

THE 1978 MIDYEAR REVIEW OF THE ECONOMY

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BEFORE THE
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JULY 19, 20, AND 25, 1978

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THE 1978 MIDYEAR REVIEW OF THE ECONOMY

WEDNESDAY, JULY 19, 1978

INTERNATIONAL ADJUSTMENT II

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

The committee met, pursuant to recess, at 10 a.m., in room 5110, Dirksen Senate Office Building, Hon. Henry S. Reuss (member of the committee) presiding.

Present: Representative Reuss and Senator Javits.

Also present: Richard F. Kaufman, assistant director-general counsel; Lloyd C. Atkinson, Thomas F. Dernburg, Kent H. Hughes, M. Catherine Miller, and L. Douglas Lee, professional staff members; Mark Borchelt, administrative assistant; and Charles H. Bradford, Stephen J. Entin, and Robert H. Aten, minority professional staff members.

Staff of Special Study on Economic Change present: Robert Ash Wallace, research director; and Richard D. Bartel, economist.

OPENING STATEMENT OF REPRESENTATIVE REUSS

Representative REUSS. Good morning.

The Joint Economic Committee will be in order for the second day of its hearings devoted to the problems of balance of payments adjustment in our international monetary system. Yesterday the focus of our attention was the problem of world economic recovery and balance of payments adjustment under the present quasi-managed floating exchange rate system. The emphasis today will be on longer range international monetary reform issues.

The Bretton Woods system of par values died with the widespread adoption of floating exchange rates in 1973. The current international monetary system, however, is not a cleanly floating exchange rate regime.

As we look toward the future, toward reform of the international monetary system, is a managed floating exchange rate system the best we can hope for? Or would we be better advised to look toward a future characterized by cleanly floating exchange rates? What about the possibility of completely fixed rates, or some variant to the recently deceased Bretton Woods system?

If a managed floating system or some modified form is used, will we not be plagued once again with precisely the same kind of problems

that led to the downfall of Bretton Woods in the first place? Or have we really learned the lesson of Bretton Woods so that we can now avoid those problems this time around?

What sort of surveillance rules do you see being established in a managed floating system? What is to stop individual countries from manipulating exchange rates in pursuit of blatant "beggar-thy-neighbor" policies? How should the burden of adjustment be divided between surplus and deficit countries? When, if ever, is it appropriate to correct for balance of payments disequilibria through the use of domestic monetary and fiscal policies?

What should be the future role of the dollar in our international monetary system? What about the role of SDR's? How would you assess the prospects for monetary integration within the European Community? Is this something the United States should encourage? Would we lose or benefit from the establishment of such a common currency?

Finally, what does the future hold with respect to the recycling of surpluses? As you know, the House passed the bill establishing a Witteveen facility some months ago. Unfortunately, the Senate has not yet acted on this.

In my judgment, the passage of this bill is important. First, it would provide an important source of finance for those countries that are especially burdened with oil-related deficits. Second, it would be an important first step in the direction of establishing an efficient mechanism for the recycling of funds from surplus to deficit countries.

All of us have been amazed at the ease with which private banks have stepped in to fill the gap and provide many of the financing needs for countries with oil-related balance of payments deficits. Under present circumstances is there any reason to believe the Witteveen facility is inadequate as a supplemental source of funds? What other recycling schemes ought we to be looking at in order to insure less burdensome adjustments to an ever-changing world economy?

Those questions say quite a mouthful. You could write a book about it, and we only have a couple of hours to go, but we couldn't have before us a more distinguished or delightful panel of witnesses than we have today.

I want to welcome Mr. Packer, Assistant Secretary of Labor for Policy Evaluation and Research; Ms. Whitman, who served with such distinction here on the Council of Economic Advisers for years and is now a distinguished public service professor of economics at the University of Pittsburgh; and Mr. Bergsten, Assistant Secretary of the Treasury for International Affairs. I well remember the spirit of attack which Mr. Bergsten as a private citizen used to be able to make on governmental international monetary policy, and the valiant defense of them which Ms. Whitman used to make. [Laughter.] Now that the roles are exchanged, I welcome you to get even. So you are all most welcome, and based, I guess, on alphabets, Fred Bergsten will be first.

You all have very kindly submitted prepared statements, and without objection, they will be placed in full in the hearing record.

Representative REUSS. Mr. Bergsten, please proceed.

STATEMENT OF HON. C. FRED BERGSTEN, ASSISTANT SECRETARY OF THE TREASURY FOR INTERNATIONAL AFFAIRS

Mr. BERGSTEN. Thank you, Congressman Reuss.

In my prepared statement I put together a review of what we have tried to do over the past 18 months in terms of our overall approach to the international economic and financial problems that you mentioned. In light of the questions that you raised now in your opening statement, what I might do is make a few comments on the international monetary aspect of those questions, and then if you care to branch off into trade or develop other issues subsequently, we could do so.

As you well know, Congressman Reuss, our focus, as well as the focus of the new amendments to the Articles of Agreement of the International Monetary Fund, has really been to look primarily to the underlying economic conditions in individual countries rather than focusing on changes in the system per se.

We do believe that the present system, relying primarily on more flexible exchange rates, is the right basis for international monetary arrangements. We share the view that you have suggested, that its evolution to provide better implementation of that system is called for, and indeed we ourselves have made a number of proposals to at least begin the process of developing an effective international surveillance mechanism through which the IMF can carry out the responsibilities handed to it under the 2d amendment to the IMF articles, which have just come into effect on April 1 of this year.

We made those proposals at the interim committee meeting in Mexico City in late April. We are continuing to work on those in the executive board of the IMF, and I am sure they will be further discussed at the annual meetings in the fall and subsequently.

But our focus has been on the underlying economics in all countries, including our own. As we have faced the large disequilibria that continue to exist in the system, our own deficit being one of the most important, the surpluses in OPEC, Japan, Germany, and Switzerland, on the other hand we have consistently and insistently sought policy measures by each of those countries, ours included, that would reduce those imbalances.

In our own case, of course, our focus has been the threefold one which the President enunciated clearly, I think, in his speech back on April 11. Namely, a broad effort to bring inflation down and under control in this country. Second, a commitment which was reaffirmed and strengthened in the summit communique this week to put into effect a comprehensive U.S. energy program to cut our dependence on oil imports; and, third, a comprehensive effort to expand U.S. exports which we are now working on and putting into final shape for submission shortly to the President.

Our success in dealing with those items will, I think, be the fundamental determinant of whether we are successful in doing what we from the U.S. standpoint can in bringing down our external imbalance and bringing it back toward a more sustainable position.

Now, obviously we have to focus on doing what we can, but at the same time we have urged other countries, particularly surplus countries, to do what they can and must in order to achieve equilibrium from their side.

Again, many of those steps were fully reflected in the summit communique of Monday of this week. Recommitments by both Germany and Japan to take the pressures necessary to achieve more rapid economic growth there, and thereby reduce their own balance-of-payments surpluses; efforts by the Japanese—which we worked on, also, in the trade negotiations in Geneva—recently to open their market further to imports from the United States and elsewhere, it cut their trade surplus. In short, we have been working at all aspects of the problem to get the surplus countries to reduce their imbalances, which also contribute to the current difficulties in the international monetary and economic system.

On the OPEC side, we have, of course, consistently worked with the OPEC countries, and through our own energy policy to try to hold down the world price of oil. This year it did remain stable, and as a result, the OPEC surplus this year has been cut dramatically, about in half, from around \$36 billion last year to under \$20 billion this year.

This is probably the most dramatic change in the international payments structure which has occurred since the increase in oil prices in 1973. It does reduce one major source of imbalance in the system, ease the recycling and financial problems to which you have referred, and since we think that for the foreseeable future that OPEC surplus is likely to continue on its downward trend, we would not imagine that large new problems would emerge from that particular source.

Indeed, now, the larger disequilibria are in the OECD world, our own deficit and the surpluses particularly of Japan, but also to a significant extent of Germany and Switzerland. Those are the fundamentals on which we are working. Beyond that are our efforts to strengthen the monetary system itself.

The new amendments to the IMF articles retain the basic Bretton Woods philosophy of international cooperation, and liberal trade and payments arrangements. But it does move away from any effort to try to enforce stability on nations with an external mechanism, as the Bretton Woods and the gold standard before had tried and failed.

Instead, it develops stabilities by sound underlying policies, which we think is a more realistic and pragmatic approach. It does focus attention less on the symptoms of instability in the world economy, such as conditions in the exchange markets, and more on the root causes of instability, the pursuit of divergent and sometimes simply inappropriate national policies by individual countries.

Now, under the new IMF articles, two basic obligations are placed on countries. First, each nation must endeavor to direct its policies toward orderly growth with reasonable price stability. Second, each nation must avoid manipulation of its exchange rate to avoid adjustment or gain unfair competitive advantage.

I might say, Congressman Reuss, in thinking on that, and on discussions we had when I was in a previous incarnation, something both you and I said 2 years ago proved all too right. The fact that the Japanese, in the course of 1976, intervened too heavily to keep the value of the yen from appreciating has really come home to haunt us all. It was a major cause, we believe, of the very sharp ballooning

of the Japanese surplus last year and again this year, with the normal 2-year time lag. Had the Japanese let that rate move toward a more equal level 2 years ago, their surplus now would be much less.

The second effect of that was when the yen started moving, as it did, it moved rapidly and very far, thereby causing unneeded instabilities in the exchange market itself, excessive concern, and even in Japan itself, because of the rapid change in its international competitive position.

But I think if we need empirical evidence as to the validity of relying on market mechanisms to largely determine exchange rate relationships and the validity of this provision in the new IMF articles that countries should avoid manipulating exchange rates, we have the proof right in front of us in what has happened in the last 2 years.

We remind our Japanese friends repeatedly of that, and urge that the mistake not be allowed to reoccur in the future.

We know that no monetary system can force countries against their will to adopting economic and financial policies. We do believe those who seek refuge in any automatic self-policing monetary system, such as a return to Bretton Woods, are simply chasing shadows.

History shows that monetary stability and underlying economic stability do tend to coexist, and to be mutually reinforcing—but that the casualty runs primarily from underlying national stability to the international arena rather than vice versa.

What we can do, and are trying to do, is to increase the extent to which national policies make a positive contribution to international stability—and the degree to which the international system contributes to constructive national policies. German and Japanese growth policy is made by German and Japanese authorities, but should be made with a view to their global impact.

American economic and energy policy is made by the President and the Congress, but must take their international effects fully into account. The exchange markets give strong signals to all these authorities, and point to the costs of inadequate action on all such issues. Today's system provides the basis for this two-way interaction. All of our efforts, such as this week's summit, aim to operate it more effectively. All of our efforts aim to make that system operate more smoothly.

I would be pleased to address your questions.

Representative REUSS. Thank you very much.

[The prepared statement of Mr. Bergsten follows:]

PREPARED STATEMENT OF HON. C. FRED BERGSTEN

International Economic Policy—Where We Stand

I welcome this opportunity to discuss with you longer term problems in the international economy. Far too often, the Congress and the Executive Branch focus solely on the short run. While this "fire-fighting" approach is inevitable to some extent, it is essential occasionally to step back and review the broader and longer term issues—and how our country is seeking to deal with them. The Carter Administration has been in office a year and a half, and it is thus particularly timely to review our international economic policies.

Philosophy

The Administration's philosophy centers on two basic factors:

- (1) The need to maintain and strengthen an open trade and payments system;
- and
- (2) The requirements of global economic interdependence.

The Administration and, I believe, the Congress and the nation as well, place basic reliance on the free market systems. The private market is the most efficient way to allocate scarce resources at home and abroad, as long as it is truly free of distortions due to governmental interference.

The free movement of goods, services and capital is essential to the efficient functioning of the global economy. Only in this way can our citizens purchase goods produced by the most efficient and lowest priced firms world wide, thus minimizing the price level within our own borders. Only in this way can our producers have access to the widest possible market for their products, thus maximizing jobs for our workers.

But trade relations must be reciprocal. Goods must be allowed to move unencumbered out of the United States to other markets, as well as into the United States. In many areas—far too many—the hard realities are that governments are deeply involved in what should be basically private market decisions. For example, subsidies to domestic producers distort investment and trade flows. In such cases it is incumbent upon the U.S. Government to undertake efforts to offset such distortions, both to defend our own producers and to try to deter others from interfering in these markets themselves.

This is a basic tenet of our philosophy—"domestic" and "international" economic issues are inextricably linked. The pressures on governments to intervene in private markets, in pursuit of their numerous policy objectives, is matched by their increased dependence on external transactions. On the one hand, this adds to the temptation to manipulate international flows. On the other hand, it compels countries to play by the international rules if they are to avoid self-defeating retaliation or evaluation by other countries. Hence increased interdependence simultaneously produces centrifugal and centripetal forces as regards the maintenance of an open world economy based largely on market principles.

Faced with this situation, the United States—to oversimplify for presentational purposes—faces two basic choices: to fight or to join the trend toward increased government involvement abroad. In practice, we will of course do some of both.

But our basic philosophy is to resist this trend in the hope and belief that the market-oriented approach is both far superior and likely, over time, to prevail. In many key instances—such as the adoption by most major countries of flexible exchange rates, and the recent progress at Geneva in reducing tariffs and other barriers to trade—there has recently been impressive evidence of the vitality of the market approach, and the confidence of nations in it.

The maintenance of an open trading system produces essential support for jobs abroad and jobs in the United States, both directly and through its effect on the policies of others. A well functioning monetary system, sustained, non-inflationary growth abroad, reasonably stable commodity prices, and healthy international competition are essential components of our fight against inflation and unemployment.

