5
	II	90.3	6.9	7.1
	III	90.8	6.7	6.9
	IV	92.1	6.6	6.6

(a) Does not include armed forces

Source: U.S. Bureau of Labor Statistics

Chart #1

Ratio of Non-Residential Fixed Investment to GNP
1972 $



FOUNDED 1899

NATIONAL CONSUMERS LEAGUE

1028 CONNECTICUT AVE.•SUITE 522•WASHINGTON, D.C. 20036•202 797-7600•SANDRA L. WILLETT, *Executive Vice-President*

February 22, 1978

Dear Member of Congress:

The National Consumers League, the oldest consumer organization in the country, urges you to support H.R. 50, the Humphrey-Hawkins bill.

President Carter, Speaker Tip O'Neill and more than 80 national organizations support this bill which will assure all Americans who are able and willing the opportunity of seeking work.

This vital legislation commits the nation and its leaders to:

- A specific target of no more than three (3) percent adult unemployment and four (4) percent overall unemployment by 1983.
- Implementation of policies and programs by a comprehensive process involving the President, the Congress and the Federal Reserve Board, to stimulate balanced growth.
- Achievement of reasonable price stability as rapidily as possible.
- Reduction of the gap between the national unemployment average and the unemployment rate differential of such groups as women, minorities, the disabled and teenagers.

Do not support the anti-inflation amendment. The unemployment-inflation "trade-off" is a myth which is not substantiated by fact. During the Kennedy-Johnson years the annual growth rate was 4.6%, the unemployment rate was a relatively low rate of 3.5% and inflation from 1961-69 averaged only 2.6%.

The National Consumers League, on behalf of its entire membership and state affiliations ask you to vote for H.R. 50 without any weakening amendments.

Sincerely yours,

Sandra L. Willett

Sandra L. Willett
Executive Vice-President

Anne Harrison Clark

Anne Harrison Clark
Legislative Director

Statement on behalf of the NATIONAL CONSUMERS LEAGUE at the
White House Conference on Balanced Growth and National Development
by Caroline F. Ware
February 1, 1978

My name is Caroline F. Ware. I am a member of the Board of Directors of the National Consumers League.

It is appropriate that the League, the oldest consumer organization in the United States, should present its views on Balanced Growth and National Development at this Conference. Ever since its founding in 1899, the National Consumers League has taken the position that the consumer interest in the economy is comprehensive. In the League's view, the consumer interest is not limited to the availability of goods and services, their quality, price, distribution and the information available to buyers and users. It believes, that the consumers' responsibility includes concern for the conditions under which goods and services are produced, hence our historic leadership for minimum wage and for the elimination of industrial homework and child labor and our continued preoccupation with minimum wage and occupational health and safety. And the League recognizes that the consumer interest extends equally to the availability of the income which provides the indispensable buying power, so we have declared our support for the Humphrey-Hawkins Full Employment and Balanced Growth Bill. It is this broad view of the consumer interest which brings us here today.

It has always been the position of the National Consumers League, moreover, that the consumer's voice must be heard on all essential economic issues if the economy is to enjoy the balanced pressures required to keep it healthy and on an even keel. As the notion of a balance between buyer and seller in an economy of individual higgling and bargaining fades into history or myth in the modern age of economic organization and concentration of economic power, the need for consumers to have the means to exert their influence responsibly and effectively is more and more apparent. To that end we recognize the urgent need to establish an Office of Consumer Representation and we also support legislation for paid public participation to facilitate the inclusion of public views in the work of administrative agencies; our organization is working with the Consumer Product Safety Commission and the National Bureau of Standards and we are training consumers to assert their rights under existing laws relating to credit and warranties.

Above all, the National Consumers League has always approached economic problems in human terms, and it is this, more than anything else, which brings us here today.

We cannot accept the use of unemployment as a regulator of the economy <u>even if it worked</u>. We cannot and do not accept the basic notion that it is the most vulnerable, the weakest, the most abused of our fellow citizens who should carry the burden of economic adjustment for the rest of us. We cannot forget that those complacent, dry unemployment figures refer to millions of hungry and frightened children and frustrated adults, any more than we could disregard the children and their mothers who sweated in dark tenements over buttons and feathers for the garment industry two generations ago.

But today the irony, and the real horror, is compounded by the fact that unemployment as a regulator of the economy has simply proved to be ineffective. Over and over again in the past quarter century we have tried to check inflation by unemployment - the "trade-off" idea - and have failed miserably. In the 1950's, the obvious failure led to the voluminous investigations of the Senate Anti-Trust and Monopoly Sub-committee under Senator Kefauver which revealed some of the ways in which the exercise of market power by corporations had made traditional assumptions obsolete. During the Nixon administration, planned stagnation and even recession failed utterly to check inflation and gave us the term "stagflation". Today, the conventional wisdom still clings to the unemployment-inflation "tradeoff", in the face of contrary experience and in disregard of the human cost.

It is hard to see how the notion can persist in the light of the history of the past 20 years when slow rates of economic growth, high rates of unemployment and high rates of inflation have gone hand in hand. During the years 1969-1976, the rate of economic growth slowed to 2.3 percent with an average unemployment rate of 5.8 percent which reached a peak of 8 percent during the period, while the rate of consumer price inflation averaged 6.5 percent and soared at times to a bouble digit rate, the highest since the Civil War. This in contrast to the Kennedy-Johnson years when the average annual growth rate was 4.6 percent, the unemployment rate in 1969 stood at the relatively low rate of 3.5 percent and inflation from 1961-69 averaged only 2.6 percent. (1)

(1) The Humphrey-Hawkins Bill "Full Employment and Balanced Growth Act of 1977": a discussion of the issues by Senator Hubert H. Humphrey and Representative Augustas F. Hawkins, pub. by the Conference on Economic Progress, 1977, p. 42.

Other industrially-developed countries have likewise failed in their efforts to curb inflation by curbing economic growth. Rates of growth have declined during the past ten years in France, Britain, Italy and Japan at the same time that rates of inflation in each country have increased dramatically.

The futility and the tragedy reflected in these figures is all too evident. In the presence of the modern market power of corporations, which can and do raise prices in the face of insufficient demand in order to maintain their customary rate of profits, and which can and do raise prices again in face of rising demand in order to take advantage of expanding markets, it is a foolish and unconscionable waste to resort to the futile device of economic stagnation. It is, in fact, an immoral affront to our dignity as a people and to our national ideals and aspirations.

Senator Humphrey, in introducing the Humphrey-Hawkins Full Employment Bill in the Senate last December, pointed out that the terrible unemployment over the past seven years had cost the nation over $600 billion in lost production and income, a loss of $12,000 for every family in the country.

But even more shocking than this stupid waste of money is the waste of human lives which it represents. "Average" unemployment of six or seven percent, that we are being asked to "learn to live with", means recorded rates of more than 50 percent for the most disadvantaged groups such as black teenagers in the inner cities, and many more uncounted because they are too discouraged to continue to hunt for jobs. All those shut out from opportunity because work is not there are denied the satifsaction, dignity and buying power that comes from work. In a nation commited to the defense of human rights as a cornerstone of national policy, we cannot pursue an economic policy which contradicts our basic principles - most especially one which has proved futile.

The National Consumers League calls on those who direct the economic fate of this nation, whether in government, by the exercise of corporate power or through the control of financial institutions, to discard both the conventional wisdom which has proven ineffective and the callous disregard for human values on which it is based. We believe that the possission of market power which characterizes the modern economy must carry with it the obligation to exercise such power responsibly. We urge the adoption of public economic policies which seek positive solutions to inflation and other problems, within a full-employment framework, through increased productivity, genuine competition, reduction in costs and a pass-through of these economic benefits to the consumer, together with increases in real income to sustain expanded production and equity in distribution, and with restraints placed on those who hold great market power if and where the irresponsible exercise of such power leads to abuse.

A national economic policy of balanced growth and development should mean no less than the full use of our human and material resources to meet the human needs of all our people.

# # #

Statement by the NATIONAL CONSUMERS LEAGUE
on the
President's Economic Report

Ever since its founding in 1899, the National Consumers League has taken the position that the consumer interest in the economy is comprehensive. In the League's view, the consumer interest is not limited to the availability of goods and services, their quality, price, distribution and the information available to buyers and users. It believes, that the consumers' responsibility includes concern for the conditions under which goods and services are produced, hence our historic leadership for minimum wage and for the elimination of industrial homework and child labor and our continued preoccupation with minimum wage and occupational health and safety. And the League recognizes that the consumer interest extends equally to the availability of the income which provides the indispensable buying power, so we have declared our support for the Humphrey-Hawkins Full Employment and Balanced Growth Bill.

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The National Consumers League calls on those who direct the economic fate of this nation, whether in government, by the exercise of corporate power or through the control of financial institutions, to discard both the conventional wisdom which has proven ineffective and the callous disregard for human values on which it is based. We believe that the possission of market power which characterizes the modern economy must carry with it the obligation to exercise such power responsibly. We urge the adoption of public economic policies which seek positive solutions to inflation and other problems, within a full-employment framework, through increased productivity, genuine competition, reduction in costs and a pass-through of these economic benefits to the consumer, together with increases in real income to sustain expanded production and equity in distribution, and with restraints placed on those who hold great market power if and where the irresponsible exercise of such power leads to abuse.

A national economic policy of balanced growth and development should mean no less than the full use of our human and material resources to meet the human needs of all our people.

# # #

STATEMENT

OF

NATIONAL SAVINGS AND LOAN LEAGUE

ON

NATIONAL ECONOMIC ISSUES

TO

JOINT ECONOMIC COMMITTEE

MARCH 15, 1978

Mr. Chairman, the National Savings and Loan League appreciates the opportunity to submit its views on economic issues concerning the Nation and especially those issues affecting the savings and loan industry. We sincerely hope that our views and comments will be of value to your Committee with respect to your findings and conclusions on the recommendations made by the President in his Economic Report.

The primary concerns of the savings and loan industry is the encouragement of thrift and the preservation of the value of the nation's savings, and the provision of housing for the country's home seekers by financing their purchases of both new and existing houses. The ability of our associations to carry out our chartered functions of encouraging thrift and home ownership is directly affected by the fiscal and monetary policies of the federal government, price levels, general economic and financial conditions, and federal tax policy.

We recognize that the nation faces a myriad of economic and financial issues, domestic and international. A partial listing would include the adoption and implementation of an energy program, deterioration of the dollar in international markets, inflation, federal deficits, wage and price policies, and the formulation of long range fiscal and monetary policies designed to assure more stable and sustained economic growth, higher employment, and a meaningful income stream to the largest possible portion of the nation's populace. We will not attempt to address our views to all areas of major concern, but will concentrate upon underlying conditions and policies affecting the level of prices and interest rates, savings inflows, and the housing market.

Notwithstanding some temporary and transient factors affecting the economy, the severe winter weather and the coal strike in particular, the economy is still in an expansion phase of the current business cycle. Consumer spending for most durables remains strong, although there appears to be some let up in purchases of domestic autos. The demand for housing shows no signs of moderating. Satisfying housing demand will depend more on credit availability than individual's and family desires this year.

While business capital spending increases have lagged the pick up that prevailed in comparable stages of post World War II business cycles, there is some evidence that equipment expenditures may accelerate somewhat from the pace of a few quarters ago, especially with an early enactment of tax relief.

There are no serious shortages, or impending shortages (unrelated to the coal strike), of basic commodities, semi-finished or finished industrial or consumer goods. Our industrial productive capacity is not strained or in danger of being overtaxed in the near future. Increases in personal income have been staying ahead of price increases, although that margin is in danger of diminishing, if not disappearing, in the light of recent increases in both the wholesale and consumer price indecies. The prospects for a reduction in personal income taxes continues to contribute to buoying consumer confidence although real concern exists as to whether tax reductions will net price increases.

There has been no shortage of credit impeding the satisfaction of business, consumer, or government demands. Market interest rates have risen in both the short and long term sectors in the past nine months, but current levels of interest rates have not yet effectively forced major credit seekers out of the market. Without question, the availability and price of residential mortgage credit will be adversely affected as the year progresses.

In addition to the prospects for declining flows of residential mortgage credit this year, about the only other area in which a shortage impends is in the labor force. This may appear paradoxical considering the high rate of statistical unemployment which structurally is concentrated in the non-skilled and younger age groups of the labor force. During the last two years some seven million people have been added to the employment rolls. The daily and weekly employment advertisements appearing in daily and weekly newspapers and trade publications attest to the widespread demand for additional employees.

February's decline in the unemployment rate to 6.1% lends credence to the demand for labor. Hopefully, this improvement in the rate of unemployment will continue throughout the year, although the teen and ethnic sectors will still present difficult problems. As the year progresses, the demand for labor may result in increasing labor costs somewhat more than required to compensate for increases in the price indecies, reflecting some premium normally associated with tightness in the labor force.

Attached to this statement is a series of Tables. They relate basically to the volume and price of credit at various stages of business activity during the last six years with projections for calendar 1978. Tables I and V show the levels and ratio relationships between the public and private sector credit demands since 1971, as well as the composition of the major credit users in the private sector since that time.

As both Tables I and V depict, we are currently in the advanced stage of a business expansion cycle similar to 1972-mid 1974, and such as prevailed in earlier expansion periods. Stages are denominated "advanced" when credit demands from the private sector reach new and ascending volume levels subsequent to sharp declines typical of recessionary periods. By all criteria calendar 1978 represents an advanced stage.

One of the untypical aspects of the current phase, however, is the persistent high level of federal governmental credit demands at a time when private sector credit demands are not only strong but still rising. This undesirable confluence spells higher interest rates as the year progresses and together with some other contributing factors will result in money and capital markets remaining extremely sensitive all year.

Inflation is the single principal factor undermining prospects for a continuation of the current business expansion well into 1979 or 1980, or even beyond. It is indeed unfortunate that we have an underlying inflation rate of around 6.00%. It is also unfortunate that recent legislative enactments of the Congress will push the inflation rate beyond the 6.00% level. The recent announcement of an 1.1% increase in the wholesale price index for February is a startling reminder that inflation is an enemy difficult to subdue.

The legislative induced costs, some of which are partially or fully effective while others are impending, which may add from 1.00% to 1.50% to the price indecies by yearend are:

1. The 15% increase in the minimum wage that became effective this past January 1st, and is scheduled to rise 11% more next January.
2. The increase in unemployment taxes.
3. The higher social security taxes which became effective two months

ago, and which are slated to increase about 10% again next January.

4. An increase in agricultural price supports accompanied by a decrease in acreage plantings.

5. A proposed increase in energy taxes whenever the Congress acts upon energy legislation.

These costs will find their way into every nook and cranny of the economy, and once implanted will be impossible to remove. Moreover, they all come on stream at the initial stages of the production process, whether the product produced is a good, food, or a service. These cost increases will make it difficult, if not impossible, to have an effective wage and price control program, voluntary or otherwise. The introduction of this package of added costs will make it more difficult to conduct a meaningful monetary policy. Together with the large contracyclical federal deficits this fiscal and those proposed for fiscal 1979, a rising cost-price scenario spells higher interest rates as well.

The outlook for increased prices, higher interest rates, and large budget deficits portend decreasing availability of mortgage credit and higher residential mortgage interest rates as the year progresses. The moderation in savings inflows to savings and loan association has already begun. Starting with the last half of 1977 (and the last quarter in particular), savings and loan associations resorted to substantial borrowings from the Federal Home Loan Bank system in order to fulfill loan commitments already on the books. This resort to external sources of funds by savings and loan associations is readily apparent from a comparison of FHLB advance activity for the second half of the last three years:

CHANGES IN FHLB ADVANCES TO S&Ls FROM JULY 1 - DEC. 31

($ billions)

	1975	1976	1977
Advances	$1.0	$0.7	$4.3

As the above table clearly shows recourse to the advance window by savings and loan associations in 1975 and 1976 was minimal. This was due, of course, to strong savings inflows. Last year with heavy commitments outstanding and moderate last quarter savings inflows there was a sharp uptick in FHLB borrowings. This resort to funding loan commitments externally, of course, resulted from the increase in competitive market rates over the past six months.

Tables VI and VII show recent market yields on various maturities of U.S. Treasury securities, their relationship to savings account ceilings under Regulation Q, as well as a review of yields obtained from the last five quarterly auctions of Treasury issues.

The recent rise in competitive market rates which has resulted in moderating savings inflows to thrift institutions is not the sole culprit on the residential mortgage availability scene. Price inflation is also having a decided affect upon the number of homes that will be able to be financed. The compounding effect of higher interest rates and price inflation upon home financing funds is readily perceived when one goes through the arithmetic.

If the average cost of new homes increases 10% this year, from $55,000 to $60,500, and we build close to 2,000,000 new units, it will require an additional $11 billion <u>more</u> in mortgage funds to finance just the same number of new units as were financed last year. Adding to these figures a similar percentage increase in the cost of existing house purchases, it is not difficult to estimate the upward pressures upon mortgage interest rates and the forces that will shortly curtail the level of new housing starts.

Conditions facing the savings and home financing industry were outlined in the March 9th testimony of the new Federal Reserve Board Chairman before the House Banking Committee. After reviewing the rise in short term rates last year and the recent slowdown in thrift institution savings inflows and pointing out that longer term savings certificates have made deposits of savings less volatile than in the past, Chairman Miller said:

> "Nonetheless, if heavy demands for money and credit should place furthur upward pressure on market interest rates, deposits subject to regulatory rate ceilings will be placed at a substantial competitive disadvantage. In such a circumstance, growth in M-2 and M-3 could fall short of the ranges. Upward adjustments in the ceiling rates on some or all categories of time deposits may be required to avoid a potential distortion in the flow of credit through our financial system, to promote equity for small savers, and to ensure the availability of loans to home buyers and others who rely on institutional cources of credit. (Emphasis supplied)

It is to be hoped that an increase in the cost of funds to thrift institutions which are the dominant supplier of home financing credit can be avoided this year. An increased cost of funds together with the Administration's proposed increased taxation of savings and loan associations certainly can not be the desired objective of the mation's fiscal and monetary managers. Yet, such would certainly be the result of a regulatory ceiling rate increase and adoption of the President's tax proposals.

An in depth study of the relationship of federal tax policy for savings and loan associations and the capital requirements these institutions will have to maintain in order to assure the nation of being able to meet conservative estimates of future housing needs is being presented by the National Savings and Loan League in its testimony before the House Ways and Means Committee on the President's tax proposals. It is urgently recommended for review by your Committee and its staff. We believe that you will agree that the nation's tax policy should not be directed to placing additional burdens upon the country's principal source of housing credit which directly impairs attainment of the nation's housing goals.

It is ironical that one set of tax proposals could contain provisions for improving the capital position of most corporations, but at the same time add to the tax burdens of our home financing system. We urgently request that your report recommend against the imposition of higher rates of tax on savings and loan associations so that these institutions can continue to underwrite the construction and purchase of homes and contribute to steadier employment in the building and construction trades as well as other industries associated with supplying goods and services that make the American home livable.

The ravages which have already resulted from the inflation of recent years and which, unfortunately, have not yet spent their force make it clear that our fiscal and monetary policies must be geared for the long haul and not be directed to attempting to correct every ill or attaining every desirable social and economic objective at once.

Improvement in our trade and current account balances, adoption and implementation of a sensible and rational energy program, protection of the value of the dollar, sustained and stable economic expansion accompanied by low levels of unemployment and stable prices are not the product of patchwork legislation or imprudent fiscal and monetary policies. They require long term policies and programs to which all sectors of the population and economy can readily lend endorsements.

We believe that one of the recommendations which your Committee might well consider in connection with the adoption of legislation by the legislative Committees of both Houses of the Congress is a requirement that these Committees estimate the impact which their legislation will have upon prices if such legislation is enacted into law. This would be a prudent extension of the present requirement for estimating the cost impact of legislation on the federal budget. Such a requirement could well make a major contribution to containing the enactment of costly legislation which, while having some desirable objectives in the short run, would in fact create more difficult problems in the long term.

Such a requirement would be in keeping with the President's desire to lessen the impact of the cost of government upon business directly, and the economy generally. A similar requirement upon departments and agencies of the executive branch in which the cost of compliance with proposed regulations had to be a part of the proposed regulation could well contribute to not only eliminating furthur proliferation of so-called governmental "red tape" but make cost-regulating an essential part of the regulatory process.

TABLE I

ANNUAL NET INCREASES IN CREDIT

($ billions)

Issuer	1972	1973	1974	1975	1976	1977-E	1978-P
Treasury	16.0	-0.6	9.7	76.3	58.6	48.2	54.2
Agencies	11.5	22.2	19.7	11.5	16.9	24.4	30.0
Fed. total	27.5	21.6	29.4	87.8	75.5	72.6	84.2
Private	153.5	174.5	152.6	92.1	174.3	250.5	263.9
Total	181.0	196.1	182.0	179.9	249.8	323.1	348.1
PER CENT FEDERAL OF TOTAL	15.2%	11.0%	16.1%	48.8%	30.2%	22.5%	24.2%

TABLE II

CHANGES IN GOV'T HOLDINGS OF TREASURY-AGENCY CREDIT

($ billions)

Holder	1972	1973	1974	1975	1976	1977-E	1978-P
Treasury debt:							
Trust funds	6.2	12.7	11.6	-1.9	7.8	13.0	13.0
Agencies	-1.2	-0.1	0.3	1.5	1.5	-2.6	-0.7
Fed. Reserve	-0.3	8.6	2.0	7.4	9.0	9.7	9.5
Agency debt	0.5	0.4	3.2	0.9	0.9	0.4	1.4
TOTAL	5.2	21.6	16.1	7.9	19.2	20.5	23.2

E - estimated

P - projected

TABLE III

ANNUAL CHANGES FOREIGN HOLDINGS OF TREASURY DEBT

($ billions)

	1972	1973	1974	1975	1976	1977	1978-E
Treasury debt*	16.0	-0.6	9.7	76.3	58.6	48.2	54.2
Foreign Holdings	8.4	0.2	3.7	8.1	11.6	27.0	28.0
% foreign of total	52%	-	38%	16%	20%	56%	52%

* Increases in privately held Treasury debt only

TABLE IV

FOREIGN INVESTMENTS*

in

U.S. MARKETABLE GOVERNMENT SECURITIES

($ billions)

Date	Amount	Change	Average Monthly change
December 29, 1976	$50.345		
March 30, 1977	56.409	$6.064	$2.031
June 29, 1977	58.032	1.623	.541
September 28, 1977	62.807	4.775	1.592
December 28, 1977	76.347	13.540	4.513
February 1, 1978	80.147	3.800	3.800
March 1. 1978	83.522	3.375	3.375

* Held by Federal Reserve Banks for foreign accounts.

TABLE V

ANNUAL INCREASES IN SELECTED PRIVATE CREDIT

($ billions)

Type of credit	1972	1973	1974	1975	1976	1977-E	1978-P
Residential Mortgages	56.6	54.4	40.1	41.5	69.3	90.0	93.5
Consumer Installment	14.8	21.4	9.3	7.5	20.5	32.0	36.5
Business Loans	26.2	41.0	35.6	-12.4	5.4	34.1	43.5
Other Bank Loans	9.4	6.8	3.6	2.7	12.1	13.2	14.0
TOTAL	107.0	123.6	88.6	39.3	107.3	169.3	187.5
CHANGE FROM PRIOR YEAR							
Dollars		16.6	-35.0	-49.3	68.0	62.0	18.2
Per Cent		15.5%	-28.3%	-55.6%	173.0	57.8	9.7
% Residential Mortgages to total	52.9	44.0	45.3	105.6	64.6	53.1	50.0
FHLB Advances	0.0	7.0	6.5	-4.0	-1.8	4.3	6.0

E - estimated

P - projected

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TABLE VI

SELECTED TREASURY YIELDS

(March 6, 1978)

Maturity	Yield	Change from Prior maturity	Cumulative Yield change
91 day bill	6.52		
181 day bill	7.00	48	48
1 year bill	7.29	29	77
2 year note	7.55	26	103
3 year note	7.64	9	112
4 year note	7.79	15	127
5 year note	7.83	4	131
7 year note	7.94	11	142
10 year note	8.02	8	150
15 year bond	8.13	11	161
30 year bond	8.26	13	174

TREASURY YIELDS VS S&L CEILINGS*

Maturity	S&L ceiling	Treasury	Yield difference
90 days	5.75	6.52	77
1 yr- 2 1/2 yr	6.50	7.29-7.60	79-110
2 1/2 yr- 4 yr	6.75	7.60-7.79	85-104
4 yr - 6 yr	7.50	7.79-7.88	29-38
6 yrs & over	7.75	7.88-8.26	13-51

* S&L yields are not compounded,

TABLE VII

1977 - 1978 QUARTERLY AUCTIONS - TREASURY SECURITIES

AUCTION YIELDS

1977	3 Year	7 Year	30 Years
February	6.62	7.25	7.65
May	(1)	7.28	7.77
August	6.84	7.26	7.72
November	7.24	7.69 (2)	7.94
1978			
February	7.53	7.88	8.23

(1) No three year note offered.
(2) This was a ten year note rather than seven.

Note - Underlined yields above are those which exceed savings account ceilings when latter are compounded.

Subsequent to the February 1978 quarterly auction the Treasury auctioned a two year note at 7.70 basis, and a four year note yielding 7.89, both of which exceed similar maturity S&L yields when latter are compounded.

The National Urban Coalition
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In the macroeconomic sense, much of the news contained in the 1977 Economic Report of the President is good news. The recovery continued with a healthy annual growth rate of 4.9%. Aggregate unemployment dropped from 7.8% in December, 1976 to 6.4% in December, 1977 and has continued to drop in 1978 to 6.2% in March. The CEA forecast for 1978 predicts that the recovery will continue. Growth will remain in the 4 1/2 to 5% range, unemployment is expected to drop further, and inflation is expected to hold steady at around 6%. All in all the economic indicators suggest that the economic expansion set in motion three years ago will continue.