Strategy

The strategy we have developed for converting philosophy into concrete results is multi-faceted. We have operated simultaneously on a number of fronts: macroeconomic policies at home and abroad; trade policy in general and the MTN in particular, further improvement in the international monetary system; more effective economic relationships between the industrialized and developing countries; and energy. Actions on each front are consistent with our basic approach: each reinforces other elements in the overall strategy. The list of specific parts of the entire program is rather long.

On macroeconomic policy, we have focused our domestic efforts on maintaining adequate growth, reducing unemployment, and controlling inflation. In discussions with our allies, we have pressed for accelerated growth wherever possible and for restraint where necessary due to domestic or external imbalances.

In pursuing the multilateral trade negotiations, we have pushed for maximum tariff cuts, sought reductions in non-tariff barriers, supported a new internal trading framework, and argued for controls on subsidies and export credit competition.

In the monetary field, we have maintained our support for the system of flexible exchange rates, emphasized the need to address fundamental imbalances in order to restore international financial stability, increased efforts at expanding U.S. exports to promote the strength and stability of the dollar, intervened in the exchange markets where necessary to counter disorderly conditions, proposed legislation for expanding IMF resources through the Witteveen Facility, sought a better definition of the concept of IMF surveillance over the exchange rate sys-

tem, and increased the availability of data on private bank lending to assess more closely any risks involved in bank exposure in foreign countries.

We have had constant discussions with the developing countries regarding commodity agreements, reduction of trade barriers, and a possible common fund, and have expanded our own foreign assistance efforts considerably.

Finally, in the energy field, we have continuously pushed for a comprehensive National Energy Policy, worked actively with OPEC and other countries to limit the world price of oil, and pursued multilateral discussions on longer term energy policies in the International Energy Agency.

Our ability to pursue these several initiatives successfully will be a major factor in providing answers to the questions raised in your letter of invitation, Mr. Chairman:

The evolution of the U.S. balance of payments will be determined largely by the relationship between economic growth rates at home and abroad (in both the industrialized and developing countries), by our success in controlling our own rate of inflation and our appetite for oil imports, by our national export effort and the willingness of other countries to reduce their barriers to imports.

The OPEC surplus, which will decline sharply this year to under \$20 billion, will turn largely on the evolution of demand for energy in this country and abroad, our success in developing new sources of energy production around the world, rates of economic growth, the stability of the international monetary system (because of its impact on decision-makers in the OPEC countries), and our ability to work constructively together both with other oil-importing countries and with the OPEC countries themselves in their efforts to develop their own economies.

The debt problems of the developing countries will turn on the growth and stability of the economies of the industrialized countries, the evolution of the world price of oil, the willingness of all countries to maintain open markets for LDC exports and to provide adequate flows of public and private capital in support of development, and the wisdom of the development policies which the developing countries adopt themselves.

This tabulation of our international economic policy efforts, and their implications, for some of the most important policy issues which we face, illustrates the inter-relationships between our strategy and philosophy, the breadth of our activity in the international economic area and the inextricable links between "domestic" and "international" issues. I would like to discuss some of the more directly international aspects of these actions in somewhat more detail.

International monetary system

Our basic approach to international monetary affairs centers on our approach to the domestic economy. It aims at the fundamentals of price stability and continued economic growth, and seeks as well to curb oil imports and expand U.S. exports. The success of our international financial policy will ultimately be determined by our success in addressing these four basic issues.

Reinforcing this strategy are our efforts to strengthen the operation of the international monetary system itself. The system encompassed in the new Amendment to the IMF Articles of Agreement retains the basic Bretton Woods philosophy of cooperation and liberal trade and payments. But it moves away from trying to force stability on nations through an external mechanism—as the gold standard to an extreme degree, and the Bretton Woods system to a lesser degree, had tried but failed.

Instead, it aims at developing stability through the application of sound underlying economic and financial policies in individual countries. It is a more realistic, more pragmatic approach. It focuses attention less on the symptoms of instability in the world economy—such as conditions in the exchange markets—and more on the root causes: the pursuit of divergent, and in some cases inappropriate, national policies by individual countries.

The main obligations placed on nations under the new IMF Articles are two-fold. First, each nation must endeavor to direct its policies toward orderly growth with reasonable price stability. Second, each nation must avoid manipulation of its exchange rate to avoid adjustment or gain unfair competitive advantage.

These are tough demands. The monetary system would function well if all nations followed sensible policies directed toward non-inflationary growth, and if they did not try to maintain exchange rates at artificial levels. But we must frankly acknowledge that neither the new monetary system, nor any conceivable

alternative system, can force sovereign nations against their will to adopt particular domestic economic and financial policies.

Those who seek refuge in an automatic self-policing monetary system are chasing shadows. History clearly shows that monetary stability and underlying economic stability do tend to co-exist, and to be mutually reinforcing—but that the causality runs primarily from underlying national stability to the international arena, rather than vice-versa.

What we can do, and are trying to do, is to increase the extent to which national policies make a positive contribution to international stability—and the degree to which the international system contributes to constructive national policies. German and Japanese growth policy is made by German and Japanese authorities, but should be made with a view to their global impact. American economic and energy policy is made by the President and the Congress, but must take their international effects fully into account. The exchange markets give strong signals to all these authorities, and point to the costs of inadequate action on all such issues.

Today's system provides the basis for this two-way interaction; all of our efforts, such as this week's Summit, aim to operate it more effectively.

Trade relations

Perhaps in no other area has the Administration moved simultaneously on so many fronts. The maintenance of an open and liberal trading system is a keystone of our international economic policies. In pursuit of this goal, we have been actively involved in the MTN, including proposals for revitalizing the GATT; discussions on a wide variety of commodity issues; and the development of positive adjustment programs.

In the recently completed high level discussion in Geneva on the MTN, we have sought a new international trading framework which will address a wide variety of major problems: injurious import competition, government subsidization, government procurement, the use of export controls, the role of the developing countries, methods of dispute settlement. The new trade rules are needed to complement the new international monetary system of flexible exchange rates, by updating the existing body of international rules to meet the demands of a rapidly changing international economy and providing a cooperative basis for addressing and resolving mutual problems. As in the monetary area, the new trading framework must be flexible and recognize that the needs and problems of domestic economies will differ among nations, yet provide acceptable guidelines and limitations upon national actions that interfere with trade flows.

In addition to these new codes and understandings, we also need to look beyond the MTN—and to the need for improved mechanisms of cooperation in trade among nations. We need to assure that trade problems can be addressed and mutually resolved before they erupt in open conflict. To do so, we must inter alia expand the means and mechanisms for increasing participation by the more advanced developing nations (ADCs) in the global economy—both through improved consultation and rights, and through their acceptance of greater responsibilities in international trade.

Relations with developing countries

Building better relationships with the developing world has been a primary goal of this Administration. Our major instruments to that end are to provide foreign assistance, conclude mutually beneficial commodity agreements where appropriate, negotiate an effective financially sound Common Fund, and reduce barriers to trade.

To assist the developing countries in meeting their development needs, we have sought sharply increased levels of foreign assistance. To increase the effectiveness of our effort to eradicate the worst forms of poverty, we have targeted our bilateral assistance on meeting basic needs—in agriculture, education and health—of the poorest. We have also encouraged the multilateral development banks to increase their emphasis on meeting basic human needs, while recognizing the crucial role of these institutions in other areas, such as infrastructure. While a great deal still to be done, we can already see positive results from our efforts—increases in health standards and life expectancy, better education systems, faster economic growth, and—in a number of countries—declines in the rate of population growth.

The fiscal year 1979 Appropriations Bill for foreign assistance and related programs is now before the Congress for floor action. The bill has been extensively cut in Committee, and further cuts are threatened on the floor. Moreover, appropriations for the multilateral banks are severely threatened by possible restric-

tive amendments—on either country or commodity grounds. The banks cannot accept any funds with such restrictions attached, so such amendments would severely undermine our continued participation in them—a participation that is vital to our nation's economic and political interests. I urge your support for the amounts recommended by the Appropriations Committee, and ask your help in averting the adoption of restrictive amendments.

In the wake of the massive economic dislocations brought about by the oil crisis, the establishment of a cohesive set of policies dealing with commodity prices has been a major aim of our development policy. Over the past eighteen months, we have sought to develop a comprehensive approach to this issue which can provide substantial benefits to both consumers and producers of primary commodities, in the United States and in other countries.

That policy seeks to integrate domestic and international elements into a single, coherent approach. In so doing, it has focussed on five policy instruments:

International commodity agreements between producers and consumers, to reduce excessive price volatility in world commodity markets. We have negotiated a sugar agreement, agreed to contribute to the buffer stock of the tin agreement, laid the basis for negotiating natural rubber and wheat agreements, seriously considered the possibilities of a copper agreement, and indicated our willingness to participate in a renegotiation of the cocoa agreement.

A common fund which, by pooling the financial resources of individual commodity agreements, would provide for adequate financing of agreements while reducing the budgetary burden on individual governments.

Promotion of increased productive capacity abroad for key raw materials through greater activity by the World Bank, the regional development banks, and our own Overseas Private Investment Corporation (OPIC).

A strategic stockpile policy based on revised strategic objectives and implemented in ways which are consistent with our national and international economic goals.

Support for the stabilization of export earnings of producing countries through the Compensatory Finance Facility of the International Monetary Fund.

A key component of U.S. policy toward the developing nations is general trade relations. Their need for access to our markets for manufactured products comes at a difficult time, because our own unemployment remains too high and our trade deficit has reached record proportions.

Nevertheless we must recognize that these countries are large and growing markets for our exports. We believe that open trading arrangements are very much in the interests of the United States—to minimize inflation, to create millions of export and import-related jobs and to avoid the imposition of non-trade restrictions in other countries. The Administration has therefore resisted proposals for wide-ranging curbs on U.S. imports from the developing (and other) countries, as an essential element of our approach to the developing countries. In addition, the Multilateral Trade Negotiations seek to further reduce barriers to international trade, particularly for products sold by the developing countries.

Conclusion

Given this long and complex shopping list, one cannot expect instant results. In some areas, our strategy has already produced significant successes. In others, there is movement in the right direction. In still others, we have recorded less progress so far.

In any event, it is clear that much work remains to be done if we are to maintain an open international economic system in today's interdependent world.

First and foremost, we must have congressional action on energy.

Second, we must move forward to complete the MTN and develop a new international trading framework.

Third, we need to develop guidelines for IMF surveillance of exchange rates as a prerequisite for a smoothly operating international monetary system.

Fourth, we need to develop a means for more effectively including the ADCs in the international system. They are fast becoming important actors, but they are not yet active in many of the major international institutions where global problems are discussed.

Progress in all of these areas is necessary in our continued pursuit of economic and political gains for both the United States and the world economy as a whole. I greatly welcome this opportunity to discuss the whole range of matters with you.

Representative REUSS. Mr. Packer.

STATEMENT OF HON. ARNOLD H. PACKER, ASSISTANT SECRETARY OF LABOR FOR POLICY, EVALUATION AND RESEARCH

Mr. PACKER. Thank you, Congressman Reuss.

I will follow the pattern Mr. Bergsten has begun of summarizing the prepared statement. It is a privilege to be here and talk about this complicated problem in which the danger is not imminent. These kinds of problems are the ones that the democracies tend to ignore—the ones that are complicated and not in a crisis proportion.

The problem I see is really not in terms of imbalances in the financial markets, as Mr. Bergsten has said. I look at a world in which there are substantial unmet needs and substantial unutilized resources. When I see that sort of a situation, I feel that there must be some better solution than to let those needs go unmet and the resources remain idle.

I point to the 16 million unemployed in the OECD countries as an indication of the idle resources.

Apparently, we have idle financial resources. I say they are idle and the recycling has not been successful, because if it had been successful, we would have full employment throughout the OECD world. The recycling may have maintained the financial stability, but it has not balanced savings and investment at a level to provide for full employment. This, in my judgment, is the test of adequate recycling.

We do see these other problems of balance of payments and so forth. However, one has to wonder whether investment is balanced in the world. Manufacturing capacity in steel and other commodities is in excess. Yet, we see investment moving in those directions, while investment in energy and food seems to be going less rapidly than one would hope.

The concern is that the fundamental solutions to these imbalances take a long time, and if one waits until the crisis is evident, it usually is too late to undertake the necessary long-term action.

I compliment the committee for dealing with the longer term problems, something that the body politic in Washington frequently doesn't have time to do.

It seems unusual, in a sense, for someone from the Labor Department to be here discussing international economics. I hope that is the beginning of a trend of greater involvement in international matters by the Department and, perhaps more importantly, by the labor movement itself. I sometimes believe that international economic policy matters are not dealt with properly because the discussion of exchange rates and disequilibria do not seem at the heart of the public's concern or political interests.

In the labor movement, employment and prices are the key data. Yet, we all know from the work that you and the committee have done that employment and prices, in fact, are partially determined by what happens in the international sphere. In recent years, this has been particularly true for the United States.

I want to point out that the AFL-CIO has spoken out on the foreign aid appropriation, particularly, the World Bank portion, and has written a letter to all Members of Congress expressing their support. I think that is a departure from their previous policy and, I hope, part of a trend that will continue.

My testimony goes on to indicate some figures about the slowing of world economic growth. I will just recite one or two figures that were not in the testimony, but struck me as being significant.

In Japan, manufacturing hours grew at a 2.2-percent rate between 1960 and 1973. After 1973 they dropped at a 3-percent rate. Germany experienced stable manufacturing hours between 1960 and 1973, but has declined at a 4.5-percent annual rate since 1973. So something happened in 1973 that has not yet been solved.