Just as the recovery and expansion have bypassed several sectors of the economy with which we are concerned, so did the Economic Report fail to sufficiently view uneven development among groups in the population, and to examine the effect of certain policies on these groups. Further, programs have been proposed as necessary to sustain the growth that we are now experiencing. In many cases, the National Urban Coalition feels that dollars spent to nudge an already healthy economy might be better spent if they were targeted to those sectors of the economy that have not participated in the recovery. This statement highlights several areas in the Economic Report of the President where the Coalition feels that appropriate attention has not been given to subgroups in the economy, in particular to minorities and city dwellers.

Employment and Unemployment

Disparities in the employment and unemployment experiences of Americans is one of the Coalition's greatest concerns. In 1977, while aggregate unemployment improved, black* unemployment remained relatively constant: in December, 1976 the black unemployment rate was 12.6%; it was 12.7% in December, 1977. In March, 1978, when the aggregate unemployment rate had declined by 16% since December, 1976, the black unemployment rate was 12.4%, and had declined only 2% over the same period. Economists have attempted to explain the difference in unemployment between blacks and whites by adjusting the population for occupational, regional and metropolitan distribution, and for age. None of these adjustments explains away a significant part of the difference in the black and white unemployment rates. A recent paper by Charles Betsey hypothesizes that blacks fare differentially in the labor market because they have more "spells" of unemployment. He estimates that these spells affect the future unemployment experience of blacks--blacks lose two weeks of employment in the year after they experience an unemployment spell, as compared to a little more than a day lost for whites.

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* Black and minority are used interchangeably. Black unemployment rates are for black and other races, a category that is over 90% black.

The Economic Report estimates a "fixed weight" unemployment rate that shows how different the unemployment figure would be if demographic groups were represented in the population in the same proportion that they were in 1956. Such estimation serves no practical use and sideswipes the issue of jobs for the present labor force, no matter what its composition. Such estimation also implies that those groups whose proportion in the labor force has increased are almost "responsible" for high unemployment rates.

The use of the prime age male unemployment rate as an alternative index is a similarly futile measure, since the proportion of prime age males in the labor force has declined. Such estimation encourages policy makers to concentrate on how much better unemployment statistics would look if the labor force were as it used to be instead of working on solutions for the problems facing the labor force as it is presently composed (and, incidentally, as it is likely to be composed in the future, at least for blacks. While the Economic Report points out that the number of white teenagers entering the labor market should taper off in the early 1980's, no such tapering is expected for black teens).

An equally evasive index of unemployment, while not highlighted in the Economic Report, is worthy of mention in this context. The so called "non-accelerating inflation rate of unemployment" (NAIRU) has gained prominence in academic and policy circles.

It estimates how low the unemployment rate can go before inflation accelerates. There is no agreement by economists as to exactly what numerical value NAIRU has (although all estimates are above 4 percent). Furthermore, such measurements highlight the traditional tradeoff between inflation and unemployment without examining how to make the so-called tradeoff better.

Policies to Reduce Unemployment

We are heartened by the efforts of the administration to reduce minority unemployment, although the fruits of these efforts have yet to be realized. The number of public service jobs available in 1977 exceeded those available in previous years, and more jobs are planned for 1978. However, PSE jobs could be better targeted towards the disadvantaged. Further, we are concerned that PSE jobs have skill content, as opposed to being "make work" jobs that do little to change the employment profile of those who badly need education and training.

We are concerned about the design of the 1.4 million jobs proposed in the President's welfare reform initiative. If the 1.4 million jobs are not enough, how will they be apportioned? Further, if the wages and qualifications of these "welfare reform" jobs are too high, there is a danger that those most in need of employment assistance (i.e. those with poor work records, and little skill or training) will participate only in the cash assistance portion of the program. While those who cannot find jobs will not be penalized monetarily, this situation will do little to transform the unskilled to productive members of society.

The President has requested $400 million in his FY 1979 budget for private sector hiring of the disadvantaged. This program must be modelled with caution, since we have the legacy of such programs that were only marginally successful or failures in the past. In particular, if there is a training component, training should be offered for skilled jobs. Further, private sector employers must be committed to not only hiring the disadvantaged, but to keeping them on their payrolls.

The Administration's endorsement of the Humphrey-Hawkins Full Employment and Balanced Growth Act is a clear statement of commitment to improve the employment situation of all Americans. However, the Council of Economic Advisors was not optimistic in the Economic Report that the 4 percent rate of unemployment mandated by the Act will be reached in 1983. Their concern is that the 4 percent rate would put inflationary pressure on the economy as the labor market becomes tight and wages are bid up. We feel that this concern is misplaced, since black unemployment stands at 12.4 percent this month, double the overall unemployment rate, and about two and a half times the white unemployment rate. The fact that the level of GNP necessary to achieve a 4 percent rate is in excess of the CEA-projected GNP for 1983 does not indicate that the 4 percent rate is unattainable, but suggests that the means for reaching the 4 percent goal lie outside conventional monetary and fiscal policy and may include developing unused human resources to prevent labor market tightness.

Tax Reform

The Economic Report presents the structure of the tax package of reduction and reform proposed by the President. While the reductions proposed preserve the inherent progressivity of the Federal tax system, we are concerned that the $25 billion budgeted for a tax package needed for "steady economic growth" might be better targeted towards those in the population who have not benefitted in the expansion thus far. $25 billion would buy hundreds of thousands of jobs, or make a difference in urban revitalization, and would not only pump money into the economy, but place it where it is most needed. Further, in absolute terms, only 20% of the proposed reforms will benefit those with incomes under $10,000.

Other of the reforms proposed tamper with the progressivity of the tax system. To the extent that the poor take advantage of it, the elimination of itemized deductions for state and local taxes is a regressive move, since such taxes tend to be regressive. The investment tax credit, even if allowable for rehabilitation expenses, is possibly anti-urban and should be thoroughly studied before being implemented. Finally the Federal subsidy to states and localities that issue taxable, instead of the conventional tax-free, municipal bonds is a step towards removing a tax advantage for wealthy bond holders. At the same time, unless the subsidy is guaranteed for an indefinite time period, the issuing of taxable municipal bonds may have an adverse effect of the finances of local areas. If monies have to be raised by alternate means, such as taxes, the ultimate losers here are urban dwellers.

Federal Expenditures

In the President's economic message, there is a commitment to reduce the Federal share of gross national product to 21%. While we realize that the Federal share of GNP has been growing and think this goal is compatible with the desire to control inflation, we are concerned that this goal may be achieved at the expense of important human and social programs. If the President intends to keep the

Federal share of GNP constant and/or falling, we suggest that this be done at the expense of defense programs, and careful management of bureaucracy, instead of at the expense of initiatives badly needed to improve the lot of the disadvantaged.

State and Local Finance

Both the Economic Report and the President's message cited aggregate state and local surpluses of $33 billion as part of the fiscal drag that is hindering economic expansion. However, the majority of states and localities have not yet recovered from the fiscal difficulties that began to plague them in the mid-1970's. Part of the $33 billion surplus represents accumulated pension and social insurance funds, and are not usable for operating expenditures. In many cases the remaining surplus was achieved only by cutting back or holding constant human services and other programs, or by raising taxes. States with the largest surpluses intend to use them to provide property or income tax relief and to expand or restore human services.

The National Conference of State Legislatures estimates that overall state surpluses will represent only 5.5% of 1978 operating expenditures. Such amount is not at all large, but represents sound budgeting, since some surpluses are needed to offset unexpected occurences or financial difficulties. In fact 29 states expect dangerously small surpluses or none in 1978. Only five states expect to enjoy surpluses of twenty percent of total operating expenses.

The attention that the Economic Report gives to state surpluses implies that state and local economies are, on the whole, sound. In fact, many states and localities depend on Federal contributions for a good part of their operating expenditures. Any attempt to cut Federal contributions to states or localities in the face of news that local economies are healthy would force states to increase state taxes and limit their services' budgets. Such action would also exacerbate the spiral of eroding tax base, higher property taxes, and flight by homeowners and businesses that has gripped several declining urban areas who depend on both state and Federal government for appropriations.

Inflation

There has been concern that the six percent inflation rate that has persisted is too high, and as one of his goals, the President has proposed to develop programs to reduce the inflation rate. In particular, voluntary measures to curb wage and price increases are suggested. Many minority workers have lagged behind the mainstream not only in their employment experiences, but in earnings. They have participated neither in the recovery, nor in large wage settlements that have been made in the past two years. We think it is unrealistic for the President to expect that such workers will forego wage increases when they are able to get them. Announcement of a voluntary program may allow employers, however, to offer modest wage increases in the national interest. While we are concerned with the inflation problem, we feel that nothing should interfere with efforts to provide more jobs and better wages to the disadvantaged.

Urban Policy

While aware that the announcement of urban policy was imminent at the time of the printing of the Economic Report, we were dismayed that there was no explicit mention of urban problems in the 1978 report. Some of the underlying issues of unemployment, tax credits, and welfare reform that plague urban areas could have been brought together in the section on major policy issues.

Summary and Conclusion

As I mentioned at the beginning of my statement, much of the macroeconomic news is good. The Urban Coalition is concerned that all segments of the population are beneficiaries of good things that are happening in the economy. To the extent that minorities, urban dwellers and others are excluded from participation in the recovery, we feel that the government has a special obligation to target its initiatives towards these groups. All of the gains that are made in the economic system are seriously undermined by the economic disparity that persists in the economy. Whether through conventional economic policy or through the development of new initiatives, the government has a responsibility to address these problems.

Statement of

NEW YORK CHAMBER OF COMMERCE AND INDUSTRY
for
THE JOINT ECONOMIC COMMITTEE OF CONGRESS

March 15, 1978

The New York Chamber of Commerce and Industry is the oldest such organization in the United States and its membership of over 2,000 includes a great number of this country's major corporate enterprises. New York City is the headquarters for many of our largest multinational institutions and, historically, it has been the focal point of our international trade and commerce. Accordingly, our membership is broadly representative of these most vital areas of the business community. We welcome the opportunity to present the following statement on national economic policy, which has been prepared by the Chamber's Committee on Finance and Currency. The membership of this Chamber Committee represents a cross section of the City and Nation's leading business institutions. A list of Committee members is attached to this statement.

At the outset, we would like to say that there is much to commend in both the President's Budget Message and the Economic Report. The progress made and the problems faced are described realistically, and the economic policy proposals are, on the whole, deserving of serious consideration. Nevertheless, we feel obliged to offer some words of warning with respect to the inflation problem.

A MEANINGFUL STEP TOWARD INFLATION CONTROL IS REQUIRED. WE SUGGEST A SUBSTANTIALLY LOWER BUDGET DEFICIT FOR FISCAL 1979 THAN IS NOW PLANNED, THROUGH A COMBINATION OF EXPENDITURE RESTRAINT AND LOWERED OR POSTPONED TAX REDUCTION.

Inflation Situation and Prospects

The President's Economic Report frankly acknowledges that the American economy is suffering from a built-in rate of inflation of around 6%, after excluding the special factors that made for the soaring price advances in 1973 and 1974 and for somewhat lower rates of price increase during the second half of 1977. The conclusion that inflation may be stuck at this unacceptably high level emerges from an analysis of existing and foreseeable cost-push forces at work in the economy. But it must also be recognized that such a rate of inflation carries within it a self-perpetuating mechanism and cannot be expected to hold at this level. As more and more price and wage adjustments are made through escalator clauses contained in a myriad of contracts and agreements, and as the assumption of a continuation of rising costs and prices becomes broadly built into business and financial planning for the future, there is the real danger that the pace of inflation will quicken.

Indeed, the rate of price advance has already begun to accelerate in the opening months of this year. We are greatly concerned that, even though the extreme weather clearly has been a factor contributing to the speedup, the rate of inflation currently is above 6% and it could go even higher by late 1978 and in 1979 if the appropriate countermeasures are not taken - and fairly soon.

Labor and material costs are rising, and productivity has been disappointing over the past year even when output was advancing at a rate well above the long-term average. With the present business expansion now in the mature stage, at least chronologically, productivity gains cannot be counted on to hold down inflation in the period ahead.

Other factors also are at work pushing up prices, many of them stemming directly from Government actions - notably the rise in the Federal minimum wage, the hike in Social Security taxes, with even sharper increases to come, a reversal of the down-trend in food prices and higher energy costs which strongly suggest that inflation is again headed higher. In addition, and not to be minimized, there is the increasing upward pressure on costs and prices of imported goods and commodities resulting from the sharp depreciation of the dollar in the foreign exchange markets.

The Rising Budget Deficit

But contributing more to the growing concern over the inflation outlook is the very sizable increase in the Federal Budget deficit. The deficit of over $61 billion projected for this fiscal year, and the prospect of another equally large budget deficit in fiscal 1979, come at a time when the economy is expanding at well above its long-term rate and when the budget gap should be narrowing; even on a full-employment basis. The Government deficit next year will be only fractionally lower than in 1978 which, in turn, will be appreciably larger than the deficit last year. Particularly worrisome is that there are no convincing signs of a reversal of this trend in the foreseeable future, which is increasingly being interpreted as assuring more inflation down the road since the deficits will have to be financed, in part at least, by printing more money.

The worry over the Federal budget picture stems primarily from the continuing rapid rise in Government expenditures. According to the most recent official estimate, Federal outlays will increase by a hefty 15% during the current fiscal year, after a rise of 9% in 1977. And the Administration is projecting a further sizable advance in spending for fiscal 1979. Moreover, most financial analysts are convinced that Government expenditures next year are underbudgeted in a number of important areas and, since 1978 is an election year, that we will see significant Congressional add-ons to spending programs. In any event, the unsettling effects of current fiscal trends on the business and financial community, and, in time, on the economy generally, should not be underestimated by the Congress.

From the viewpoint of the financial markets - about which our Committee is especially well qualified to speak - it is abundantly clear that fiscal developments and prospects and the anticipation of an escalation of inflation is already significantly influencing decision-making. Despite a relatively strong performance by the economy over the past year, the stock market has continued to decline, primarily because advances in nominal profits are viewed as inadequate to keep pace with

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rising replacement costs and to provide for future growth, and also because of the fear that inflation will inevitably result in higher interest rates.

In fact, interest rates on bonds and mortgages are again edging upward, notwithstanding some slowing of the growth in demand for long-term funds as passbook deposits are shifted out of the thrift institutions into higher yielding Government and other marketable securities, or into money market funds, in an attempt to achieve a measure of protection against the erosion of savings.

These developments, if continued, pose a real threat to the home building industry and to construction activity in general, later this year and in 1979. The fear of inflation, and its impact on profitability, is also an important factor holding back business fixed investment, especially outlays for bricks and mortar, which is essential if faster productivity growth is to be achieved in the years ahead and if we are to have enough capacity to expand output in line with projected needs and create an adequate number of jobs for our growing labor force.

The Dollar Problem

The obvious loss of confidence in the dollar internationally in recent months is also largely traceable to worry over U.S. fiscal and other policies and to the anticipation of a continued decline in the purchasing power of the dollar. While the rate of price advance in the United States is still comparatively moderate by world standards, the fact that inflation is speeding up here in this country at a time when it is declining in many of the other leading industrial nations is a matter of deep concern to the many foreign holders of dollars and dollar denominated assets.

In addition to the adverse financial impact it is having on Americans working and traveling abroad, the marked depreciation of the dollar is pushing some countries to place restrictions on foreign capital and, if not soon halted, will surely lead to the imposition of more controls on foreign trade, which will hurt our exports. The depreciation of the dollar is also contributing to unrest among the OPEC countries and could lead to an increase in the price of oil, with all of the attendant problems this would bring. Of concern, too, is that the depreciation of the dollar is allowing foreigners to acquire many American companies at bargain basement prices.

Finally, of concern both here and abroad is that the eventual attack on inflation will again fall upon the shoulders of the monetary authorities, bringing with it the likelihood of soaring interest rates followed by an eventual abrupt slowdown in economic activity, which would probably not be confined to this country. Memories of the 1973-75 experience are still vivid and are highly unpleasant reminders of what a prolonged acceleration of inflation can do to the financial markets and to economic activitv generally.

A Need for Fiscal Restraint

Against this background, some convincing action by an Administration and Congress is sorely needed to halt the spread of inflation psychology and restore confidence in the dollar both here at home and internationally. The President's call for a voluntary price and wage deceleration program, however well intentioned, will not do the job. Indeed, there are grounds for believing that the Administration's call for voluntary restraint on prices and wages may actually have contributed to the uneasiness in financial markets - as well as among businessmen and even labor - because of the fear of an eventual resort to mandatory controls.

At this juncture, what is needed to put a damper on inflationary expectations and to build confidence in financial markets and among businessmen, both here and abroad, is a meaningful reduction in the size of the Federal budget deficit for the upcoming fiscal year, and some indication that further progress will be made toward cutting the budget deficit as long as the economy continues to expand at or above its long-term rate of growth. To this end, we urge that any tax reduction enacted this year be accompanied by some offsetting pruning of Government expenditures. However, and remembering the experience of 1977, we also recommend that if a tax reduction is to be enacted in 1978, it be held in abeyance until there is more convincing evidence, than is available at the present time that such fiscal stimulus is required and in what form.

The effects of the extreme winter weather over much of the country and the extended coal strike are contributing to some uneasiness, and admittedly make it difficult to get an accurate reading on the health of the economy at the moment. But business activity entered the year with a good deal of momentum, with employment at record levels, with inventories lean in most lines and final demand strong. As yet, there are no visible signs of excesses or imbalances to suggest that the economy is weakening more than temporarily.

As happened last year, the largely weather-induced slowdown in business activity no doubt will be followed before long by a rebound in production and sales, which will have a buoying effect on employment. Consequently, there is no need to rush to provide more fiscal stimulus.

Freeing Up Monetary Policy

Moreover, holding back on the fiscal stimulus will enable the Federal Reserve to pursue more appropriate policies. Heretofore, monetary policy has largely had its hands tied in the fight against inflation by a lack of support from the fiscal side, and ultimately it has had little choice in how it responded to events. Monetary policy will still have to keep a watchful eye on the growth of the money supply if existing inflationary fears are to be calmed.

But not being under pressure to help underwrite large back-to-back borrowings by the Treasury, while at the same time accommodating expanding private sector requirements for credit, monetary policy may not be forced to deviate so far from its present stance in the period ahead as to cause further serious trouble for housing and to put a chill on the climate for business capital investment.

An Important Opportunity

In sum, it is our considered judgment that the United States stands at a crucial crossroad in terms of economic policy and, if we choose the right path, we can hopefully look forward to continued healthy economic growth with a further gradual reduction in unemployment domestically, while at the same time bolstering confidence in the dollar internationally. Sustaining domestic economic growth and removing the tarnish from the United States economic image abroad, however, are inextricably tied to reducing inflationary pressures and dampening inflationary psychology.

At this juncture, an expansionary fiscal policy, which is widely being taken as a proxy for more inflation, in an attempt to insert new vigor into the economy could well turn out to be counterproductive.

NEW YORK CHAMBER OF COMMERCE AND INDUSTRY
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STATEMENT OF THE SIERRA CLUB

BEFORE THE JOINT ECONOMIC COMMITTEE

REGARDING PRESIDENT CARTER'S ECONOMIC REPORT

WASHINGTON, D.C.

MARCH 15, 1978

The Sierra Club is grateful for the opportunity to comment on the Economic Report of the President. Our remarks will address only two of the elements of President Carter's economic strategy: energy and unemployment. The present lack of an environmentally sound, national, energy program is a very serious problem. We commend the President for his efforts in this area, but especially for his recommendations that the conservation of energy and the development of alternative sources are important elements in the transition to more efficient energy use. As President Carter has indicated a large part of our recent economic problems stem from too great a dependence on sources of energy, in this case gas and oil, over which we as a nation exercise essentially little control. The Sierra Club believes that more rapid development and use of appropriate, alternative sources of energy would not only reduce the pressure on our natural resources, but make good economic sense as well. We feel that the problems of unemployment and our need for clean energy sources, with prices and supply under our control, can be addressed simultaneously. One of the major areas where this can be done is through the accelerated development and greater utilization of the existing technology in the solar energy field.

The California State Energy Commission in it's 1977 Biennial Report says that there is a widespread consensus within this field that solar space and water heating are ready for commercialization in both residences and commercial establishments. If this not precisely be the case, we feel that in a very short amount of time nationwide commercialization will be feasible. Though there is continued development in solar cells which directly generate electricity, much remains to be done before they can be utilized on a scale which would have the desired effects on our economy and environment.

The installation of solar energy equipment is a labor intensive process. To illustrate; the Environmentalists for Full Employment determined recently that if $2 billion were invested in solar energy it would create more than four times as many jobs than if it were invested in the construction of a nuclear reactor (specifically: 64,000 jobs versus 15,000 jobs). This particular study also indicated that with solar energy the ratio of tradespeople to professionals is higher, 9 to 2 versus 2 to 1 for the nuclear energy situation.[1] Another study estimated that the installation of solar space heating units on only 10% of the new housing units built in California between now and 1985 would generate approximately 5,000 jobs a year over the next ten years, 4,000 more jobs than an equivalent nuclear alternative.[2] Solar energy has the potential of creating many jobs, but of equal importance these jobs would go to people in occupations that are more susceptible to unemployment, in addition, many of the jobs created could be filled by training of the long-term unemployed.

The Sierra Club urges the Congress and the Administration to make available greater federal funding for research on alternative energy sources, especially solar. The development and widespread use of solar energy to generate electricity could not only provide cheap energy again, and this time clean, but has the potential to generate a tremendous amount of employment and perhaps establish, within the U.S., a major new export industry. The committment is needed now

[1] Jobs and Energy, Environmentalists for Full Employment, Spring 1977

[2] "A Conservation Economy: Employment", Perspectives, Sierra Club, Vol. 11 No. 5

so that this fledgling industry could that much sooner make a direct and positive impact on our problems of unemployment, inflation, trade dificits, etc.

Energy is not the only important area where a redirection of federal subsidies and public works money could contribute to both the environment and the economy. Additional federal funding should go toward transportation systems which, compared to freeways and highways, have less of a negative impact on the environment, are more energy efficient, and contribute to the growth and rehabilatation of the central cities instead of urban sprawl. Less emphasis on road construction and more funding of mass transit can have positive effects on total employment. A recent study demonstrated that a $5 billion transfer of funds from highway construction to mass transit would result in a 3.2% increase in the number of total transportation construction jobs.[3]

Consider the extensive intercity rail systems of Europe. Many, if not most, are powered by electricity. They are clean, fast, efficient, and heavily used. There is no reason that high quality systems, even better than those in Europe, could not be given higher priority for development here. Our experience with the Northeast Corridor Program demonstrated that high quality service does draw the passengers necessary to help sustain that kind of service. New rail systems of all types should be given more priority. The Urban Mass Transit Administration recently identified some twenty cities that it feels are potentially suitable for development of new intracity rail systems. It may not be long before fast, electrical rail systems such as these could be deriving their power from solar energy. How soon that comes about probably depends on the Administration and you, the Congress.

There are other areas within our existing rail system needing investment which could provide much additional employment of a type not requiring extensive training. AMTRAK has in the past identified about half a dozen intermediate distance passenger rail corridors where track improvements are necessary, but

[3]Bruce Hannon, Energy Research Group, Center For Advanced Computation, Univ. of Illinois

where funding has not been provided. More recent information reveals that over two dozen corridors are in need of more than routine repair. The recent derailments involving toxic substances makes even more immediate the question of what degree of deterioration will be allowed on passenger rail lines before track improvements are carried out.

The rehabilatation of existing urban housing is another important area where additional federal funding should be provided. This idea is not new. It has been tried in the past. But we believe that with proper implementation it can work, not only providing many jobs but, with proper direction, jobs for the very people whose neighborhood is effected. It has been estimated that for every $1 billion invested in urban rehabilatation, approximately 50,000 jobs would be created and roughly 25,000 units, of various types, could be refurbished.[4] Improving urban housing would predominantely effect low and moderate income families. It helps reduce urban sprawl with it's adverse effects on energy use, and increases the property tax base. A rehabilatation program should also include widespread utilization of simple conservation methods such as installation of insulation, use of storm windows, wider use of clock thermostats, etc.

There are numerous other projects involving conservation and environmental restoration that could provide substantial amounts of employment, perhaps especially effecting those hardest to employ. An article in a recent issue of The Nation describes many unfunded but very necessary projects to be found within such organizations as the Forest Service, Bureau of Land Management, HUD, and the National Park Service.[5] The various projects include wilderness restoration, campground and picnic area development where appropriate, replanting of over-grazed rangeland, control of erosion on surfaced-mined lands, replanting of clearcut forest land, the clearing of debris-clogged streams, and the establishment and maintainance of urban parks. All of the above would provide jobs, restore

[4]Based on statistics from the Department of Labor and the Homebuilders Asso.
[5]"An Environmental Works Program", Neil B. Goldstein and Samuel H. Sage, The Nation February 11, 1978

some of the environment, and in some cases are a direct investment in resources for future consumption.

The Sierra Club endorses the efforts of the Carter Administration and Congress in expanding training programs which are designed to attack the problems of structural unemployment. Increasing the availability of skills and the opportunities to change occupations not only is important for the happiness of the individual involved, but is obviously healthy for the nations economy. It has specific applicability to the environmental movement in those situations where the conservation of important resources comes in conflict with relatively static production systems, often of marginal efficiency, resulting in some job displacement. Increasing the level of skills makes the labor market much more "fluid" which helps to reduce unemployment and reduce obstacles to vital conservation efforts.

The Sierra Club has actively supported the full employment goals found in the Humphrey-Hawkins legislation. We believe that environmental quality and the goals of full employment are inextricably intertwined; a nation that does not try to provide the dignity of a job for all it's citizens will not respect it's future generations sufficiently to preserve some of it's natural resources for them. The conservation movement's long-time goal has been to preserve some of the earth's bounty for tommorrow, a national full employment policy will help more people share in that bounty today.

TAXATION WITH REPRESENTATION

AND THE TAX ACTION CAMPAIGN

A Public Interest Taxpayers' Lobby

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THOMAS J. REESE
Legislative Director

February 10, 1978

Honorable Richard Bolling
Chairman, Joint Economic Committee
U.S. House of Representatives
Washington, D.C. 20510

Dear Chairman Bolling:

This is in response to your letter of February 6th to our Executive Director Thomas F. Field.