As has been pointed out many times, the problem is that the substantial increases in oil prices and the imbalances that turned up as surpluses of funds were not invested in employment-producing activities. Investments in land or in Treasury bills are clearly a place to put your money, but they don't directly produce employment. If the Federal Reserve has a domestic target, these inflows of foreign moneys do not do what monetarists think they do in terms of creating full employment. Again, I point out the fact that the OECD world does not have full employment, and this suggests to me that the monetarists' view is clearly not accurate.

Some observers think there is an imminent crisis. I don't think that the system is on the brink of failure, but I do believe we have the beginning of something that could be a problem. As I point out in my prepared statement, most of the world's problems had been around for many years in a manageable state before they got out of control. The rise of fascism in the 1930's or the Vietnam war are a good examples. I think we have a situation in which the south countries in the north-south dialog are doing without, while we have the richer countries saying their desire to consume has diminished. One would hope that this would be an opportunity to do something for the poorer countries, but, in fact, it turns out to be a problem.

We all hope now that the richer countries will consume more so that the rest of us can go to work. It seems to me that, even here, one can desire a more optimal solution.

The solution that I point to in my prepared statement uses the World Bank or other international financial institutions and transfers idle resources—whether they be in the OPEC countries or in Japan or Germany—to places where purchasing power will be created. Appropriate places would be primarily the developing countries; either the more advanced developing countries or the poorer ones. This will lead to balanced investment in the sectors of the world that lack developed resources, including energy, agriculture, infrastructure, and raw materials.

I would be happy Congressman Reuss, to try to answer any questions you have. Thank you.

Representative REUSS. Thank you, Mr. Packer.

[The prepared statement of Mr. Packer follows:]

PREPARED STATEMENT OF HON. ARNOLD H. PACKER

It is a privilege to be here this morning to testify on this important subject. It may seem unusual for a representative of the Labor Department to be discussing international economics. However, I hope that it is just the beginning of a trend towards greater involvement in international matters by both the Labor Department and the labor movement. It is noteworthy that the AFL-CIO has spoken out quite strongly on the foreign aid appropriation, particularly the World Bank portion.

U.S. FULL EMPLOYMENT AND THE INTERNATIONAL ECONOMY

The observation that we are all part of one interdependent world has become inescapable. The Labor Department, the labor movement, and, increasingly, the general public are now aware that domestic policy objectives cannot be achieved unless the world economy is healthy. The U.S. economy is increasingly dependent

on the level of international economic activity. Last year, for example, U.S. imports were greater than all business fixed investment in the U.S. and twice as large as residential construction. Roughly one in eight jobs in the manufacturing sector can be attributed to exports. Furthermore, these export-related jobs are typically high wage and high productivity jobs.

While the relative size of the export sector of our economy is quite significant, its rate of growth has tapered off considerably in the last few years. Our economy would be much stronger without the sluggishness of the export sector. I would point out that developing country's share of U.S. exports is growing. In the twenty years prior to 1943, real exports grew from 3.8% of real GNP to 7.1%. If the strong 1953-1973 growth in exports had continued over the last four years, GNP would now be \$22 billion higher and the Federal deficit \$5 billion lower.

Economic distress in the rest of the world encourages foreign countries to increase their exports to the U.S. and to reduce their imports of goods which they themselves can produce. It also encourages them to export surplus labor. The U.S. economy is vulnerable to imported surplus labor, particularly in the form of undocumented workers, and this problem appears to be worsening. While no hard data on this issue exists, the flow of surplus labor to the U.S. shows little sign of slowing down. We believe that undocumented workers now account for a substantial portion of the labor force in certain markets and segments of industry. Faced with economic stagnation, low wages, and sometimes politically repressive situations, workers from other countries see the U.S. labor market as an extremely attractive alternative. Hundreds of thousands of undocumented workers enter the U.S. annually.

Meanwhile, several European nations which used to welcome "guest workers" from other parts of the continent no longer face labor shortages. In the near future the drop in airline fares could possibly increase the flow of undocumented workers to the U.S. and make it relatively inexpensive for potential emigrants from Asia, Africa, and the rest of the less developed world to place new strains on the U.S. labor market.

The interest of the Labor Department and the labor movement in the health of the international economy has heightened, because we can no longer maintain strong economic growth ourselves unless the rest of the world economy is also growing. If economic stagnation persists in foreign countries, it will be difficult to achieve the goals of the Humphrey-Hawkins Bill. If we are to attain these essential goals on schedule, we must strive to build a stronger world economy.

THE PARADOX OF INTERNATIONAL IMBALANCE

Until 1973, the economic interdependence of the United States and the rest of the world grew at a slow and steady pace. The sudden quadrupling of energy prices following the oil embargo made all Americans aware of our increased economic vulnerability and the need to maintain a strong international economic order. But, if the economic imbalance which followed the dramatic events of 1973 persist, they will slow the return to a healthy world economy.

The symptoms of the imbalance are numerous. Within the United States, it has become more difficult to reconcile full employment and a balanced budget. The dollar is falling on the international currency markets, while the trade deficit continues to assume astronomical proportions. Since December of 1975, the dollar has depreciated 22 percent in terms of the yen and 34 percent in terms of the D-Mark. Nominal net exports declined from a \$20.3 billion surplus for 1975 to a \$23.7 billion deficit in the first quarter of this year. U.S. industries face increasingly stiff competition from imports, while our export growth is slowing. Real exports grew at a 6.7 percent annual rate between 1954 and 1974. They dropped in 1975, recovered in 1976 but grew only 1.8 percent in 1977.

The symptoms are clear on an international level, as well. Much of the industrialized world faces persistent high unemployment. There is the potential for political instability. Once again we are hearing the call for increased protectionism among the industrialized countries. In few areas is the imbalance as evident as it is in the uneven growth patterns of some poorer countries. In many nations in Asia and Africa, real growth is only 2 percent per year, while population growth is 2.6 percent. On a per capita basis, GNP is dropping in these countries. In 1975 Africa imported 2¼ times as much food as it did in 1970. However, last year the average African had less to eat than he did in 1970. These nations have, in the past, emphasized manufacturing and urban development at the expense of agriculture and rural development. This approach led to excess capacity in the

light manufacturing industries and in basic industries such as steel and autos. Meanwhile, agricultural development proceeded at a pace insufficient to meet world food needs. Too much effort was often spent on developing energy-intensive and capital-intensive industries, while too little effort was spent on developing energy and water resources.

Some observers believe that this situation will worsen before it improves. Senator Javits has expressed concern that the world financial system will be unable to tolerate the continuation of the current situation. Recent work by Professor Ronald Muller at American University supports Senator Javits' thesis. While we continue to believe that the financial system possesses the necessary resiliency to cope with these problems, we do not discount the views of those who take a more pessimistic approach. Moreover, the Administration's view is based upon the continuation of the domestic recovery and a resumption of growth in the Organization for Economic Co-operation and Development (OECD) countries.

The world now has an opportunity to prevent the next crisis—worldwide economic stagnation. Most emergencies give ample warning, if only the world's leaders are attuned to the signals. The rise of fascism, bringing with it the seeds of World War II, was apparent at a time when it could easily have been contained. Vietnam was brewing for at least a decade before it reached the proportions which tore the nation apart. Future historians may look back upon the latter half of this decade as yet another instance when the symptoms of an ensuing problem were ignored, letting the problem grow into a crisis of unmanageable proportions.

Currently, the seeds of the next crisis may be visible. An international imbalance of savings and investment started with the unused Organization of Petroleum Exporting Countries (OPEC) surplus (which resulted from the quadrupling of energy prices). More recently, this problem has been intensified by the large surpluses held by other industrialized nations. As a result, many countries including our own, must run budget deficits in order to compensate for the purchasing power which is being siphoned off by the underutilization of trade surpluses.

Four years after the increase in oil prices, most industrialized countries are desperately trying to earn the foreign exchange necessary to pay for oil imports. This attempt has generated considerable pressure to promote exports in both rich and poor countries.

While some countries can eliminate their current account deficits some of the time, deficit countries cannot do so simultaneously as long as the oil-exporters and a handful of industrial nations remain heavily in surplus. In the last few years, the deficit has moved from one group of countries to another as different nations accept an extraordinary share of the imbalance. But, since no country can sustain this taxing burden for long, there is a tendency to try to shift the hot potato to someone else.

In 1974 and 1975, developing nations bore most of the deficit caused by the rise in oil prices. In 1974, the non-oil exporting developing countries ran a \$24.5 billion deficit on current account. In 1975, their deficit on current account was \$40.0 billion. The comparable 1975 figure for the OECD nations was only \$6.3 billion. This could not continue for long since there were limits to how much debt these countries could finance without raising fears of possible default.

Recently, the United States picked up the burden of a massive deficit. Our 1977 deficit on current account was \$18 billion. The previous year's deficit was only \$1.4 billion, and in 1975 we ran a surplus of \$11.6 billion. In large measure, last year's deficit occurred because our imports grew while our export growth diminished. The deficit, in turn, contributed the recent decline in the dollar and triggered further inflationary problems. Additionally, the combination of high unemployment and a sizeable trade deficit has made protectionism seem more attractive.

Worldwide, we face the classic Keynesian situation where desired savings exceeds investment. The imbalance between savings and investment within individual countries stems from a failure to make up for OPEC surpluses in terms of effective demand. Deficits induced by the higher costs of imported oil have made industrialized democracies extremely cautious in effecting policies to offset these imbalances.

If investors were sufficiently confident and were able to obtain bank loans at low enough interest rates, private investment might rise by enough to replace the purchasing power lost through oil imports. But, this is not the prevailing situation. Quite simply, under current interest rates, investment will not rise enough to match desired savings. Similarly, governments could replace lost purchasing power through full employment budget deficits. However, again, most govern-

ments appear unwilling to take this risk. Instead, as Secretary Marshall noted before the Empire Club in Toronto, "the industrial world leaders are uncomfortably balancing the political costs of budget deficits against those of high unemployment."

A major problem is the recycling of OPEC trade surpluses into effective demand. With the industrial countries fearful of such stimulation because of a possible rekindling of inflation, actions should be taken to channel these resources to balanced development in less developed countries. Currently, many investors in the OPEC and industrialized countries holding surplus funds are reluctant to increase their investments in less developed countries because of the risk which they perceive. However, by providing some mechanism, such as greatly expanding the lending capacity of international financial institutions, such rechanneling of these funds could be made possible.

POTENTIAL SOLUTION

A number of observers have indicated such a possible solution. Most recently, the OECD ministerial meetings noted that "increased investment in developing countries would contribute to sustained and more balanced economic growth as well as enhancing development in the countries concerned." The analysis divides the world into three sets of actors. One is the large surplus countries—certain OPEC nations, European surplus nations, and Japan. The second set is composed of the deficit industrial countries of the OECD, and the third is the developing world.

The surplus nations are clearly unable or unwilling to consume all they can afford. It is ironic that the lack of consumption by rich provides—within the current institutional framework—not an opportunity but a problem. The deficit industrial countries—and the United States is a good example—are consuming or importing more than they are producing or exporting. In some cases, this is not what they would wish to do. The imbalances in world financial flows have created a situation in which continued trade imbalances seem unavoidable.

Only an expansion of international export markets would be able to eliminate these deficits. For the United States, an expansion in export markets could mean increases in real output, employment, and productivity, and reductions in both the trade and budget deficits. We could eliminate much of the federal deficit and one of the real causes of inflation—the continuing decline of the dollar in the world currency markets.

Current investment efforts in the developing nations often center too much on "showcase" projects such as steel mills or on investments with a short term payoff such as textile mills. In general, this approach has no long run benefit for the countries. Private investors are currently unwilling to take the risk of investing in long run projects which enhance the infrastructure and lead to long run growth. Aid should continue to be directed towards projects which will expand the agricultural sector. There are few developing nations which would not benefit from rural cooperatives, and agricultural extension services which help to introduce more advanced agricultural technologies. Industrial aid should be tailored towards the recipients' special resources. Some nations could generate cheap hydroelectricity. Solar energy projects would be useful in desert areas. But these projects are all long term—the immediate return will be too small and the risk too great to interest private investors.

What is needed is a great expansion of the lending capacity of the international financial institutions which would make development loans to the less developed world. These can only be made through an unprecedented degree of cooperation between the industrialized nations and the OPEC countries.

To be most effective, these development loans should emphasize agriculture, water, and energy production. Increased agricultural productivity, and rural nonfarm development in the less developed world would slow migration from rural to urban areas, pave the way for an increasing standard of living, and avoid serious food shortages. These loans should not be intended to impose Western norms on the developing world. Rather, they should be designed to help each country choose its own formula for balanced growth.

The World Bank, its soft loan window (IDA), and regional development banks are the main financial institutions that can make these loans. It is essential that the industrial world and the OPEC nations recognize their common interest in expanding world demand.

My message is simple. As a result of various economic forces, we face a situation where certain nations are running large trade surpluses which they are unable to channel back into productive investment. This has led to a reduction in

effective world demand, and we have had to compensate by running large budget deficits. If we can, through international financial institutions, find a productive way to use the idle trade surpluses, we can restore the purchasing power which has been siphoned away. In this manner, we can help restore robust economic growth to the industrial nations and pave the way for meaningful economic development in many poor countries.

If we fail to act promptly, we could face major, worldwide economic stagnation in the coming decades. We must act now, with an unprecedented degree of international cooperation, in order to avoid this next crisis.

Representative REUSS. Ms. Whitman.

STATEMENT OF MARINA v. N. WHITMAN, DISTINGUISHED PUBLIC SERVICE PROFESSOR OF ECONOMICS, UNIVERSITY OF PITTSBURGH, PITTSBURGH, PA.