Enclosed you will find a copy of my testimony on the college tuition tax credit which I will be giving before the House Ways and Means Committee. In addition, you will find copies of two issues of Tax Notes which contain articles on the President's tax package. We will be happy to give you permission to reprint Dr. Gerard Brannon's article in the January 30 issue of Tax Notes and the article by Allen Manvel in the February 13th issue of Tax Notes.

I think these three articles will be of interest to you and your Committee.

Best regards,

Thomas J. Reese

Thomas J. Reese
Legislative Director

TJR/eh

TAXATION WITH REPRESENTATION
AND THE TAX ACTION CAMPAIGN
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COLLEGE TUITION TAX CREDIT

Testimony on February 15,1978
before the
Ways and Means Committee

by
THOMAS J. REESE
Legislative Director of
Taxation with Representation

Mr. Chairman and members of the Committee, my name is Thomas J. Reese and I am Legislative Director of Taxation with Representation, a public interest taxpayers' lobby. I am testifying in opposition to the college tuition tax credit proposals which are being considered by Congress and your committee.

The proposals of tax allowances for college education expenses seem to be motivated by a desire to alleviate the financial burden of middle-income families who must bear the high costs of putting their children through college, without either the resources of the rich or the aid programs available to the poor. In fact, however, the credit is nothing but a placebo. It will not help the middle class for which it is designed. This is so for a number of reasons.

Tuition Costs Have Not Risen Dramatically. A presupposition in all of the arguments in favor of the college tuition tax credit is that educational expenses have risen dramatically. This is simply not true when compared with the relative increase in median family income. Between 1967 and 1976, college charges for tuition, fees, room and board, rose about 75%. But at the same time, median income has increased almost 89%. As a result, the relative financial burden for putting a student through college is actually less than it was 10 years ago. This does not mean that some families might not need help, but it does show that a general tax subsidy to everyone is no more necessary today than it was 10 years ago.

Aid to Middle Income Families. Another fallacy supporting the credit is the argument that middle-income families are not helped by the current programs. Again, this is not true. In fiscal 1977, the federal government provided $8.5 billion in student aid in the form of direct outlays and tax expenditures. Students from families with incomes between $10,000 and $20,000, who account for 33% of all students, received 36% of this total, although they received a smaller share (21%) of the $2.3 billion provided under programs based on need. Middle-income families are, therefore, already getting their fair share of federal educational aid.

Credit Helps Wealthy. From the statements of the proponents of the tax credit for college expenses, one would think that the credit will only help middle-income families. But, in fact, 54% of the benefits of a $250 nonrefundable credit will go to taxpayers with incomes in excess of $20,000, who make up the richest third of the population. Middle-income families, those with incomes between $10,000 and $20,000, receive only 34% of the benefits from the credit. If the college tuition tax credit is aimed at middle income families, it misses its target.

Credit Means Higher Tax Rates. Some supporters of the college tuition tax credit favor any tax credit or deduction which will lower taxes for the middle class because they feel that those taxes are too high. This approach is simplistic. The tax system will raise as much money as Congress determines is necessary no matter how many credits, deductions and exclusions are available. What these gimmicks mean is that tax rates must be higher than necessary. If Congress adopts a college tuition tax credit costing approximately $2 billion in revenue each year, that will be $2 billion that will be unavailable for general tax cuts for all taxpayers. Thus, this credit means higher taxes for the elderly, for people who have already put their children through college, for childless couples, for single persons, for people in vocational schools, for everyone who does not qualify for the credit.

Credit Means Higher Tuition? One of the major uncertainties of the credit is its effect on tuition costs. Some people argue that the credit will allow colleges to raise their tuitions at a faster rate than they would have otherwise. To the extent that tuition costs are increased, the credit's benefits for taxpayers are reduced as the colleges capture some or all of the benefits through higher charges. If this happens, the tax credit will be an aid to colleges and not to taxpayers.

On the other hand, if one argues that the colleges will not be able to raise their tuitions, then one must also recognize that they will receive no benefits from the credit. Both the colleges and the students cannot enjoy the same benefits. To the extent that one gets the benefits, the other does not.

Credit Hurts Private Institutions. Many people believe that the college tuition credit is especially helpful to private institutions. This is not the case. In fact, a flat credit will hurt private institutions. Although the credit will reduce the absolute cost of attending a private or public institution by an equal amount, the relative price of attending a private institution will be increased.

For example, if it costs $2,000 to attend a private college and $1,000 to attend a public institution, the absolute cost difference is $1,000, and in relative terms, the private school costs twice as much. A $500 tax credit would reduce the net price of attending these schools to $1,500 and $500 respectively. While the subsidy would not change the absolute cost difference, it would raise the relative price of attending the private institution to three times the price of attending the public institution. This increase in the relative price of education at private institutions will induce some students to attend the public institution whose relative price has fallen. This is why the Coalition of Independent College and University Students (COPUS) has called the tuition tax credit the Trojan Horse of independent higher education.

If the goal of the tax credit supporters is to aid the independent colleges and universities, the credit does not do it. As HEW Secretary Joseph A. Califano Jr. pointed out in analyzing the tax credit proposal, "only 30% of the benefits would go to families sending their children to private colleges, although they have almost 50% of the financial need..." Why should a millionaire sending his or her child to a low tuition institution get the same credit as a worker whose child attends an expensive independent college?

Tax Credits Add Complexity. Tax credits for college educational expenses will complicate the lives of students and their families. It will provide new regulations, new forms, new requirements that they will have to be familiar with in order to benefit from the program. In addition, they will have to figure out how the credit relates to other educational aid programs. Will it reduce their scholarships? Will it reduce their eligibility for loans?

Many people claim that the red tape involved in tax gimmicks is less than that involved in direct expenditure programs. This is only true if the requirements for qualifying for the credit are simpler than for the spending program. In addition, the administrative cost of the program for the government is less only because the Internal Revenue Service audits less than 3% of tax returns. If HEW only checked on less than 3% of the students who applied for educational aid, its administrative costs would also be low.

Loans Help More Than Credits. The college tuition tax credit is supposed to help families who are burdened by college expenses. They will be more than happy to receive a $250 credit, but it will not help very much those who are really burdened by the cost of education. A credit of $250 provides little real relief to students or their families, who now face average tuition costs of $3,300.

College expenses cause a short-term cash flow problem to students and their families which will be followed with higher earnings by the students or with lower expenses for the family. The best way to deal with a short-term cash flow problem is with a loan. Loans provide a subsidy larger than could be provided through a tax credit at the same cost to the government. Some of the cost of these loans can be borne by students when they are earning more after their education is completed; or the cost can be borne by parents whose expenses are reduced when the student is out of school and independent.

Before 1976, eligibility for federal interest subsidies on Guaranteed Student Loans (GSLP) was lost when family income reached $15,000. The 1976 Amendments lifted this ceiling to $25,000 (equal to about $31,000 of adjusted gross income) and thus expanded the eligibility to about 85% of all students. The 1976 Amendments also raised from $10,000 to $15,000 the total amount that a student can borrow for undergraduate and graduate training. The 7% interest on the GSLP loans is not payable until a year after the student finishes his education. In addition, there is a National Direct Student Loan (NDSL) program for which the interest rate is only 3% payable beginning nine months after the student finishes school. An expansion of these programs would make much more sense than a new college tuition tax credit program.

Conclusion. TWR urges the Congress not to adopt a college tuition tax credit. Such a program would benefit the rich more than the middle class or the poor. It will require that tax rates be kept artificially high in order to raise the $2 billion needed to fund the program. It is questionable if the credit will even benefit families with college students, since colleges may be able to raise tuition charges and thus wipe out any savings to taxpayers. In addition, it is likely that the credit will upset the current balance between private and public higher education in favor of public education. Finally, the credit will add new complexity to an already complex area of educational aid when more help could be given through a fuller funding of already existing programs.

SPECIAL REPORT

TAX REFORM, AT LAST! OR TAX REFORM, AT LAST?

by Gerard M. Brannon

After nearly a year filled with trial balloons that self destructed, we have finally received a real Carter tax reform proposal. The waiting was more exciting.

Detailed comment on the program at this point is difficult, because we have been given only the Presidential message and a collection of Treasury "fact sheets." Both of these channels of communication are part of the selling operation (puffery) as distinct from the serious evidence and the detailed description that will accompany the Treasury Secretary's testimony to the Ways and Means Committee. But this is all we have, and my editor wants an article.

Table 1 is my effort to see the package in some perspective.

Tax Reduction?

Quantitatively the big thing is the rate reduction. On this the message is less than candid. There is a big negative that needs to be put alongside this tax cut, before we swallow the President's claim that "the tax reductions will more than offset the recent increase in social security taxes and will provide the consumer purchasing power and business investment strength we need to keep our economy growing strongly and unemployment moving down." The big negative is the inflation tax.

There is a revealing discussion of the inflation problem buried back in Fact Sheet Number 3 which says that the ratio of individual federal income tax to total personal income of Americans is now (1977) 10.7%, and that with no change in the law it will rise to 11.4% in 1979! The "generous" Carter program will slash the tax burden in 1979 from the present 10.7% to 10.5%! The fact sheet doesn't carry out the arithmetic for 1980, which is obvious from the attached chart. By 1980 the tax burden *with* the Carter relief will be higher than it is now!

We have been going through these rinkydinks for a long time now. We have an income tax system in which rates and exemptions are not indexed for inflation, so the rates automatically rise with rising money income. This lets the politicians blow their horns about how they are cutting our taxes. "Thankee, Massa." Baloney!

Needed: Automatic Inflation Adjustments

We will really have a more coherent tax system when we move to making automatic inflation-adjustments in the exemption levels and the bracket widths. Then we will have a basically stable tax burden, and we can have some coherent dialog on whether this should be higher or lower. As it stands now, it is just too hard for the public to know what's going on.

For example: If the so-called tax reductions barely offset the inflation increase, then it's simply wrong to say that they also offset the social security tax increases. (Incidentally, most of the public finance textbooks say that the social security tax on employers is shifted to employees so Treasury tables understate the social security tax increases by 50%.)

Table 1 — An Overview of the Carter Tax Program

Rates, etc. reductions	1979 ($ billion)	1983
1. Individuals (including per capita credit)	-23.5	-40.1
2. Corporate rate	- 6.0	-10.8
3. Investment credit	- 2.3	- 2.6
4. **Total**	-31.8	-53.5
5. Less reform revenue	9.3	18.6
6. Equals net income tax change	-22.5	-34.9
Reform of itemized individual deductions		
7. Gasoline tax	.9	1.5
8. Sales tax	2.5	4.2
9. Miscellaneous tax	.6	1.0
10. Medical & casualty	1.9	2.9
11. **Total**	5.9	9.6
Individual "scandal items"		
12. Capital gains alternative tax	.1	.2
13. Real estate tax shelters	.1	.5
14. Unemployment compensation exclusion	.2	.2
15. Deferred annuity changes		.1
16. Minimum tax increase	.3	.4
17. **Total**	.7	1.4
18. Tax exempt bond option	.2	2.2
Corporate tax reforms		
19. Repeal of deferral	.1	.9
20. Repeal of DISC	.7	1.8
21. Cut in entertainment deductions	1.5	2.1
22. Tax on mutual finance & banks	.3	.5
23. Real estate shelters	.1	.3
24. **Total**	2.7	5.6
25. Total reforms — all types	9.5	18.8

Source: Taken from Table 2 in the President's tax message. With rounding line 25 (the sum of lines 11, 17, 18 and 24) should equal line 5. The two are close enough to suggest we caught all the big reforms.

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Further, for example: It is well known that there is very little of the inflation updrift in the corporation tax. Is the present package simply a cancelling of the inflation tax increase for individuals and a net tax reduction for corporations? If this so, would we not do better to use the corporate reduction money to make a start on corporate tax integration?

So much for the rate reductions.

The Proposed Tax Reforms

The tax reforms come out to about one-third of the rate reductions. Slightly over half of the reform revenues arise from lower itemized deductions for individuals; about a third come from some relatively standard proposals for business tax reform, and less than 10% come from changes in the "scandal" kind of provisions that are apt to be involved in high income cases with low tax.

The individual deduction reforms consist mostly of removing deductions for state and local sales, gasoline and personal property taxes. These eliminations are eminently sensible. If one thinks of these changes in deductions along with the related tax rate cut, they must be of very little interest to individuals.

The interested parties are, of course, the states. With federal deductibility, a $100 sales tax burden on a state's citizens only costs them about $92. This sounds trivial but I learned in my youth never to underestimate the rapacity of governors. And considering the amount of money we throw away on revenue sharing, I have also learned never to underestimate the willingness of Congress to satisfy the greed of governors.

The trick of combining the medical and casualty loss deductions into one item with a 10% of AGI floor seems reasonable, but the logic is not exactly overpowering. A 10% floor seems high.

Curiously, the one itemized deduction that has figured mostly in the serious tax reform literature — property taxes and mortgage interest on owner occupied homes — escapes mention.

Another curiosity is a projected gain in revenue of $2.2 billion by 1981 as a result of adoption of an optional taxable state or local bond with an interest subsidy. Hopefully, this projection is a mistake. Certainly the Treasury is not asking us to believe that we save $2 billion in revenue by taxing bond interest, while we pay out more than $2 billion in subsidies. Incidentally, the taxable bond option is listed as a revenue loss under corporations, which is even curiouser. (The answer, of course, is that we do *lose* money on this proposal. The TBO makes the system more equitable, but we lose money.)

There is not much separate discussion of the proposal to change the personal exemption to a credit. Most tax scholars would agree that this is bad tax policy, but apparently the Treasury is convinced that rich childless couples and lower income large families are two classes especially deserving of relief. The reasoning escapes me.

Probably the most innovative Treasury suggestion is the proposal to tax some unemployment compensation. It is a shame not to do this under $20,000 as well as over, but the precedent value of this move justifies any compromise necessary to establsih the principle.

The other individual reforms are both good and modest; they would be approved by most liberal reformers. (They raise some problems if you think our system taxes savings too much already, but that is a topic for another essay.) The Treasury table, incidentally, has a "limitation on tax credits of individuals" which I could not find explained in the text.

Business Tax Changes

The biggest business tax reform is in the entertainment area, and it is almost as big as the DISC repeal. These two proposals are eminently sensible and important.

The first class air fare and the foreign convention changes seem niggling, but the other cutbacks are good. The device of half a deduction for business meals is a smart way to cut the gordian knot that had this area all tied up when Kennedy pushed reform in 1961.

Four Ticketed for Salvation

My friends who claim to be able to predict Congressional reaction tell me that the Congress will buy the tax cuts and deep six most of the reforms. That really would be a shame, but anticipating some such scenario, I will stick in my vote for four reforms that really should be saved:

- A cutback in business entertainment expenses
- Repeal of DISC
- A tax on some unemployment compensation, and
- Straight line depreciation on real estate.

fiscal facts and figures

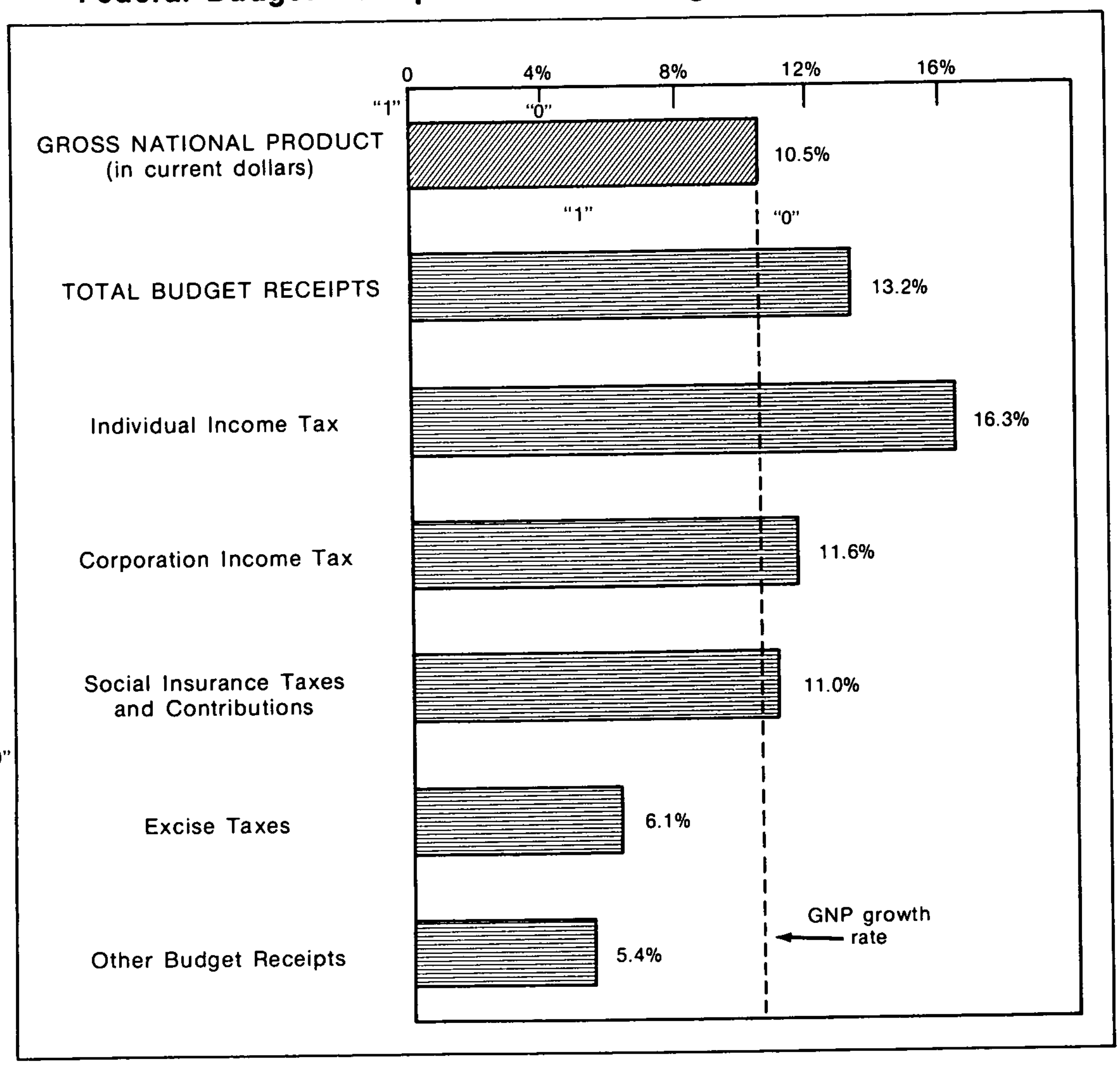
THE "TAX CUT" PACKAGE

By Allen D. Manvel

In preparing budget projections for 1979-83, the Congressional Budge Office postulated a 4.5 percent-a-year growth rate in real GNP and an annual inflation rate of about 5.7 percent. Given such trends, current-dollar GNP would increase from $1,898 billion in 1977 to some $3,465 billion in 1953, for a six-year annual growth rate of 10.5 percent.

With such GNP growth, and if there were no change in Federal tax laws, total budget receipts — according to the CBO projections — would increase at an annual rate of 13.2 percent between 1977 and 1983. Much of this reflects individual income tax receipts, which, under the assumed conditions, would grow more than 16 percent a year. In contrast, as shown by the accompanying chart,

Consistently Projected Annual Rates of Growth in GNP and in Federal Budget Receipts Under Existing Laws, 1977 to 1983*



*Reflecting economic assumptions described in the source report of the Congressional Budget Office.

corporation tax receipts would increase only a little faster than GNP, and the same is true for social insurance taxes and contriubtions, while excise taxes and other budget receipts would increase at a slower pace.

These marked differences are hardly surprising. The strong response of the individual income tax to inflation and economic growth is largely a result of its progressive rate structure (including the effect of personal exemptions). The corporation income tax has but a slight degree of "progression," which is due only to its lower rate for firms with very small income. And the major excise taxes — on gasoline, liquor, and cigarettes — are not bolstered by inflation because they apply to the physical volume rather than the dollar value of the commodities involved.

As the CBO report emphasizes, these data are not predictions but projections, conditioned upon circumstances that are not expected to occur. Existing tax laws will *not* remain unchanged until 1983, so the indicated growth rates will never develop. Nonetheless, the CBO figures afford a useful background for considering possible tax changes.

For example, the data illustrate that a considerable reduction in the statutory rate structure of the individual income tax will be necessary merely to keep its average effective rate unchanged — *i.e.*, to offset what Walter Heller recently described as "income tax increases stealthily 'legislated' by inflation and growth as they pump income into higher tax brackets." In the absence of statutory rate cuts, according to the CBO projections, individual income tax receipts would move up from 8.3 percent of GNP in 1977 to 9.1 percent in 1979 and 11.2 percent in 1983.

In contrast, since changes in receipts from the corporation income tax and from social insurance taxes closely parallel changes in overall economic activity (as measured by current-dollar GNP), inflation and growth do *not* raise their effective rates materially.

The tax package proposed by President Carter includes not only a downward adjustment of individual income tax rates, but also a material cut in the corporation income tax and in the telephone excise tax. The CBO projections suggest (1) that a "cut" in the individual income tax would do little if any more over all than to offset the actual and imminent effects of inflation upon its effective rate structure; (2) that, in contrast, any cuts made in other taxes would be fully effective; and hence, (3) that one effect of adopting such a tax package would be to reduce further the relative financing roles of the corporation income tax and excise tax — components which even now provide a far smaller proportion of all federal revenue than they did in earlier decades.

Desirable or not, a shift of this nature deserves to be recognized in advance.

Data underlying the chart are as follows:

	Amount ($ bil.)		**Increase, 1977 to 1983**		
	1977 (estd.)	**1983 (projected)[1]**	**Amount ($ bil.)**	**Percent**	**Annual rate (%)**
Gross national product	*1,898.0*	*3,465.2*	*1,567.2*	*82.6*	*10.5*
Budget receipts, total	*356.9*	*751.0*	*394.1*	*110.4*	*13.2*
Individual income tax	*156.7*	*389.0*	*232.3*	*148.2*	*16.3*
Corporation income tax	*54.9*	*106.0*	*51.1*	*93.1*	*11.6*
Social insurance taxes and contributions	*108.6*	*203.0[2]*	*94.4*	*86.9*	*11.0*
Excise taxes	*17.5*	*25.0*	*7.5*	*42.9*	*6.1*
Other budget receipts	*19.0*	*26.0*	*7.0*	*36.8*	*5.4*

Source: Congressional Budget Office, Five Year Budget Projections: Fiscal Years 1979-1983, tables 1 and 12.

[1]Assuming a 4.5 percent-a-year growth rate in real GNP, annual inflation rate of about 5.7 percent, and moderately strong "nonfederal demand." GNP amounts shown are for calendar years; receipts are for fiscal years ended October 31. Because of rounding, detail may not add to totals shown.

[2]CBO has estimated that the social security legislation adopted after preparation of the source report would increase this 1983 amount by about $26 billion.

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UNITED STATES LEAGUE of SAVINGS ASSOCIATIONS 111 EAST WACKER DR. / CHICAGO, ILLINOIS 60601 / TEL. (312) 644-3100

NORMAN STRUNK
Executive Vice President

March 10, 1978

The Honorable Richard Bolling, Chairman
Joint Economic Committee
Congress of the United States
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of February 6. We appreciate this opportunity to comment briefly on The Economic Report of the President. Our primary interest in this report deals with the thrift and housing industries and the interplay of stabilization policy on them.

We agree that substantial progress was made last year in achieving most of our economic goals, especially those of real growth and unemployment. We are concerned, however, that recent events suggest that little progress has been made to achieve price stability at a lower inflation rate. This problem has also resulted in our inability to establish stability in the international trade area. Our relatively high inflation rate has resulted in continued devaluation of the dollar on foreign exchange markets.

While we support efforts by the Carter Adminstration to encourage economic growth through tax cuts, rather than federal spending increases, and especially his goal to limit federal spending to a lower percentage of GNP (p. 85 of the Economic Report), we remain very apprehensive about a growing federal budget deficit scheduled for fiscal 1979. Our view is that our nation's employment and real growth goals can be achieved only by greater capital formation which results from the encouragement of higher rates of investment and savings.

During the last three years, housing construction has been one of the primary factors contributing to the economic recovery that has taken place. This housing boom occurred because the inflation rate declined from the 1974 peak level and because interest rates moved down to levels which encouraged record flows of savings into savings and loan associations -- the nation's primary mortgage lending institutions.

Recent economic trends, however, do not suggest a continuation of these favorable conditions. During the last year, short-term interest rates increased by over 2%. More recently, savings deposit growth in savings and loans have been running from 30 to 50% below the monthly gains of the previous year.

The Honorable Richard Bolling, Chairman
March 10, 1978
Page 2

Our primary concern is that large federal deficits will absorb much of the savings that should otherwise go into productive investments such as housing, manufacturing plants and equipment, and commercial building. The report states that "Third, in recent years the aggregate net savings by State and Local governments and the foreign sector has become very large. In 1977, net private savings was again near zero, but a Federal deficit of nearly $50 billion was required to counterbalance the aggregate surpluses of State and Local governments and the excess of receipts over expenditures stemming from our international trade and payments" (p. 89 of the Economic Report). We disagree with this interpretation of the need for federal budget deficits and suggest, to the contrary, that if the large budget deficit had not occurred, interest rates and inflation would have been lower and investment by business and individuals higher.

Our concern over rising budget deficits is discussed in the attached testimony by our Chief Economist, Dr. Kenneth J. Thygerson before the Senate Subcommittee on Taxation and Debt Management on May 17, 1977. This testimony deals with the impact of fiscal policy on housing and capital formation and may be more relevant today than it was a year ago. This testimony offers some specific suggestions to encourage savings and investment.

We appreciate your efforts to work toward a sound economy. We particularly appreciate your willingness to concern yourself with the special problems of the thrift and housing industries.