Ms. WHITMAN. Thank you, Congressman Reuss. I, too, am very glad to have this opportunity to talk about the international adjustment process and the international monetary system. I hate to disappoint you, but it doesn't sound as if Mr. Bergsten and I are going to have much to fight about.

Representative REUSS. Well, do the best you can. [Laughter.]

Ms. WHITMAN. I will do the best I can. When I started teaching this subject of international economics in the early 1960's, we told the students that the international monetary system should be evaluated in terms of its performance in providing three fundamental necessities: Adjustment, liquidity, and confidence. Despite the cataclysmic changes that the system has undergone in the intervening years, these three terms still offer convenient categories into which to group my comments about the present performance of the system.

Let me begin with the international adjustment process. The behavior of exchange rates over the last year or so poses something of a puzzle. On the one hand, the instability of these rates, and particularly the precipitous decline of the dollar, are widely regarded as one of the primary problems of the international economy, destroying confidence, disrupting financial markets, interfering with investment decisions and acting as a drag on economic growth. We hear that all the time.

At the same time, the United States has developed unprecedentedly large deficits on trade and current account, deficits that show no sign of abating. Viewed as an instrument of external adjustment, one might be tempted to conclude that, far from being excessive, the depreciation of the dollar hasn't gone far enough. I guess it is lucky that I am now at the University of Pittsburgh and not in the Government, or the dollar would take another plunge on the basis of that statement.

But things are not all that simple. For one thing, we are talking about different exchange rates. Investment and financial markets are dominated by the relationship between the dollar and two or three other major currencies. Here the shifts have indeed been large: Over the past year, the dollar has fallen by roughly 15 percent against the German mark, and by about 25 percent against the Japanese yen and the Swiss franc. Measured against a wider group of currencies, on the trade-weighted basis that is a more appropriate measure for gaging international competitiveness, the depreciation of the dollar has been 7.5 percent—and in real terms, that is, adjusted for differences in inflation rates, it has been less than half of that.

Even more surprising is the fact that the dollar's value today, in effective terms, is only about 2 percent below where it stood in mid-February 1973, just after the second formal dollar devaluation that marked the beginning of the era of managed floating. The reason, of course, is something that Mr. Bergsten talked a bit about, too, that in between there was a significant appreciation of the dollar, caused at least partly, and perhaps substantially, by the very heavy intervention by other countries, and certainly by the Japanese, in the exchange markets.

I think the picture is also blurred by the fact that changes in exchange rates appear to exert their effects on international competitiveness and trade flows with substantial lags of up to 2 years or more. Thus, the main impact on trade flows of the dollar's decline over the past year presumably lies ahead. In fact, a recent study by the International Monetary Fund staff estimates that, by 1980, there should be a beneficial impact on the U.S. current-account balance of nearly \$7 billion stemming from changes in relative prices—that is, exchange rate changes adjusted for domestic inflation differentials—that have not yet exerted their impact on trade flows. I hope they are right.

So, whether the value of the dollar has dropped too far, not enough, or just the right amount vis-a-vis other leading currencies, is a question neither I nor anyone else can answer with any degree of certainty. Certainly any American living or touring abroad can tell that, in purchasing-power-parity terms, the dollar is undervalued; that is, that at present rates of exchange it will buy you considerably more in Kansas City, Washington, or even New York than it will in Munich, Zurich, or Tokyo.

The trouble with this sort of comparison is that, while over very long periods of time such purchasing-power-parity relationships appear to hold up pretty well, in the short and medium runs exchange rates have to clear financial as well as commodity markets, to reflect capital flows as well as trade flows, and to adjust for differences in energy production and consumption, degree of export-orientation, differences in real growth rates, and a whole lot of other factors in addition to changes in relative price levels and rates of inflation.

In addition, exchange markets, like the stock market, take account not only of the past and the present, but of the future as well, or at least of expectations regarding it. It is increasingly apparent that in the United States inflation is accelerating, which in the three "strong currency" countries it appears to be stable or declining.

I believe that present exchange rates incorporate this anticipated widening of this gap. If we are dismayed—as we should be—by the visions of the future reflected in exchange market behavior, we would be better advised to seek effective policies to alter those expectations than to cavil against the markets that mirror them. No one has ever succeeded in averting bad news by killing—or beating up—the messenger who brings it.

The fundamental uncertainty regarding the criteria by which exchange rate relationships should be judged make the IMF's post-Jamaica responsibility for surveillance over exchange rate policies as difficult as it is vitally important. And it is vitally important, because obviously there is no such thing as an exchange rate completely free of Government intervention. Most countries today still peg their currencies, and those that don't are certainly managing their rates. The

central banks of some five or six industrialized countries have bought more than \$40 billion in 1977 and the first quarter of 1978, mainly in order to dampen the appreciation of their own currencies.

Furthermore, as the IMF's Executive Board has recognized, there are many instruments other than direct intervention that a country can use to manipulate its exchange rate to its own advantage and the disadvantage of others, including official borrowing or lending on international capital markets, the use of controls on current or capital-account transactions, or changes in the mix of monetary and fiscal policy used for domestic stabilization purposes.

The fact is, of course, there are no principles defining what constitutes socially acceptable behavior in these areas, any more than there are concrete means to distinguish appropriate from inappropriate exchange rates. But the fact that no such criteria have been developed should be reason for support rather than criticism or abandonment of the IMF's efforts to carry out its surveillance mandate.

In addition to the conceptual uncertainty surrounding these issues, the IMF faces the inevitable constraints felt by an international agency attempting to impinge on sovereign nations in the exercise of legitimate—if not always constructive—instruments of national economic policy.

Inevitably the IMF must move slowly in this area, building precedents gradually and on a case-by-case basis, through the consultative process. The fact that there are no general standards for acceptable behavior does not mean that the Fund cannot gradually evolve procedures for earmarking unacceptable behavior in particular instances, any more than the inability to find a general definition of beauty means that we cannot get a consensus on when it is absent, particularly in extreme cases. It is essential that the United States give firm support to the International Monetary Fund as it struggles to evolve effective techniques for exchange rate surveillance in a world of managed floating.

I don't mean to say, of course, that exchange rates are the alpha and the omega of the adjustment process. They are not. This is partly because, as I have already mentioned, they are far more completely free to equilibrate the balance of payments. It is also because, even if they were completely "unmanaged," exchange rates alone could not, especially in a world of high international capital mobility, guarantee the achievement of stable and acceptable current account positions, insulate a country against external economic disturbances, or prevent the international transmission and magnification of economic disturbances.

Recognizing the need for complementary measures to promote external adjustment in an environment of stable world economic growth, the United States has for some time joined the OECD and various other international agencies in urging that those countries with low rates of inflation and strong external positions take a leading role in stimulating and maintaining world economic recovery.

But, of the three countries originally envisaged as "locomotive economies" or "engines of recovery," the United States has run up against both inflation and balance-of-payments constraints of its own, while Germany and Japan insist that fear of rekindling inflationary pressures and structural problems that limit the effectiveness of meas-

ures to stimulate domestic demand severely constrain their ability—and their willingness—to do more along these lines.

So there has been something of an impasse on the “locomotive” issue. This is not the place for an exhaustive evaluation of the locomotive strategy or its successor, the so-called convoy approach, which would spread the responsibility for stimulating global recovery more widely to include such countries as France, Italy, and the United Kingdom, whose inflation rates and balance-of-payments positions have recently shown substantial improvement.

Let me confine myself to two brief comments, recognizing that, even as I make them, the subject may have once again become a bone of contention at the Bonn summit discussions.

First, the tremendous uncertainty that currently prevails regarding the impact of the traditional tools of aggregate demand policy in an environment of persistent stagflation lies at the root of the problem. Until some general consensus on this critical issue emerges, and until some reliable ways are found to sustain or stimulate real growth while restraining inflation, divergent national views and preferences are bound to stand in the way of further progress on the international coordination of macroeconomic policies.

The second point is that, while appropriate demand-management policies in the leading industrialized countries, and particularly in the leading surplus countries, are clearly essential to global economic recovery and real growth—which has been faltering badly outside of the United States—we should not expect too much of changes in real growth rate differentials among the industrialized countries as a means of eliminating balance of payments disequilibria.

Specifically, a recent OECD study and one by the International Monetary Fund estimated that demand-stimulating programs in other countries sufficient to eliminate entirely the present growth gap differential—that is, differences in the size of the discrepancy between actual and potential growth rates—between the United States and other industrialized countries would result in an improvement in the U.S. balance on current account of less than \$5 billion.

They get estimates that would range between \$2 and \$5 billion in our current account position by 1980, clearly not insignificant, but by no means the major solution to the problem.

Another issue, of course, is the development of an effective U.S. energy policy, which has been viewed as essential to the health of our economy and a balanced external position. More recently, attention has turned also toward the development of export promotion policies in a nation that has traditionally regarded foreign markets rather casually. This latest policy development has drawn added support from the trade data for the first 4 months of 1978, a period during which oil imports actually decline significantly, nonpetroleum imports soared and nonagricultural exports rose very modestly indeed. This pattern suggests that broader issues of trade competitiveness, rather than simply the petroleum import question, may underlie our deteriorating current account position.

The trials and tribulations of U.S. energy legislation are too well known to the members of this committee to require any recapitulation here, while concrete details of a proposed export policy are not yet known. So I will confine myself, once again, to a couple of brief ob-

servations. One is that, quite apart from the delays inherent in the political processes of a democracy, it is highly unlikely that either our energy or our export promotion policies, in their final form, will set in motion structural changes sharp enough to bring about significant changes in the U.S. trade and current account positions over the next couple of years.

While firm action in either or both of these areas would doubtless bring about a significant temporary firming of the dollar, via effects on expectations, we should not count on such developments to make a major contribution to the payments adjustment process in the immediate future, although I think they are important for the longer run.

The second point is to caution against taking actions in either of these areas that can be justified solely on balance-of-payments grounds. If we find it politically infeasible to allow U.S. petroleum prices to rise rapidly to world levels, then alternative means of stimulating domestic production and discouraging consumption make sense as second-best policies. And, of course, we should, as part of our export promotion effort, encourage basic research and development, stimulate innovation and productivity increases, improve information about potential export markets, and clear away obstructionist governmental regulations that reduce competitiveness without bestowing commensurate social benefits. But such actions would be desirable at any time, the fact that our trade deficit may provide the essential political catalyst notwithstanding.

The point is that we should not allow concern about our external position to lead us into actions that would otherwise be economically unjustifiable. Back in the 1960's, when the increasing overvaluation of the dollar appeared difficult or impossible to correct directly, one could perhaps make an intellectually respectable argument for such behavior. But today, when our exchange rate is much freer to move to equilibrate our external position, we are only fooling ourselves if we attempt to reduce our current account deficit or shore up the dollar by taking actions that would not make sense if we were in surplus or the dollar were not under downward pressure.

The fact is that, despite widespread opinion to the contrary, there is nothing magical about exports that makes a dollar's worth of additional demand originating in foreign markets any less inflationary, or more employment-creating, than a dollar's worth arising from increased domestic consumption, investment or government spending.

In fact, increased exports, like defense spending, may fuel domestic inflation by adding to domestic income without adding to the supply of goods available in this country to spend it on. Increased investment, on the other hand, adds to productive capacity and thus helps to counteract inflationary pressures over the longer term. The solution to the stagflation problem does not lie in artificial subsidization of exports or restriction of imports.

This brings me, inevitably, to the question of trade policy. These hearings are not directed toward that issue, and I won't say very much about it. But there is no way to separate trade policy from considerations of the adjustment process. It is always attempting to respond to external deficits or currency weakness by imposing tariffs or quantitative restrictions on imports, and it is quite possible that such measures would have the desired effect in the short run.

Fortunately, U.S. policymakers have on the whole stood firm against pressures for increased protectionism. Such measures would not solve either our external or our internal economic problems in the long run. On the contrary, at a time when policymakers are searching intensely for ways to improve the currently unattractive tradeoff between inflation and unemployment, trade liberalization offers such a way, and they are very rare and hard to find.

Now the Geneva participants have reached a "framework of understanding" to eschew protectionism as the solution to current economic problems, it is incumbent upon the major industrialized nations in general, and upon those in strong surplus positions in particular, to move ahead in fleshing out this general agreement with concrete actions as regards both agriculture and manufactured goods. The effectiveness of exchange rate adjustments in reducing the trade deficit of the United States and the surpluses of Germany and Japan depends heavily on how free trade is to respond to changes in price relationships. For the United States, export promotion and expanded market access—in both directions—must go hand in hand.

Finally, and most crucially, there is the issue of inflation. Not only has this country's inflation been running at a significantly higher rate than in the leading strong currency countries, but the indications are that this gap is increasing and will continue to increase in the near future. As I mentioned, I believe that exchange markets are already reflecting this outlook and will continue to do so until there is a solid basis for a change in expectations.

In recent months, as our unemployment rate has dropped and inflationary pressures have accelerated, a stronger anti-inflationary stance has been emerging in the United States. Whether these moves prove adequate to reverse the acceleration of price increases remains to be seen. Obviously, we just don't know. In any event, their full force is more likely to be felt in 1979, and beyond, than in 1978.

The question seems to be whether we can stop the inflation without throwing ourselves into a recession. For the long run, however, our performance as regards inflation remains the key factor in the performance of our balance of payments and our exchange rate. If we can regain our superior performance vis-a-vis other leading industrialized countries in this regard, not only will our international competitiveness and our current account position improve, but the dollar is likely to strengthen even in anticipation of these developments.