Sincerely,

Norman Strunk

Norman Strunk
Executive Vice President

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Attachment

STATEMENT OF DR. KENNETH THYGERSON
ON BEHALF OF THE U. S. LEAGUE OF SAVINGS ASSOCIATIONS
TO THE SENATE SUBCOMMITTEE ON TAXATION AND
DEBT MANAGEMENT

May 17, 1977

Mr. Chairman: My name is Kenneth J. Thygerson, of Chicago, Illinois. I am Chief Economist and Director of the Economics Department for the United States League of Savings Associations*.

The U. S. League of Savings Associations appreciates this opportunity to discuss with you the broad subject of capital formation and, in particular, incentives for economic growth.

The savings and loan business is concerned primarily with the business of mortgage finance and the ability of our country to adequately house its citizens. Thus, in my comments before you this morning I would like to address specifically the types of incentives which are needed to encourage economic growth and at the same time assure the adequate supply of capital to house the American people.

*The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,400 savings and loan associations, representing over 98% of the assets of the savings and loan business. League membership includes all types of associations -- Federal and state-chartered, insured and uninsured, stock and mutual. The principal officers are: John Hardin, President, Rock Hill, South Carolina; Stuart Davis, Vice President, Beverly Hills, California; Lloyd Bowles, Legislative Chairman, Dallas, Texas; Norman Strunk, Executive Vice President, Chicago, Illinois; Arthur Edgeworth, Director-Washington Operations; and Glen Troop, Legislative Director. League headquarters are at 111 E. Wacker Drive, Chicago, Illinois 60601; and the Washington Office is located at 1709 New York Avenue, N. W., Washington, D.C. 20006; Telephone: (202) 785-9150.

Need for Greater Capital Formation Well Known

During the recent Presidential and Congressional campaigns and more recently in testimony by officials of the Carter Administration, we have come to grasp the scope of the capital formation needs of our country. Five major national priorities have been outlined by the new Administration -- full employment, inflation abatement, environment, energy, and housing, particularly the problem of rebuilding the central cities.

It goes without saying that the solution of each and every one of these problems will require enormous amounts of capital. Creating new jobs requires substantial investments in plant and equipment before a new worker can be put on the payroll. Inflation abatement will require enormous increases in plant capacity, food production, and energy production to insure an adequate supply of goods and services in response to the growing needs of our country. Solving the energy problem will require enormous capital inputs to increase the production of energy substitutes, as well as conservation efforts to decrease our reliance on oil and gas. Increasing coal output, solar energy, and nuclear energy will require mammoth inputs of capital, as does the conversion of business and industry and the consumer from today's limited energy sources to more abundant fuels or solar and wind devices. A clean environment also requires significant capital inputs. Reclaiming land, and cleaning the smoke from coal-burning furnaces are but two examples of the demands on our capital resources necessary to clean our country's environment.

Finally, revitalizing the housing stock of our urban areas and accommodating the housing needs for the household formations anticipated through the mid-1980's, as a result of the baby boom of the last 1940's and early 1950's, will require enormous capital inputs.

Thus, there is no need to belabor the well documented needs for greater capital formation in this country. Several years ago the New York Stock Exchange, The Brookings Institution, Data Resources, Inc., and the National Planning Association all completed extensive studies to answer the question of whether or not our country would face a capital shortage in the years ahead.[1/] While the conclusions of these studies differ, each highlighted the role that the Federal Government must play in order to assure an

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1/ See: Bosworth, Barry; Duesenberry, James; and Carron, Andrew. Capital Needs in the Seventies (Brookings Institution, 1975);

Dennis, Robert. Investment in the Eighties (National Planning Association Report No. 75-N-2);

New York Stock Exchange. The Capital Needs and Savings Potential of the U. S. Economy: Projections through 1985 (New York, September 1974); and

Sinai, Allen; and Brinner, Roger E. The Capital Shortage Near-Term Outlook and Long-Term Prospect (Data Resources Economic Studies No. 18, 1975).

adequate supply of capital. More specifically, each of these studies highlighted the role of fiscal policy, and the impact that budgetary deficits and the use of Government spending have on the ability of our country to generate adequate capital. Each of these studies, for example, assumed substantial declines in Federal budgetary deficits in the years from 1978 through 1984. One of the studies actually assumed a surplus in the Federal Budget beginning in 1980.

The key conclusion to be gained from these studies is that the Federal Government's fiscal policy and the composition of Federal expenditures will probably be the key factor in determining whether or not this country faces a severe capital shortage as it moves to solve the problems of employment, inflation, energy, housing, and environment.

In the few short minutes I have with you this morning, I would like to review the impact on the mortgage market and housing of the fiscal-monetary policy mix, the composition of Government spending, the use of tax expenditures, and the growth of Federal mortgage credit agencies. From this review, I will then develop a series of recommendations designed to encourage capital formation, economic growth, and assure an adequate housing stock.

Fiscal-Monetary Policy Mix

Because of the key role that fiscal policy plays in the ability of this country to generate capital, I'm including for the record an article entitled "National Fiscal Policy and Housing" written by Dennis J. Jacobe and myself a year ago and published in Real Estate Issues in the fall of 1976. This analysis reviews the role of fiscal policy over the last several decades in determining our country's ability to achieve one of our top social priorities -- "... a decent home and a suitable living environment for every American family " -- as directed by the 1949 Housing Act. This paper includes a review of the growth of Governmental spending and a study of the impact on housing of our Government's fiscal-monetary policy mix, Federal housing outlays, Federal tax expenditures, and Federal mortgage credit programs.

The paper shows that the primary way in which the nation's overall fiscal policy generally influences the economy is through the general level of prices and interest rates. Therefore, the availability of capital to finance housing depends to a large extent on the relationship of Government spending and taxation (i.e., fiscal policy, especially Federal Budget deficits or surplus) to monetary policies. These two economic tools are employed to achieve the overall economic objectives of eliminating the gap between aggregate demand and non-inflationary full employment levels of output. These policies influence the availability of mortgage credit for savings and loan associations directly through their impact on the rate of inflation and level of interest rates.

A number of economists assume that it is possible to achieve the same overall production level in the economy with different combinations of fiscal and monetary policies -- within some limits. The choice between the alternative monetary and fiscal policy mixes depends primarily on the formulation of many subsidiary economic goals or targets which are affected differently by the alternative fiscal-monetary policy mixes.

These subsidiary economic goals include such important national priorities as:

(1) the level of interest rates;

(2) the possible effects of the various fiscal-monetary policy mixes on the financial system;

(3) the impact on our balance of payments;

(4) the effects on the long-term growth rate in the economy; and,

(5) the effects on housing production.

It is this last subsidiary goal that is most directly influenced by savings and loan associations.

The extent to which fiscal policy has contributed to instability in savings and loan operations and the availability of mortgage funds relates directly to the influence of the fiscal-monetary policy mix on the rate of inflation and level of interest rates.

A review of the last fifteen years suggests that Federal deficits are detrimental to savings and loan operations and housing under the following conditions. A very stimulative fiscal policy -- characterized by large Federal deficits when we are in an economic upswing and approaching full employment -- has resulted in a tendency to force monetary policy to bear too great a responsibility for slowing the growth of aggregate demand in the economy. Such policies are particularly detrimental to savings and loans and mortgage availability because monetary policy works through the credit markets causing interest rates to move to ever higher levels. During such periods tight monetary policy restricts the flow of funds into thrift institutions and substantially decreases the volume of mortgage credit.

This set of conditions -- a large Federal deficit continuing long after full employment has been attained -- occurred during the Vietnam War years of mid-1964 through mid-1968 and during late 1971 through 1972. In both these instances large Federal deficits contributed to rising inflation, ballooning credit demands, and the necessity for monetary policy to sharply restrict credit growth -- both during and in the months following these periods. This resulted in substantial deposit losses for savings and loan associations and a sharp restriction of mortgage funds in late 1969, as well as during the second half of 1973 and late 1974.

Fiscal policy also can be detrimental during periods of recession This occurs when large Federal deficits, used to stimulate the economy, reach such levels that monetary policy is unable to ease commensurately to assure a satisfactory increase in money and credit growth. The best example of this situation relates to the large Federal deficits registered during fiscal years 1975 and 1976. During this period, the major burden to stimulate the economy was put on fiscal policy. As a result, the easing of monetary policy during this period was less successful in bringing down interest rates than if the Federal deficits were smaller.

There is a growing bias toward the use of fiscal policy to spur eoncomic growth during recessions while at the same time placing heavy emphasis on monetary policy to slow the economy during periods of rising inflation and low unemployment rates. The increased tendency to do this during the last decade and one-half has been particularly detrimental to the savings and loan business and our nation's ability to maintain an adequate supply of mortgage capital. Relying primarily on fiscal policy rather than monetary policy to bring the economy out of recession has resulted in less savings being available to finance capital goods such as housing. It also has kept interest rates higher than would have been the case with a more balanced fiscal-monetary policy mix.

Similarly, during those periods when fiscal policy has remained in deficit long after the economy has reached full employment, the result has been demand-induced inflationary pressures. This has led to the eventual need for monetary policy to carry too great a burden in slowing down the economy in order to bring inflation under control.

This policy mix places an inordinate burden on the savings and loan business, since associations are unable to cope with the resulting inflation-induced high interest rates. During these periods, open market instruments such as Treasury securities attract money away from savings and loan associations and, therefore, impair the supply of mortgage credit.

Thus, Federal deficits which create these unstable economic conditions have made life almost intolerable for the nation's savings and loan associations at times during the last decade.

Inflation and Capital Formation

The tendency of our Government to run larger and more frequent budgetary deficits has resulted in higher and more volatile inflation rates. This inflation problem really dramatizes the basic cause of our country's inability to generate adequate capital. High and unpredictable inflation rates stand as the single major enemy to generating greater savings and investment.

The individual who purchases a home and experiences a capital gain only finds that he has received an illusory increase in his wealth. Higher prices for all other goods and services have yielded him no increase in his price-adjusted wealth position.

Moreover, high and volatile rates of inflation, created by fiscal excesses, have resulted in consumer and business uncertainties. Each rise in inflation carries with it the seeds of an economic upheaval. The 1973-74 inflation experience resulted in the worst recession in the post-war period. The result has been greater uncertainty on the part of businessmen and consumers over the potential rewards of investment Businessmen, worried that a new inflation spiral will occur, are unwilling to invest in new plant and equipment since they anticipate a recession. Consumers, anticipating additional price rises respond by "spending now" rather than "saving for future purchases." The result is less overall capital formation.

All this is compounded by the graduation of individual taxpayers into higher marginal tax rates -- which further lessens the desire to save -- where capital gains and ordinary income are subject to a bigger tax bite.

Inflation, then, created by fiscal budgetary excesses, remains the primary cause of our nation's capital dilemma.

Composition of Federal Spending

Another important way in which the Federal Budget directly impacts the capital markets and savings and loan associations is through the composition of Federal spending. The change in the composition of Federal spending is illustrated by the fact that national defense expenditures, which took 45% of national outlays in 1964, represented only 29% in 1974. By contrast, income security programs, which represented 21% of total outlays in 1964, represented a much greater 32% in 1974. This change in national priorities -- apart from other considerations -- represents, in economic terms, a shift in the orientation of the Federal Budget toward consumption and away from investment.

Expenditures on Federal highways, energy generating equipment, bridges, dams, space programs, and Government-sponsored solar energy research represent long-term investments. In each instance, these investments produce income for the nation's economy years after their expenditures.

The new areas of national priority -- mainly income security programs -- however, stimulate the immediate consumption of basic commodities such as food, clothing, and energy. This consumption-demand stimulus, although clearly beneficial to the economy in some periods, does not provide -- in economic terms -- future benefits as in the case of investment-oriented Federal expenditures.

The increased tendency to finance this changing Federal outlay composition through the use of Federal deficits, as opposed to taxes, has significant long-run impact on the capital markets, inflation, interest rates, and capital formation in the United States. This means, in effect, that we are tapping our limited credit markets to finance consumption as opposed to financing investment. The tapping of our nation's limited credit pool to finance primarily consumption-oriented expenditures means that there will be less capital available to finance such credit intensive durables as business plants and equipment, and housing. In the long run, this results in a lower rate of capital formation, a lower rate of real economic growth, an increased inflation rate, and higher interest rates.

Tax Expenditures

Another aspect of the Federal Government's fiscal impact on the availability of capital for housing is reflected by the Federal Government "tax

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expenditures." Tax expenditures is a term used to account for those tax revenues which the Federal Government does not collect because income subject to tax is reduced by special provisions, credits, deductions, exclusions, or exemptions.

Housing must compete with other national priorities in the tax expenditure area. As a result, the success of housing in this competition also reveals its national priority status. During the last decade housing tax expenditures have been on an uptrend. Included in this area are the deductibility of mortgage interest and the deductibility of property tax. Tax expenditures for housing were estimated at $4.6 billion in 1967 or roughly 12% of total tax expenditures. By fiscal 1975, these tax expenditure estimates had increased to about 15% of total tax expenditures or roughly $11.9 billion.