If we continue to inflate faster than the strong currency countries, and there are no solid reasons to expect a narrowing of this gap, our trade and payments positions will remain weak and the dollar will continue under persistent downward pressure.

Let me turn now to international liquidity, leaving the adjustment process for the moment. The question of whether global reserves are inadequate or redundant, and what should be done about it has receded into the background. There are good reasons for this development.

First, with the steady expansion of international capital markets and increased borrowing by official or semiofficial agencies for balance of payments purposes, the distinction between owned reserves and borrowing capacity has substantially eroded. Internationally, as domestically, the line between cash and credit has become steadily fuzzier as new forms of the latter have become an increasingly good substitute for the former.

Even more important in defusing the liquidity issue has been the shift in the exchange rate regime. The concern with global liquidity management came to the forefront in an area of pegged exchange rates and was nurtured by the explosive creation of dollar reserves in the waning days of the Bretton Woods system. Under the old rules of the game, countries acquired—or surrendered—foreign exchange reserved in the course of exchange market intervention undertaken to fulfill their parity obligations under the IMF Articles of Agreement.

Under managed floating there is what might be termed consumer sovereignty; countries that accumulate reserves do so voluntarily. They have the alternative of allowing exchange rate changes to clear the market for foreign exchange without the political difficulties associated with official revaluations or devaluations under the Bretton Woods system.

Certainly the need for reserves has not disappeared, but I think the issue has become less significant under the present exchange rate regime. I think that is also true with respect to the composition of reserves, or more accurately, controlling the instability caused by shifts from one reserve asset to another.

Shifts obviously can and do occur under the new system. There has been some diversification away from dollars since 1973, and there probably will continue to be some diversification. How far it goes on depends, I think, on the question of relative inflation rates, and how fast different currencies lose purchasing power. But the existence of a continuously functioning adjustment mechanism that can prevent the buildup of cumulative disequilibria and thereby eliminate the threat of large, discontinuous changes in rates among major currencies should help to forestall sudden, destabilizing shifts in the composition of reserve assets.

This does not mean, of course, that all the issues relating to international liquidity have been satisfactorily resolved. The question of whether gold has actually been effectively demonetized or not remains somewhat up in the air, although it has receded into the background for the time being. Certainly, the Jamaica agreement's stated objective of making the SDR the principal reserve asset of the system has gone nowhere at all so far.

My own feeling is that it may be time to consider the possibility of a new allocation of SDR's, not so much because there is any clear-cut need for additional international reserves at the moment as to support and enhance the authority of the International Monetary Fund. They need all the support they can get at the moment.

Even more important, however, is that the Fund be endowed with additional capacity to provide conditional liquidity, funds whose availability is predicated upon the borrowing countries taking actions that will facilitate adjustment of their payments imbalances.

In this connection, it is imperative that the long-delayed legislation needed to permit U.S. participation in, and thus activation of, the \$11 billion Witteveen facility be promptly enacted. I think it is also important that during the IMF's seventh review of quotas, currently underway, we should also take account of the fact that only if it has adequate resources can the IMF perform effectively its role of supervising and encouraging the elimination of external disequilibria and the stabilization of domestic economic conditions that must underlie any durable stability of payments positions and exchange markets.

Unfortunately, an adequate capacity to lend can enhance the IMF's authority only over deficit countries, which is only half of the picture. Pressure on surplus countries to play their role in eliminating payments disequilibria can only come from the gradual development of effective and acceptable criteria and instruments for the surveillance of policies bearing on exchange rates, which I have already talked about.

Finally, there are a number of questions that bear on the dollar's role as a reserve currency. In the days of Bretton Woods, a great deal of rhetoric was expended in debating whether this reserve currency role represented a "unique burden" or an "exorbitant privilege." Although, for a variety of reasons I have detailed elsewhere, I expect the dollar to continue as the world's major reserve asset for the foreseeable future, it seems to me that the move to managed floating has greatly reduced both the exorbitant "privilege" and the unique "burden" associated with that role.

On the one hand, other countries need no longer accumulate unwanted dollars in fulfilling their parity obligations under the IMF Articles of Agreement, thereby enabling this country to run what some regarded as a "deficit without tears." On the other hand, the United States is no longer constrained by the dollar's special position from allowing its exchange rate to move in order to alleviate disequilibria in its external position.

In light of this situation, it seems to me that our attitude as regards developments likely to affect the dollar's reserve currency role should be relatively relaxed and low key. I myself am not convinced, at this moment, that an asset-substitution account in the IMF, which would exchange some portion of official dollar reserves for SDR's is likely to prove either necessary or sufficient to eliminate instability in the dollar exchange market. But if other countries feel strongly that such a facility is desirable, and would provide them with the reassurance required to make their own behavior as regards trade liberalization or demand-management policy more forthcoming, I think we should agree to a thorough and intensive joint evaluation of concrete proposals along these lines.

Of more immediate concern, just now, is how the United States should respond to the recent EEC agreement to work toward an expanded "snake"—a joint float of their currencies vis-a-vis the dollar supported by a pool of reserves amounting to perhaps \$50 billion. Obviously, any detailed response on the part of the United States would be premature, since no one yet knows the details of the plan, and I suspect that includes the participants themselves at the moment.

It would be easy to detail many obstacles that confront any such plan, and it would almost certainly require the Germans to modify their insistence on strictly limiting any reserve currency role for the deutsche mark, a position that has so far tended to dampen the appreciation of that currency. But these are properly the concerns of the Europeans.

Our legitimate concern should be assurance, as the plans proceed, that this latest step in European economic unification should be fundamentally liberal and internationalist rather than inward looking and mercantilistic in thrust. Beyond that, we should think twice—or three times—before abandoning the position of interested and sympathetic spectator for that of active participant in what is bound to be a complex and difficult evolution.

Finally, there is the question of confidence, the most mysterious and elusive ingredient of an effectively functioning international monetary system.

I am afraid I have no magic solutions to offer in this area. Yes, close consultation and coordination among central banks as regards exchange market intervention to counter disorderly market conditions can be helpful in avoiding confusion and misunderstanding and promoting good feeling among the major industrialized countries. But we should have learned from recent experience not to expect too much from such intervention: unprecedented sums have been poured into exchange markets during the past 18 months or so in ultimately unsuccessful efforts to dampen currency movements. In fact, I would agree with Mr. Bergsten's comments that they may have only made things worse.

And, yes, Government officials should avoid, insofar as it is humanly possible, rattling supersensitive exchange markets by comments that lend themselves to exaggeration or misinterpretation. But except in the very short run, it is the behavior of economies, not the words of policymakers, that will determine the behavior of financial markets, including exchange markets.

I suspect that confidence, like happiness, is seldom achieved when sought directly, but is most likely to be reached as byproduct of the pursuit of other goals. The key elements in any U.S. contribution to stabilization of currency markets, the facilitation of international trade and investment, and thus the promotion of stability and growth in the world economy, are three: The avoidance of protectionism—including manipulation of exchange rates as well as restrictive trade policies—both at home and abroad; the establishment of an effective anti-inflationary stance that will eliminate or reverse the unfavorable differential in inflation rates between the United States and the strong currency countries; and the development of a sensible energy policy, which means eliminating, by direct or indirect means, the stimulus to energy consumption and the discouragement of domestic production, at least relative to other industrialized nations, that are implicit in our present policies.

I will be glad to answer questions.

Representative REUSS. Thank you, Ms. Whitman.

[The prepared statement of Ms. Whitman follows.]

PREPARED STATEMENT OF MARINA V. N. WHITMAN

I appreciate this opportunity to participate in the midyear hearings of the Joint Economic Committee, and specifically to make some comments on the operation of the international adjustment process and the international monetary system.

When I started teaching international economics in the early 1960's, we told our students that the international monetary system should be evaluated in terms of its performance in providing three fundamental necessities: adjustment, liquidity, and confidence. Despite the cataclysmic changes that the system has undergone in the intervening years, these three terms still offer convenient categories into which to group my comments about the present performance of the system.

THE ADJUSTMENT PROCESS: EXCHANGE RATES

Let me begin with the international adjustment process. The behavior of exchange rates over the last year or so poses something of a puzzle. On the one hand, the instability of these rates, and particularly the precipitous decline of the dollar, are widely regarded as one of the primary problems of the international

economy, destroying confidence, disrupting financial markets, interfering with investment decisions and acting as a drag on economic growth. At the same time, the United States has developed unprecedentedly large deficits on trade and current account, deficits that show no sign of abating. Viewed as an instrument of external adjustment, one might be tempted to conclude that, far from being excessive, the depreciation of the dollar hasn't gone far enough.

It's a good thing I'm currently a college Professor, rather than a government official; otherwise that last comment would doubtless cause another plunge of the dollar on international markets. Let me hasten to add, though, that things aren't at all that simple. First of all, there is more than one exchange rate involved. Investment and financial markets are dominated by the relationship between the dollar and two or three other major currencies. Here the shifts have indeed been large: over the past year, the dollar has fallen by roughly 15 percent against the German mark, and by about 25 percent against the Japanese yen and the Swiss franc. Measured against a wider group of currencies, on the trade-weighted basis that is a more appropriate measure for gauging international competitiveness, the depreciation of the dollar has been $7\frac{1}{2}$ percent (and in real terms, that is, adjusted for differences in inflation rates, it has been less than half of that). Even more surprising is the fact that the dollar's value today, in effective terms, is only about 2 percent below where it stood in mid-February 1973, just after the second formal dollar devaluation that marked the beginning of the era of managed floating. Perhaps these differences help to account for a puzzling ambivalence on the part of observers who decry the instability of floating rates. When pressed, many of them note that the exchange-rate changes that have taken place so far (that is, up to the date on which they are speaking or writing) appear to be on the whole justified, but that any further changes would be economically unwarranted, financially disastrous, and the result of speculative excesses.

The picture is also blurred by the fact that changes in exchange rates appear to exert their effects on international competitiveness and trade flows with substantial lags of up to two years or more. Thus, the main impact on trade flows of the dollar's decline over the past year presumably lies ahead. Indeed, a recent study by the International Monetary Fund Staff estimates that, by 1980, there should be a beneficial impact on the U.S. current-account balance of nearly \$7 billion stemming from changes in relative prices (that is, exchange-rate changes adjusted for domestic inflation differentials) that have not yet exerted their impact on trade flows.

Whether the value of the dollar has dropped too far, not enough, or just the right amount vis a vis other leading currencies is a question neither I nor anyone else can answer with any degree of certainty. Certainly, any American living or touring abroad can tell that, in purchasing-power-parity terms, the dollar is undervalued, that is, that at present rates of exchange, it will buy you considerably more in Kansas City or Washington or even New York than it will in Munich or Zurich or Tokyo. The trouble with this sort of comparison is that, while over very long periods of time such purchasing-power-parity relationships appear to hold up pretty well, in the short and medium runs exchange rates have to clear financial as well as commodity markets, to reflect capital as well as trade flows, and to adjust for differences in energy production and consumption, degree of export-orientation, differences in real growth rates, and a whole host of other factors in addition to changes in relative price levels and rates of inflation.

In addition, exchange markets, like the stock market, take account not only of the past and the present but of the future as well, or at least of expectations regarding it. It is increasingly apparent that in the United States inflation is accelerating, while in the three "strong currency" countries it appears to be stable or declining. I believe that present rates incorporate this anticipated widening of this gap. If we are dismayed—as we should be—by the visions of the future reflected in exchange-market behavior, we would be better advised to seek effective policies to alter those expectations than to cavil against the markets that mirror them. No one has ever succeeded in averting bad news by killing—or beating up—the messenger who brings it.

The fundamental uncertainty regarding the criteria by which exchange-rate relationships should be judged makes the IMF's post-Jamaica responsibility for surveillance over exchange-rate policies as difficult as it is vitally important. For there is—and can be—no such thing as an exchange rate free of government intervention. The vast majority of countries today still peg their rates to some currency or to a basket of them. And, even among the floaters, that floating is heavily

managed, as attested to by the fact that the central banks of some five or six industrialized nations together purchased more than \$40 billion in 1977 and the first quarter of 1978, mainly in order to dampen the appreciation of their own currencies.

Furthermore, as the IMF's Executive Board has recognized, there are many instruments other than direct intervention that a country can use to manipulate its exchange rate to its own advantage and the disadvantage of others, including official borrowing or lending on international capital markets, the use of controls on current or capital-account transactions, or changes in the mix of monetary and fiscal policy used for domestic stabilization purposes.

The fact is, of course, there are no principles defining what constitutes socially acceptable behavior in these areas, any more than there are concrete means to distinguish appropriate from inappropriate exchange rates. But the fact that no such criteria have been developed should be reason for support rather than criticism of the IMF's efforts to carry out its surveillance mandate. In addition to the conceptual uncertainty surrounding these issues, the IMF faces the inevitable constraints felt by an international agency attempting to impinge on sovereign nations in the exercises of legitimate—if not always constructive—instruments of national economic policy. Inevitably, the IMF must move slowly in this area, building precedents gradually and on a case-by-case basis, through the consultative process. The fact that there are no general standards for acceptable behavior does not mean that the Fund cannot gradually evolve procedures for earmarking unacceptable behavior in particular instances, any more than the inability to find a general definition of beauty means that we cannot get a consensus on when it is absent, particularly in extreme cases. It is essential that the United States give firm support to the International Monetary Fund as it struggles to evolve effective techniques for exchange-rate surveillance in a world of managed floating.

THE ADJUSTMENT PROCESS: GROWTH, ENERGY, TRADE, AND INFLATION

Exchange rates are not, of course, the alpha and the omega of the payments adjustment process. This is partly because, as I have already mentioned, they are far from completely free to equilibrate the balance of payments. It is also because, even if they were completely "unmanaged," exchange rates alone could not, especially in a world of high international capital mobility, guarantee the achievement of stable and acceptable current-account positions, insulate a country against external economic disturbances, or prevent the international transmission and magnification of economic disturbances.

Recognizing the need for complementary measures to promote external adjustment in an environment of stable world economic growth, the United States has for some time joined the OECD and various international agencies in urging that those countries with low rates of inflation and strong external positions take a leading role in stimulating and maintaining world economic recovery. But, of the three countries originally envisaged as "locomotive economies" or "engines of recovery," the United States has run up against both inflation and balance-of-payments constraints of its own, while Germany and Japan insist that fear of rekindling inflationary pressures and structural problems that limit the effectiveness of measures to stimulate domestic demand severely constrain their ability—and their willingness—to do more along these lines.

This is not the place for an exhaustive evaluation of the locomotive strategy or its successor, the so-called convoy approach, which would spread the responsibility for stimulating global recovery more widely to include such countries as France, Italy, and the United Kingdom, whose inflation rates and balance-of-payments positions have recently shown substantial improvement. Let me confine myself to two brief comments, recognizing that, even as I make them, the subject may have once again become a bone of contention at the Bonn summit discussions. First, the tremendous uncertainty that currently prevails regarding the impact of the traditional tools of aggregate demand policy in an environment of persistent stagflation lies at the root of the problem. Until some general consensus on this critical issue emerges, and until reliable ways are found to sustain or stimulate real growth while restraining inflation, divergent national views and preferences are bound to stand in the way of further progress on the international coordination of macroeconomic policies.

The second point is that, while appropriate demand-management policies in the leading industrialized countries are clearly essential to global economic recovery and real growth (which has been faltering badly outside of the United

States), we should not expect too much of changes in real growth rate differentials among the industrialized countries as a means of eliminating balance-of-payments disequilibria. Specifically, a recent OECD study estimated that demand-stimulating programs in other countries sufficient to eliminate entirely the present "growth gap differential" (that is, differences in the size of the discrepancy between actual and potential growth rates) between the United States and other industrialized countries would result in an improvement in the U.S. balance on current account of less than \$5 billion. A similar exercise by the IMF staff—using somewhat different assumptions—yielded an estimated improvement of only \$2 billion by 1980.

Ever since OPEC changed the face of the world petroleum market in 1973-74, the development of an effective U.S. energy policy has been regarded as essential to the health of the American economy. When our current account moved sharply into deficit and the dollar came under sustained downward pressure during 1977, such a policy, leading to a reduction in oil imports, was seen as the key to improvement in our external position as well. More recently, attention has turned also toward the development of export-promotion policies in a nation that has traditionally regarded foreign markets rather casually. This latest policy development has drawn added support from the trade data for the first four months of 1978, a period during which oil imports actually decline significantly, non-petroleum imports soared and nonagricultural exports rose very modestly indeed. This pattern suggests that broader issues of trade competitiveness, rather than simply the petroleum-import question, may underlie our deteriorating current account position.

The trials and tribulations of U.S. energy legislation are too well known to the members of this committee to require any recapitulation here, while concrete details of a proposed export policy are not yet known. So I will confine myself, once again, to a couple of brief observations. One is that, quite apart from the delays inherent in the political processes of a democracy, it is highly unlikely that either our energy or our export-promotion policies in their final form will set in motion structural changes sharp enough to bring about significant changes in the U.S. trade and current-account positions over the next couple of years. While firm action in either or both of these areas would doubtless bring about a significant temporary firming of the dollar, via effects on expectations, we should not count on such developments to make a major contribution to the payments adjustment process in the immediate future, nor to provide sustained support to the dollar in the absence of other developments.

The second point is to caution against taking actions in either of these areas that can be justified solely on balance-of-payments grounds. If we find it politically infeasible to allow U.S. petroleum prices to rise rapidly to world levels, then alternative means of stimulating domestic production and discouraging consumption make sense as second-best policies. And of course we should, as part of our export-promotion effort, encourage basic research and development, stimulate innovation and productivity increases, improve information about potential export markets, and clear away obstructionist government regulations that reduce competitiveness without bestowing commensurate social benefits. But such actions would be desirable at any time, the fact that our trade deficit may provide the essential political catalyst notwithstanding.

The point is that we should not allow concern about our external position to lead us into actions that would otherwise be economically unjustifiable. Back in the 1960s, when the growing overvaluation of the dollar appeared difficult or impossible to correct directly, one could perhaps make an intellectually respectable argument for such behavior. But today, when our exchange rate is much freer to move to equilibrate our external position, we are only fooling ourselves if we attempt to reduce our current-account deficit or shore up the dollar by taking actions that would not make sense of we were in surplus or the dollar were not under downward pressure.

The fact is that, despite widespread opinion to the contrary, there is nothing magical about exports that makes a dollar's worth of additional demand originating in foreign markets any less inflationary, or more employment-creating, than a dollar's worth arising from increased domestic consumption, investment, or government spending. (In fact, increased exports, like defense spending, may feel domestic inflation by adding to domestic income without adding to the supply of goods available to spend it on. Increased investment, on the other hand, adds to productive capacity and thus helps to contract inflationary pressures over the longer term.) The solution to the stagflation problem does not lie in artificial subsidization of exports or restriction of imports.

Such considerations bring me, inevitably, to the question of trade policy. These hearings are not directed toward that issue and, as I write, no one knows what will emerge from the Geneva negotiations or the summit discussions. But there is no way to separate trade policy from considerations of the adjustment process. It is always tempting to respond to external deficits or currency weakness by imposing tariffs or quantitative restrictions on imports, and it is quite possible that such measures would have the desired effect in the short run. Fortunately, U.S. policymakers have on the whole stood firm against pressures for increased protection. Such measures would not solve either our external or our internal economic problems in the long run. On the contrary, at a time when policymakers are searching intensely for ways to improve the currently unattractive trade-off between inflation and unemployment, trade liberalization offers such a way. Now that the Geneva participants have reached a "framework of understanding" to eschew protectionism as the solution to current economic problems, it is incumbent upon the major industrialized nations in general, and upon those in strong surplus positions in particular, to move ahead in fleshing out this general agreement with concrete actions as regards both agriculture and manufactured goods. The effectiveness of exchange rate adjustments in reducing the trade deficit of the United States and the surpluses of Germany and Japan depends heavily on how free trade is to respond to changes in price relationships. For the United States, export-promotion and expanded market access (in both directions) must go hand in hand.

Finally, and most crucially, there is the issue of inflation. Not only has this country's inflation been running at a significantly higher rate than in the leading strong-currency countries, but the indications are that this gap is increasing and will continue to increase in the near future. As I mentioned, I believe that exchange markets are already reflecting this outlook and will continue to do so until there is a solid basis for a change in expectations. In recent months, as our unemployment rate has dropped and inflationary pressures have accelerated, a stronger anti-inflationary stance has been emerging in the United States. Monetary and fiscal policy have taken a less stimulative turn, the Administration appears to have scaled down somewhat its real-growth target for 1978, and an intensified anti-inflation jawboning effort has been placed in charge of one of the nation's most skilled and successful practitioners of the art.

Whether these moves prove adequate to reverse the acceleration of price increases remains to be seen. In any event, their full force is more likely to be felt in 1979 and beyond than in 1978. For the long run, however, our performance as regards inflation remains the key factor in the performance of our balance of payments and our exchange rate. If we can regain our superior performance vis-a-vis other leading industrialized countries in this regard, not only will our international competitiveness and our current account position improve, but the dollar is likely to strengthen even in anticipation of these developments. If we continue to inflate faster than the strong-currency countries, and there are no solid reasons to expect a narrowing of this gap, our trade and payments positions will remain weak and the dollar will continue under persistent downward pressure, perhaps interrupted by brief flurries of strength in response to news headlines on central-bank interventions, flurries that will serve to increase the apparent instability of exchange markets without altering the underlying trend in rates.

INTERNATIONAL RESERVES: QUANTITY AND COMPOSITION

As regards international liquidity, the question of whether international reserves are in the aggregate either inadequate or redundant and, if so, what should be done about it has somewhat receded into the background. There are good reasons for this development. First, with the steady expansion of international capital markets and increased borrowing by official or semi-official agencies for balance of payments purposes, the distinction between owned reserves and borrowing capacity has substantially eroded. Internationally, as domestically, the line between cash and credit has become steadily fuzzier as new forms of the latter have become an increasingly good substitute for the former.

Even more important in defusing the liquidity issue has been the shift in the exchange-rate regime. The concern with global liquidity management came to the forefront in an era of pegged exchange rates and was nurtured by the explosive creation of dollar reserves in the waning days of the Bretton Woods system. Under the old rules of the game, countries acquired (or surrendered) foreign-exchange reserves in the course of exchange-market intervention undertaken

to fulfill their parity obligations under the IMF Articles of Agreement. Under managed floating, there is what might be termed consumer sovereignty: countries that accumulate reserves do so voluntarily. They have the alternative of allowing exchange-rate changes to clear the market for foreign exchange without the political difficulties associated with official revaluations or devaluations under the Bretton Woods system. Floating today is managed, not free, and a need for international reserves remains, but the change in the exchange-rate regime has substantially reduced the problem of controlling the global volume of liquidity.

The change from pegged rates to managed floating has also reduced the urgency of the related problem of controlling reserve composition or, more accurately, the potential for instability created by shifts among reserve assets in a multiple-reserve system. Shifts can and do occur under the new system as well; significant diversification away from dollars in favor of other currencies apparently took place during the early years of managed floating. Nor is such asset-diversification necessarily a thing of the past; the rate at which it continues to take place will certainly be affected, among other things, by our old bugaboo, inflation differentials—that is, differences among the rates at which different currencies lose purchasing power. But the existence of a continuously-functioning adjustment mechanism that can prevent the buildup of cumulative disequilibria and thereby eliminate the threat of large, discontinuous changes in rates among major currencies should help to forestall sudden, destabilizing shifts in the composition of reserve assets.

This does not mean, of course, that all the issues relating to international liquidity have been satisfactorily resolved. The question of whether gold has actually been effectively demonetized or not remains somewhat up in the air, although it has receded into the background for the time being. Certainly, the Jamaica Agreement's stated objective of making the SDR the principle reserve asset of the system has gone nowhere at all, nor is it likely to in the foreseeable future. My own feeling is that it may be time to consider the possibility of a new allocation of SDRs, not so much because there is any clear-cut need for additional international reserves at the moment as to support and enhance the authority of the International Monetary Fund.

Even more important, however, is that the Fund be endowed with additional capacity to provide conditional liquidity, funds whose availability is predicated upon the borrowing countries' taking actions that will facilitate adjustment of their payments imbalances. In this connection, it is imperative that the long-delayed legislation needed to permit U.S. participation in, and thus activation of, the \$11 billion "Witteveen facility" be promptly enacted. The position taken by the United States during the IMF's Seventh Review of Quotas, currently underway, should also take account of the fact that only if it has adequate resources can the IMF perform effectively its role of supervising and encouraging the elimination of external disequilibria and the stabilization of domestic economic conditions that must underlie any durable stability of payments positions and exchange markets. Unfortunately, an adequate capacity to lend can enhance the IMF's authority only over deficit countries, which is only half of the picture. Pressure on surplus countries to play their role in eliminating payments disequilibria, essential if the adjustment process is to work symmetrically and equitably, can only come from the gradual development of effective and acceptable criteria and instruments for the surveillance of policies bearing on exchange rates, discussed earlier.

Finally, there are a number of questions that bear on the dollar's role as a reserve currency. In the days of Bretton Woods, a great deal of rhetoric was expended in debating whether this reserve-currency role represented a unique burden or an exorbitant privilege. Although, for a variety of reasons I have detailed elsewhere, I expect the dollar to continue as the world's major reserve asset for the foreseeable future, it seems to me that the move to managed floating has greatly reduced both the "privilege" and the "burden" associated with that role. On the one hand, other countries need no longer accumulate unwanted dollars in fulfilling their parity obligations under the IMF Articles of Agreement, thereby enabling this country to run what some regarded as a "deficit without tears"; on the other, the United States is no longer constrained by the dollar's special position from allowing its exchange rate to move in order to alleviate disequilibrium in its external position.

In the light of this situation, it seems to me that our attitude as regards developments likely to affect the dollar's reserve-currency role should be relatively relaxed and low key. I personally am not convinced at this moment, that the establishment of a so-called substitution-account facility in the IMF, intended

to "sterilize" some portion of dollar reserves via special issues of SDRs, as recently proposed by the IMF's Managing Director, is likely to prove either necessary or sufficient to eliminate instability in the dollar exchange market. But if other countries feel strongly that such a facility is desirable, and would provide them with the reassurance required to make their own behavior as regards trade liberalization or demand-management policy more forthcoming, I think we should agree to a thorough and intensive joint evaluation of concrete proposals along these lines.

Of more immediate concern just now is how the United States should respond to the recent EEC agreement to work toward an expanded "snake"—a joint float of their currencies vis a vis the dollar supported by a pool of reserves amounting to perhaps \$50 billion. Obviously, any detailed response on the part of the United States would be premature, since no one yet knows the details of the plan, including the prospective participants themselves. It would be easy to detail many obstacles that confront any such plan, and it would almost certainly require the Germans to modify their insistence on strictly limiting any reserve-currency role for the Deutsche mark, a position that has so far tended to dampen the appreciation of that currency. But these are properly the concerns of the Europeans.