This gradual rise indicates that one of the primary tools employed by the Federal Government to encourage homeownership has been through the use of tax expenditures. An analysis of these housing tax expenditures indicates that they represent one of the most successful means used by the Federal Government to encourage homeownership. Because of the success of these tax expenditures, the United States today has one of the highest percentages of homeownership of any country in the world.

Federal Mortgage Credit Programs

A fourth impact of the Federal Government on the availability of credit for housing is through their promotion of mortgage credit agencies to support housing finance. During the last decade, the Federal Government has significantly altered the structure of the mortgage market through the encouragement of Federally-sponsored credit agencies such as the Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, Government National Mortgage Association, and Farmers Home Administration. These credit agencies have substantially altered the flow of funds from the savings markets to the mortgage investment markets.

As part of this testimony, I would appreciate including a recent paper to be presented to the American Real Estate Urban Economics Association entitled "Federal Secondary Market Programs: Impact on Specialized Mortgage Lenders." This paper, by Dennis J. Jacobe and myself, reviews the impact of these credit programs on facilitating investment in home mortgages. The analysis indicates that Federal credit programs have acted primarily as substitutes for private mortgage credit. As Federal credit agencies have grown, private mortgage lenders have lessened their mortgage lending activities by nearly an equal amount.

This review suggests that the Federal credit agency approach to meeting the capital needs in the housing market is one of the least efficient mechanisms available to the Federal Government.

Capital Growth in Housing

The discussion of the impact of inflation on savings and investment is particularly evident in the housing market.

This problem has its greatest impact on the first-time homebuyer. The Congressional Budget Office study entitled Homeownership: The Changing Relationship of Costs and Incomes, and Possible Federal Roles emphasizes this finding.

The inflexibility in the form of the mortgage document which calls for full amortization at fixed monthly payments has put a growing burden on the first time homebuyers. In addition, the difficulty in saving the downpayment which rises constantly as home prices increase also inhibits the ability of the first time buyer to purchase a home. For these reasons, the U. S. League supported in recent testimony before the Senate Banking Committee Senator Edward Brooke's "Young Families Housing Act", S. 664.

Of particular interest to this discussion is the Individual Housing Account portion of S. 664. (As a tax law change analogous to the Individual Retirement Account, it falls within the jurisdiction of your parent Finance Committee.)

The IHA works to correct a major hurdle of the first time homebuyer -- namely, the initial downpayment requirement. As home prices have increased, so have the necessary downpayments. Even if a household is able to support the monthly payment on a mortgage, it may not have saved enough to meet the necessary downpayment. Thus, young families are precluded from entering today's home market. The Individual Housing Account provision in S. 664 will ameliorate the problem of many households in attempting to save the necessary downpayment for a new home purchase.

As an economic matter, our country's Federal tax system acts as a disincentive to savings. In order to acquire a downpayment, the household must first have enough after-tax dollars to put away in a savings account and then must suffer the consequences of having to pay taxes on interest accrued to those accounts. The IHA successfully eliminates both of these disincentives. First, it provides a deduction of up to $2500 per year on the amount of funds set aside for the Individual Housing Account. Thus, the household is encouraged to save because the amount of such savings comes out of pre-tax dollars rather than after-tax dollars. The incentive is increased further by eliminating the tax on interest credited to funds set aside in the Individual Housing Accounts.

This provision in S. 664 allowing for a buildup of up to $10,000 over 120 months seems to be sufficient to allow most potential new homebuyers to acquire a downpayment sufficient to acquire homes at the average home price in our country.

Importantly, the impact on Treasury revenues is minimized by limiting the IHA to first-time home purchasers.

Energy Conservation

Housing, new and existing, also will play a large role in our nation's ability to successfully implement our nation's energy conservation goals. As outlined in President Carter's energy program, additional capital resources will be needed to assure that newly-built homes are more energy-efficient, as well as to retrofit existing homes with energy-saving materials and systems.

The Carter program calls for tax incentives to homeowners who add insulation and invest in solar energy systems, for example. Although the use of the tax system to provide subsidies and incentives has been frequently criticized, it is clear that such incentives do work in many cases, as with the tax incentives to achieve homeownership. Moreover, the tax incentive system is preferable to establishing a bureaucracy to administer direct subsidies or other alternatives which restrict individual choice.

The need for energy conservation and development of alternative energy sources points up the need to expand the sources of capital for these needs. One approach would be the expansion of savings and loan lending powers to include investments in utilities, increases in home improvement lending limits to encourage lending on energy conservation improvements, and greater mortgage instrument flexibility to service existing borrowers desirous of retrofitting their home.

Concluding Recommendations

From our review of the impact of fiscal policy and credit programs on the ability of our country to generate adequate capital to meet our housing needs we can conclude and recommend the following actions:

First, it seems clear that the tendency of the Federal Government to run budgetary deficits long after the economy is on the road to recovery has put an enormous burden on monetary policy to control inflation.

The trends of the last decade suggest that housing capital has been restricted as a result of the increased tendency to emphasize monetary policy more heavily than fiscal during deflationary phases of stabilization policy, and fiscal policy more heavily during expansionary phases. Both tendencies are generally disadvantageous to capital formation and a strong housing market.

Fiscal imbalance is also the primary cause of ever higher rates of inflation and economic uncertainty. The more frequent presence of budgetary deficits stands as our nation's major hurdle to achieving greater rates of capital formation and faster rates of economic growth.

In this respect, we agree with the statement in the report entitled Task Force on Capital Formation which reads, ". . . the surest way to increase total savings through tax policies is to increase the Federal budget surplus (or reduce the deficit) in periods of high employment."

It is suggested that every effort be made to achieve President Carter's goal to balance the Federal Budget by 1981.

Second, it was shown that the increasing consumption-orientation of Federal expenditures has also been deterimental to capital formation generally, and to housing in particular. The implications of the consumption-orientation of the Federal Government to the nation as a whole can be derived from the fact that housing is an investment good. As immediate consumption increases, as a result of fiscal stimulus, the resources available for investment become more limited and the competition for them more intense. Recent history indicates that housing does not do well as the intensity of competition for funds in the credit markets escalates.

Every effort should be made to review the overall allocation of Government spending to strike a more favorable balance between consumption and investment-oriented expenditures. The increased allocation of Government spending to consumption stimulus should be reversed.

Third, our analysis of Federal tax expenditures indicates that these means are the most favorable for capital formation in housing.

The tax deductibility of mortgage interest and real estate taxes for owner-occupied housing should be maintained in order to assure that our country continues to achieve its enviable position as a nation of homeowners.

Fourth, our study of mortgage credit progams indicates that they are of more limited usefulness in garnering funds for housing. The activities of the major mortgage credit agencies have been shown to merely reallocate the investment in mortgages from private lenders to Government agencies, with no real increase in capital formation. The exceptions to this are the Federal Home Loan Banks which act as a liquidity reserve for savings and loans -- thus enabling associations to maintain a very high percentage of assets in mortgages.

We feel that less emphasis should be placed on Federal credit programs, generally, as a solution to capital shortage problems.

Fifth, we recommend that special savings incentives be created for the most victimized segment of the home-buying market -- the first-time homebuyer.

S. 664, which provides for establishment of Individual Housing Accounts, has great merit for solving the specific problem of the first-time homebuyer. We strongly urge your consideration of this approach.

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The U. S. League of Savings Associations has appreciated this opportunity to present its views to your Subcommittee on these issues of such vital importance to our nation's future economic health. I look forward to your questions.

COMMENT ON ECONOMIC ISSUES

SUBMITTED TO THE JOINT ECONOMIC COMMITTEE

FEBRUARY 1978

By

JERRY VOORHIS

This comment will be confined to one generic proposal for altering the pattern of production and energy consumption in the United States.

Such a new direction is necessary if unemployment is to be overcome, if the looming critical shortage of capital is to be mitigated, if the environment is to saved, and if there is to be an adequate supply of clean, inexhaustible energy for the nation's needs.

The thrust of American industry during the post-war II period and even before has been governed by one primary motivation-maximization of profit. With the rapid growth of monopoly and elimination of effective price competition in most industries corporate decisions aimed at maximization of profit have been generally harmful to the true long-term welfare of the United States.

That thrust has been actually to create unemployment by substituting capital-intensive, and energy-intensive means of production for the employment of labor. A classic example of this is the petrochemical industry which not only consumes vast amounts of capital and energy in producing its products but actually uses as its raw materials fossil fuels-mainly petroleum-which are more and more critically needed as energy fuels. Thus the very existence of the petrochemical industry threatens premature exhaustion of traditional energy sources.

Furthermore this industry, by its production of attractive synthetics such as plastics, fabrics, detergents and the like, has largely replaced such labor-intensive and capital and energy sparing industries as cotton, wool, leather, soap, and glass.

More profit was-apparently- to be made in petrochemicals than in the less glamourous and older-established ones just mentioned. But from the viewpoint of the nation's welfare the decision to abandon industries that employ labor and require comparatively little capital or energy such as cotton, wool, leather, and soap in favor of nylon, plastics and detergents which use vast amounts of capital and energy has been a very bad decision. And it has now become apparent that we face an alarming shortage of capital and that the capital-intensive industries themselves are crying to the government to supply to them the capital they no longer are able to generate from their own operation. This is because the productivity of capital has been sharply declining in line with the increasing productivity of labor. The recent sharp decline in profit rates is one evidence of this.

All of this becomes all the more clear and all the more alarming when we consider the energy industries themselves. Not long ago the Ford Administration proposed a $100 billion subsidy to the various branches of the power business to guarantee it large profits. Fortunately Congress was wise enough to give that proposal scant consideration.

The obvious reason for that proposal was that the companies engaged in nuclear energy development as well as the oil, coal and gas companies were not able to generate enough capital-unproductive as it was becoming--to take care of their own needs.

There are increasing instances where private utilities are trying to get permission from regulating commissions to add the cost of their plants to the bills charged against their consumers. Since the charges to consumers for energy are largely based on providing what is considered a "fair return" on capital, were these petitions to be granted the consumers of the utilities' services would be charged higher rates because of their own increasing contribution to the companies' capital!

Competent studies have shown that there is probably enough petroleum in the ground under the United States to last for some 50 to 60 years. But the oil corporations choose not to develop it because they can make larger profits by buying circuses and Montgomery-Ward- decisions quite in accord with maximization of profit, but very bad for the nation's welfare.

It is now apparent that the amount of capital and energy required to produce nuclear energy has become so great that it will be more costly even than coal as an energy producer. And this despite the tens of billions of taxpayers dollars that have subsidized and are still subsidizing nuclear developments.

The hope of anything approaching inexpensive energy from nuclear plants is gone. It is gone because the capital costs of nuclear plants has escalated so sharply in recent years, as well as because of the inherent and unresolved dangers in such plants.

Meanwhile the one kind of energy that is perfectly clean and non-polluting, that is utterly inexhaustible and that can be fitted economically and without waste to the exact purposes desired has been neglected, sabotaged and until recently almost forgotten. This is solar energy including all its ramifications such as direct solar energy collection, wind power, tidal power, geothermal power and power from temperature differentals in the oceans.

Why has this happened? Because solar power would compete with petroleum, coal and gas-all owned by the same giant corporations-and with nuclear power as well. Vested interests in the energy business do not want clean solar power to be developed and will oppose it in every way.

At the very time that we are supposed to be concerned about the future supply of energy we are wasting it at a criminal pace. We have been deprived of electric trolley-car transportation because the automobile and oil companies deliberately created subsidiary corporations to buy up the electric transportation systems which are energy-efficient in order to destroy them and compel the American people to use oil and gasoline burning vehicles which are energy wasteful.

We are wasting energy by using electricity-a very high quality source, capital expensive to produce-to do such things as heating, cooling, cooking, drying and the like when solar energy could do all of this at a fraction of the capital cost and without any resulting pollution or the exhaustion of any of the exhaustible sources of energy.

So what should be done?

It is here proposed that in order to provide jobs for the unemployed, to conserve the nation's energy resources, to save the Earth from pollution, and to overcome the mounting shortage of capital-for all these reasons, the Congress enact a package of selective sales or value-added taxes along with certain tax credits in order to alter the pattern of production and energy use and direct it into channels that are in the nation's interest rather than that of maximization of private profit.

Such a package would call first of all for tax credits to all ~~phases of~~ industry engaged in development of solar energy in all its aspects. Tax credits also to consumers including industries who install solar devices. But repeal of all investment tax credits to petrochemical industries.

Then the package would provide heavy taxes on petrochemical products but very light ones if any on cotton, wool, leather, soap and glass products. Heavy taxes would be imposed on large private automobiles and all taxes would be removed from railroad tickets or anything having to do with bus or trolley transporation. Electric cooking and heating and cooling devices would be heavily taxed but these taxes would be gradually, not immediately, imposed so as to phase them in only as solar energy becomes widely available.

Such a proposal will sound drastic-radical.

Indeed it is.

Congress would be accused of abusing the taxing power. But is would ~~not be~~.
It would be using that power to correct in the national interest the wrong decisions that have been forced upon the nation by corporations powerful enough to control the course of the economy in their quest for maximisation of profits.

Those wrong decisions have brought about an economy so capital-intensive, so wasteful of energy, so destructive of employment opportunities that is is time to call a halt and reverse the trend.

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