Our legitimate concern should be assurance, as the plans proceed, that this latest step in European economic unification should be fundamentally liberal and internationalist rather than inward-looking and mercantilistic in thrust. Beyond that, we should think twice—or three times—before abandoning the position of interested and sympathetic spectator for that of active participant in what is bound to be a complex and difficult evolution.

RESTORING CONFIDENCE: A MATTER OF FUNDAMENTALS

I come finally to the question of confidence, the most mysterious and elusive of the three ingredients of an effectively-functioning international monetary system. I'm afraid I have no magic solutions to offer in this area. Yes, close consultation and coordination among central banks as regards exchange-market intervention to counter disorderly market conditions can be helpful in avoiding confusion and misunderstanding and promoting good feeling among the major industrialized countries. But we should have learned from recent experience not to expect too much from such intervention: unprecedented sums have been poured into exchange markets during the past 18 months or so in ultimately unsuccessful efforts to dampen currency movements. And it has proved extraordinarily difficult to distinguish, *ex ante*, between speculative excesses and the pull of market forces. It is not that currency markets, left to themselves, are models of stability so much as that central bankers and government officials do not seem to be endowed with any special prescience in discerning the shape of the future. And, yes, government officials should avoid, insofar as it is humanly possible, rattling super-sensitive exchange markets by comments that lend themselves to exaggeration or misinterpretation. But, except in the very short run, it is the behavior of economies, not the words of policymakers, that will determine the behavior of financial markets, including exchange markets.

I suspect that confidence, like happiness, is seldom achieved when sought directly, but is most likely to be reached as a byproduct of the pursuit of other goals. The key elements in any U.S. contribution to stabilization of currency markets, the facilitation of international trade and investment, and thus the promotion of stability and growth in the world economy, are three: the avoidance of protectionism (including manipulation of exchange rates as well as restrictive trade policies) both at home and abroad, the establishment of an effective anti-inflationary stance that will eliminate or reverse the unfavorable differential in inflation rates between the United States and the strong-currency countries, and the development of a sensible energy policy, which means eliminating, by direct or indirect means, the stimulus to energy consumption and the discouragement of domestic production, at least relative to other industrialized nations, that are implicit in our present policies.

There is nothing new or surprising in this litany, and you may be weary of hearing the obvious once again. But it is far from a counsel of despair. For all the problems and uncertainties that beset us, the United States possesses a remarkable array of economic strengths. We have the richest endowment of natural resources, the stablest political climate, the sturdiest economic recovery and the most attractive environment for investment among the major industrialized nations. What we must do is find more effective ways of putting these assets

to work in accomplishing the tasks I have just outlined, accomplishments that hold the key, not only to restoring confidence in the international monetary system, but to ensuring the stability and growth of our own and the world economy.

Representative REUSS. Thank you all, on the panel, for truly excellent presentations today.

I have lots of questions, starting with the matter of the energy policy, which our witnesses have alluded to several times. You have said, in effect, that no energy policy now on the legislative agenda is going to produce wonders in the less than 2 years anyway, but that it is a very important psychological hangup with all our dollar trading partners.

I agree with both facets of that statement. That being true, wouldn't it seem to you to make sense, and others have been arguing for some time, for the administration to get—you have to have a package of five, and take the three or four elements of the five-point package—get Congress to enact energy legislation, and with a little skill this would be done in a couple of weeks.

This could be called energy package No. 1, admittedly imperfect, but it allows us to do something in the way of home insulation, conversion of factories from oil and gas to coal, reform of utility rates, and probably partial deregulation of natural gas.

Take that which has been agreed on in conference at least, forget about the very controversial, very inflationary \$5 billion a year well-head tax, and either make that part 2, or the second energy package, or try to evolve some method which less exclusively rations, which is what any overall tax or price increase does.

Would we be better off going with what we have instead of endlessly dragging this thing out? Congress has been the principal culprit, but this could all be solved very quickly. In my conversations with foreign central bankers and finance ministers it is that they don't mind Canadian rollover with incremental crisis, and would be satisfied with an energy package.

Ms. WHITMAN. This is getting off into tactics, and I am not the appropriate person to make comments, particularly since I have been off in China for the last month. I think what does disturb me a little about that is that, as compared to the original notions of what would constitute an effective energy package that most economists dreamed up, the administration's five-part package is already a very much reduced and trimmed-down and compromised-out kind of thing.

I think many of the major aspects dropped out long ago, as I suppose might have been expected, because the truth is that any proposal which makes a sudden change in energy production and consumption is also going to cause a sufficiently sharp structural wrench so that the country will probably not tolerate it. There is the problem you referred to, again, that any measure—like a wellhead tax—which takes what I think is the ultimately necessary step of adjusting U.S. prices toward world prices, is in the short run bound to be inflationary.

I agree with you that foreign observers might not be terribly fussy at the present moment about what kind of package they got. I think we would get a short-term favorable effect on exchange rates if any significant pieces of energy legislation passed. What troubles me is that I am afraid we would also get a backlash effect later. That is, we would get, certainly, a strengthening of the dollar when this legislation passed. If, however, as a result of that legislation, we did

not get much change in the energy picture in the United States, I think that would be reflected in a backlash, and I am not sure there is any greater percentage in buying a short-term appreciation of the dollar now which would later be reversed. That, it seems to me, would only contribute to instability on the exchange markets.

Now, petroleum imports into this country appear to be dropping at the moment. If we were lucky enough to latch onto a trend that was happening anyway and then say, "Look what happened as the result of the legislation we passed," that would be terrific, but I think it is pretty chancy.

Representative REUSS. Mr. Packer, not so long ago I wrote our trade negotiator, Mr. Strauss, a letter in which I suggested there be added to trade negotiations on tariffs and nontariff barriers the general concept, at least, of environmental controls and other controls, the idea being that the host of environmental laws and similar laws does unquestionably add to American costs, and that it should at least be put on the agenda of future trade negotiations that these are legitimate subjects to talk about with Korea and Taiwan, Nigeria, and other countries, which ought to be thinking about clean air and water and better conditions in factories if they aspire to the fruits of freer trade.

I got back a reasonably sympathetic response. The difficulties of such an approach are obvious, but what is your feeling about the inclusion on the overall agenda of the international trade discussions items like that which are usually looked upon as purely domestic?

Mr. PACKER. If you had written your letter to the Secretary of Labor, you would have gotten a very enthusiastic response, partially because it is not our responsibility to impose those requirements. [Laughter.]

It is something the Secretary has spoken about many times, international fair labor standards and the inappropriateness of export of our cancer problem to some other countries.

Representative REUSS. Has he included environment in there? I am aware of the fact he has talked about factory conditions.

Mr. PACKER. And the health situation, and I do not know whether he has spoken to the environmental conditions themselves. I think that is a somewhat more complicated problem, but, if those environmental factors are related to health, as opposed to esthetic values, then I think his position would be sympathetic to that, too.

Representative REUSS. What we do by our domestic legislation by way of the ozone, let us say, could be of some use to noninhabitants of the North American Continent.

Mr. PACKER. That is correct.

Representative REUSS. So I would think we have a perfect right to put that on the docket, and I encourage your department to give the trade negotiating department of government all the help you can on that.

Ms. Whitman, in your discussion of IMF progress on developing rules for the surveillance of exchange rate policies, you quite reasonably pointed out that countries get very sophisticated about how they cut corners on exchange rate policies.

In fact, 2 years ago our Japanese friends were doing it very crudely by dumping yen and buying dollars, and thus establishing trade patterns which still make their contribution to our country's woes, but

then, as you pointed out, there are many other ways of skinning a cat, international borrowing practices, and so on.

My question is this: Since the IMF, to its credit, in its bilateral team negotiations with countries, including mighty ones like the United Kingdom a couple of years ago, isn't the least bit loathe to get quite specific about internal methods, why should it not be equally ready to take quite a wide vision and look at everything a country may do that could discombobulate the international exchange market?

Ms. WHITMAN. I think they can and they should.

My guess is that they may already be beginning to do that. I think it is one of the characteristics of the process by which they operate that much of what they do may not be made public. I would expect that at least their initial efforts to negotiate bilaterally with particular countries on the appropriateness of their general policies which have a major effect on exchange rates would be private and that it would be only in extreme cases, where the negotiations have really gone very badly and the IMF is very exasperated, that they will start to go public. And I suspect that lots of us may have to spend lots of time reading closely between the lines of those annual country reports that the IMF puts out to see if they are subtly slapping anyone's hand.

I would expect that publicity regarding this activity would come fairly late in the game.

The problem with trying to generalize the IMF's behavior regarding Great Britain is one I referred to in my testimony, and that is with major deficit countries the IMF does have a particular clout. It controls, either directly or indirectly, significant amounts of access to capital markets. It doesn't have that particular bit of clout with surplus countries, which I think makes a kind of jawboning, if you like, moral pressure through the consultation process and through bringing to bear a certain amount of multilateral pressure at appropriate moments, all the more critical.

I don't think it is an impossible thing to do. But, as I say, the IMF doesn't have a commensurate weapon on the surplus side corresponding to its influence over access to financial markets by deficit countries.

But I don't think that that means they can't develop some, especially if they get substantial and outspoken support from the leading industrialized countries in carrying out this effort, which obviously means the tough proposition that one has to accept their advice graciously even when it affects you and not the other guy and, given the political processes in democracies, that will clearly be possible sometimes only to a limited extent.

Mr. BERGSTEN. Congressman Reuss, to reinforce what Ms. Whitman said, certainly in its consultation with countries, whether in the context of a stabilization program or just in the annual view—such as I chaired for the United States just a couple of months ago for this year—the Fund certainly does consider the whole range of economic policy measures including trade policy, export credit policies, the whole range of measures that do indirectly, as well as directly, affect the exchange rate.

Now, in an effort to do what I think you are suggesting, Congressman Reuss, one of the proposals we have made toward the evolution of this new surveillance process is precisely for the Fund to prepare reports on individual countries and how their policies are affecting

the overall international adjustment process, and to consider the possibility of publishing those reports, which would be a means by which Fund influence could be brought to bear in a broader sense, including on surplus countries.

That is something we very much have in mind. We put it on the table as an item for discussion as we work with the other IMF countries now to evolve the surveillance mechanism, and we think it might be a useful part of that process.

Representative REUSS. That sounds like an excellent idea, and I am going to have the staff take a look at the Freedom of Information Act and see if we can't get hold of those reports, whether you decide to publish them or not. That may be one way of saving your face and getting the message, too. [Laughter.]

On the economic summit, since it seems to be that—well, it may not have been earth-shaking, but nothing bad was said. I think it went in a constructive direction. But let me ask, perhaps Mr. Bergsten: What reason is there to think that there is going to be more rapid growth in Europe and Japan after this latest round of affirmative commitments than there has been in the past when commitments have also been made and honored in the breach?

Mr. BERGSTEN. Let me say, Congressman, that we were already expecting in the second half of this year and into 1979 some substantial pickup in growth rates abroad, both in Europe and in Japan, thereby bringing into better balance growth rates between our country and the rest of the OECD, which should contribute to a more balanced international economic and financial situation.

What I think did emerge from the summit was a very strong re-affirmation on the part of Japan that it intends to meet its growth target for this fiscal year. Prime Minister Fukuda explicitly noted that he will be making a decision in August or September as to whether additional measures are needed to move Japan toward that target. I think that makes much more sense than had been the case before the Japanese commitment to take action, if needed, to achieve its target.

In the case of Germany, Chancellor Schmidt really for the first time said publicly that as a contribution to the international situation he would be, by the end of August, proposing to his legislative bodies a rather substantial stimulus program in Germany to try to boost their growth rate and contribute to a better international economic equilibrium.

Now, one can always, of course, question what the end results of such commitments and measures are going to be, and we all know too well that none of us can simply turn the dial and achieve the economic results we want, whether in terms of growth or inflation. So in that sense we all have to be modest in our expectations and hold the judgment until we see what the results are.

But I think the summit did add specificity, and in the case of Germany a new decision to what had previously been on the agenda in terms of major efforts by the two most important surplus countries to add to their growth rates during the year and therefore add to better balance in the world economy.

I would say it is a significant step forward. We certainly hope the results would be as those countries intend. We know they can't assure the bottom line, but I think it is a very significant indication of will-

ingness for them to make decisions that move in the right direction, and in a context where it is clearly done, at least in important part, for purposes of better international economic balance.

Representative REUSS. There are, of course, stimuli and stimuli; and one serve one purpose well, and some serve another purpose.

Talking to Germans of various persuasions in recent months, the thing that Germany seems to them to need most is a housing program, housing for reasons not completely different from our own housing industry. It has about ground to a halt, and publicly stimulated housing in the cities seems to be a real need for a country which is otherwise affluent.

Thus, if you get an indirect macroeconomic stimulus by doing a microeconomic thing by helping housing, that is a good way for Germany to help itself and the world all together.

On the other hand, I suppose a German direct tax cut might be of more benefit internationally to this country and perhaps some other deficit countries because it would enable us to sell the Germans more imports.

Do we get into stimuli evaluation discussions at any level with the Germans, or is that considered verboten?

Mr. BERGSTEN. No, it is not verboten. We have active discussions with them, both of the array of measures we are thinking about taking internally here both for macroeconomic reasons and sector policies, such as energy, and discuss with them the various measures they have in mind.

I think we do recognize that it is basically up to them, as to the Japanese, or any other country, and certainly ourselves, to make the decisions as to how most effectively to achieve the overall objective for international purposes, and we would certainly not try to suggest to them how best they should do it.

But we do have active discussions. We share experiences in terms of reactions to tax cuts, reactions to Government expenditure programs, how they may work out both substantively and psychologically, and I think all of our countries have benefited a great deal by that interchange.

It is up to them, obviously, as to what measures they take. Every outsider has legitimate base to comment on in terms of the net result, the country's balance-of-payments position, and what it contributes to the international scene.

Representative REUSS. Senator Javits.

Senator JAVITS. Thank you, Congressman Reuss. I have just come from a meeting with the President about the summit, and for me, it was interesting to learn that the most decisive action taken at the summit had nothing to do with economics. Instead, it had to do with terrorism. And I think that decision is characteristic of the summit.

I believe the President, considering the atmosphere and his own attributions, did very well personally, but I don't think the summit went as well. Of course, it is high time that the civilized world declared itself in an effective way to be against terrorism. I say that, like any consensus at a time when boldness is required, the summit bypassed all the bold things in favor of the safe course of retreading old ground; for example, what growth rate is Japan going to have, what growth rate is Germany going to have, and what we are going to do about these inside deals on trade and so on.

This is what we face, Mr. Bergsten, and I want to discuss it a little more and then ask you a question about it.

At this summit, I gather that there was a real gearing up for the next one. This was really stage one, but the next summit, from what we can see now, should be concerned with very specific contributions to growth.

As Mr. Packer properly says in his presentation, which I have read, I have some doubts that the world is going to be able to wait for the next summit before acting, for it may be headed for a serious recession or depression, which may overtake us in the 1978-79 period, instead of politely waiting for the 1979-80 period.

I hope we can avoid that dread event.

Mr. Bergsten, I want to discuss with you the possibility of gearing up—it takes at least a year's time—for a massive effort toward investment and development on a major world scale that will expand markets and materially accelerate the process of development, especially for the middle level developing countries, which you call the ADC's. I would hope we would be joined in some way by the Soviet Union and her associated countries.

I notice you refer to such a possibility in your prepared statement, where you speak of commodity agreements, reduction of trade barriers, a common fund, and expanded foreign assistance, and also where you deal with the net balance of payments problems of the developing countries—a very serious matter in view of the fact that our banks are very heavily loaned up to the developing countries.

Would you discuss the attitude of the Department of the Treasury respecting these matters to which I have referred?

MR. BERGSTEN. I think we would not foresee a recession or anything approaching a depression on the horizon either in 1978 or 1979. Nevertheless, we share your view that investment levels are inadequate both in this country and around the world, and that new measures need to be adopted wherever possible in order to rectify that situation.

You have noticed, I am sure, that there are several references in the summit communique to that need, and specifically to the advanced developing countries.

Indeed, two or three paragraphs of the summit communique itself refer specifically to that body of countries as important and growing participants in the trading system, as countries who need increased help through the multilateral development banks, not concessional finance, but World Bank type of lending, and a very clear statement by the summit governments that they will support replenishment of the banks' abilities to make those loans on the necessary scale, and also explicitly, and I am citing from paragraph 26 of that communique, "encourage governmental and private cofinancing of development projects with the banks."

So I think on that, Senator, we are very much on the same wavelength.

The problem has really, as you well know, been a practical one of how much support congresses and parliaments around the world have been prepared to provide to that process.

Now, Mr. Packer in his testimony this morning has proposed a rather dramatic program, somewhat akin, I think, to your own proposal, Senator, of a vast expansion in the financial flows to the

developing countries, particularly the more advanced developing countries, through institutions such as the World Bank.

We face, however, at the same time, a reluctance here in the Congress to provide not only the full amount of the rather modest appropriation sought this year by the administration, but threats of massive cuts in that and, indeed, that has delayed the bill coming to the House floor for the last several weeks.

The need does seem to be clear. The effective utilization of the money seems to be assured by the proven track record of the banks, and what it seems to me that we need to do is all work more effectively, and I would certainly include the administration within that directive, to sell the case and make clear how we need not only to provide the full funding that is now available but, as the communiqué agreed, on the part of all seven countries, further capital to be channeled in this effective mechanism to places where it can be used more effectively.

So I think we are in agreement with you on the basic approach needed. The question is how to get it done.

Senator JAVITS. I appreciate what you say, and I agree with you.

I come now to Ms. Whitman, if I may, and I like what you say in the last part of your prepared statement about confidence.

Confidence, like leadership, is not created; it is induced.

I want to examine briefly various states of confidence and their effects on the world. Consider a world in which the Peace Corps would be again a cause for ideology. We would have a lively world economy in which there would be an accelerated effort to develop, to grow, to expand, to create, and to produce. Such a world would be one in which people could look ahead to the future and feel something good is going to happen in the world.

Do you find that true now? And what do you attribute the absence of it to, if you do not?

Ms. WHITMAN. I think, as you say, Senator, there are "animal spirits," as Keynes called them, or whatever it is; I think they are very important. I think if there were expectations of that kind of growth and dynamism in the world economy, yes, we would have a much better framework for the specific things we were talking about.

I think we don't have that now. I think what we have is massive uncertainty. If anything, there is a tendency to look at the world situation as worse than it is, or to anticipate the worst, which, of course, one never can prove won't happen.

It is easy to point to some of the reasons. Clearly, we know that the vast shakeup caused by OPEC, and the very real changes in income and wealth positions, in countries' terms of trade, caused a big shock. We had a major recession. No country in the world has been terribly successful, although the degree of success differs, in full recovery from the recession without exacerbation of inflation: we have certainly done the best on the recovery side. In fact, most other industrialized countries haven't gone anywhere in recovery.

By the same token, we have done the worst on the inflation side, certainly in terms of the direction that inflation is going.

In that process, I suspect we do tend to overlook some of the economic strengths that work in our favor. I didn't talk about these

orally, but I did mention them in the last paragraph of my prepared statement.

Senator JAVITS. Yes, I read it.

Ms. WHITMAN. I do think we have some major things going for us in this country. We have the most stable political climate in the world, and the best recovery—that is a relative statement, but still it is true. We have the best climate for investment, surprising as that may sound. I am not at all convinced that the picture is so bleak. We have a lot of important unsolved problems and, as is always true, the only really important problems are the ones you haven't solved yet and that is still true.

I think there is a breakdown of what used to be a consensus in the economics profession as to how we can manage these twin problems of inflation and unemployment.

I don't know any better than anybody else does whether we are in the grip of something more than just a cyclical problem and whether, indeed, there is some more longrun slowing down of world growth going on or not. One can find lots of reasons to adduce on either side.

I think, by the way, that one of the bright sides that is a bit overlooked is how much better many of the developing countries have done in pulling out of the oil crisis and recession than the industrialized countries.

Again, there are individual less-developed countries that clearly have terrible problems still, but if you look at the overall picture, those countries have done much better in terms of maintaining or increasing rates of growth than the industrialized countries have, and they have done it at a time when the cards were stacked against them in the sense that the industrialized countries, which normally provide their largest markets, were themselves growing very slowly.

For people who worry, as so many of us did so intensively in the 1960's, about the increasing income gap between the rich and the poor countries, this kind of performance has its very encouraging side. If they have done so well now, how much better might they do if the industrialized countries could recover some of their own momentum.

That means, at the same time, that we have to accept certain implications. They are going to increasingly become effective competitors with us in a wide range of areas. If we are unwilling to accept that, we will cut off and severely interrupt their economic momentum.

Senator JAVITS. Ms. Whitman, one great achievement or breakthrough for American business is that the price of real estate is the highest on a street that is occupied by competing stores. Another is the proposition that, if A wins, it doesn't mean B loses. A third point is the effects of mutual ownership and limited corporate liability. These are the brilliance of the American system which contribute to our domestic confidence.

We don't need to emphasize how inadequate we are. Some of us have spent a lifetime trying to get people to understand the strengths of the American system, sometimes with meager results.

I would like to ask you this: Assume that this summit is undistinguished, as it really is; if it is used as a springboard so that the next summit may redeem many of these assurances, such as those regarding the more advanced developing countries, and I read from the summit

communiqué, we renewed our pledge "to support the replenishment of the multilateral development banks' resources and agreed to encourage governmental and private cofinancing of development project with these banks." Moreover, we urged "the developing countries to cooperate with them in creating a good investment climate, and adequate protection of foreign investment in order to let private foreign investment play its effective role in generating economic growth and in stimulating the transfer of technology." The developed countries reaffirmed "their commitment to continue actively the negotiations on the Common Fund, to conclude individual commodity agreements, and to complete studies of various ways of stabilizing the export earnings of the developing countries."

If we started to carry out all these assurances, you think they would make an important contribution to confidence?

Ms. WHITMAN. Wow! Yes; that is a very long list and, while I might take issue with some items on that list, clearly, if we could make substantial progress on all those fronts, that would be a major achievement and would have a tremendous impact on confidence.

Those are all ongoing efforts. We are not starting from scratch on any one of them. It is a question of how far we can go. I think we have to remember, too, the interrelations among them. It is important to shore up the multilateral lending institutions, but all that can come to grief unless we make sure, at the same time, that the policies of both the industrialized countries and the developing countries themselves are such as to allow them to develop economic dynamism so that they can pay the loans back.

We will only make the situation worse if we increase funding facilities without at the same time insuring that our policies and the policies of the developing countries themselves are appropriate to assure their generating the means of repayment.

Senator JAVITS. I take my text from what you said, and I understand that because it has been our attitude.

I would like to turn to labor. Although I realize neither of you is a Secretary, both of you are influential people testifying before us, and we will call your bosses to tell them the same thing.

I would like to ask you two things, one each.

The inhibition about markets—that is, letting their goods in, as Ms. Whitman mentioned quite properly—is that it will take away the jobs of American workers. This requires two things: One, a rerationalizing of our economy—we can't make simplistic things forever and live in a peaceful world, and second and critical, it means, Mr. Packer, that we have to be showing our people that we are acquiring markets. If you look at the trade figures and see how trade has grown—when I first came here, we talked about \$50 billion in exports and imports. Now the figure is well over \$200 billion, and that is not all a result of inflation.

Inflation is high, but it is a very different problem.

I gather, and this is a conservative estimate, that 67 million American workers engage in exports, a number which far exceeds that for those who are harmed by imports.

I think it is a grave failure of your department not to marshal those figures and have their voices be as loud as that of the guy who wants to exclude everything and says "to hell with tomorrow." I am very serious about this.

If I may say to you Mr. Bergsten, I suggest to you that as a society we are very bashful about our aid, and that is what is in the craw of our people here on the hill.

I have been a Congressman and Senator for a long time. The United States does very well when you add the private flow of dollars to the public flow, particularly when you add in such activities as OPIC and the Ex-Im Bank. Moreover, the connection is strong between these U.S. activities abroad and counterpart American activity, including the stock exchanges and various banks, all yielding increased U.S. employment resulting from export activity and U.S. dollar flows abroad.

The New York Clearinghouse Association has proposed bringing a free trade zone for banking into New York City. I am all for it. You know its justification? Four to five thousand jobs.

It is not that New York City is going to be richer, but it is that we are going to increase jobs available in New York City.

In addition, I think we are much too inhibited about laying it on the line as to what we mean by the international financing of our institutions. Some seem to think the funds are sent from heaven. I expect that 20 percent or more of the total funds required is our natural proportion, and that the money is mostly raised right here in U.S. financial markets. If we don't like it, we could shut those financial markets down.

I beg you to tell your people that those nations we assist will take the money, even if we tell them it is from us. They won't be that insulted.

Gentlemen, I am all-fired-up about this matter because I see the opportunity, and I see how it should be moved.

I would appreciate any comment.

MR. BERGSTEN. If I might respond on the last point, Senator, it does fall to me in this administration to handle our negotiations on contributions to the development banks, as you know, and I can assure you that neither I nor my compatriots are at all bashful in making clear the major contributions the United States continues to make to every one of these institutions and thereby try to wield an effective U.S. role.

But the problem emerges when we do not make good on our pledges. This is really what the issue comes down to. We neither should nor need be bashful in terms of our past role and what we have pledged in each of these institutional arrangements, but when we fail to make good on the pledges that have been worked out in consultation with the Congress, based on full authorization with the Congress, and we lag over 2 years—as we now are in ARDA, and as we lagged over a year in the Witteveen facility—and then our position is weakened and our ability to take credit for what you quite rightly say we have done and continue to plan to do is weakened very badly.

Now, I am talking to the converted here. It is not, as you know, a criticism of you. You have been one of the major supporters, indeed fathers, of this whole effort; but our international credibility, our ability to get credit for what we have done over the years and are trying to do now is badly jeopardized when we fail to come through on our pledges and actually play our fair-share role. That is the problem as I see it.

If we can get that on track, then we can work together and go many steps ahead, as you suggested, but we have to get up-to-date first on our past problems.

Representative REUSS. I will come to that in a moment after Mr. Packer has a chance to comment.

Mr. PACKER. I think you are right about the export situation. I did some lobbying myself on the Witteveen facility in the House. It was unusual for somebody from the Labor Department to give a damn, frankly, about the Witteveen facility. To most domestically oriented people, it is just another aid operation, and nobody understands what it is about. We have problems with the World Bank getting tied up with proposition 13. Adding money to the World Bank will reduce the Federal deficit, not increase it.

The question of the World Bank appropriations seems more to swing on whether World Bank officials fly the Concorde or get paid too much rather than what is really at stake.

We have been trying with the labor movement, and Mr. Meany wrote to each Member of the House and Senate asking for support on foreign aid and the World Bank. I think all of us have not been successful in making the real issues clear to domestic political interests. There is so much at stake here—there are jobs in exports, that balance among the developing countries is in our interest, not because of the goodness of our hearts because it bothers us that people starve to death while Americans are on diets—which it should. American full employment, and the Humphrey-Hawkins bill, are unachievable, in my judgment, if we have 16 million unemployed in the OECD world. We have a whole host of impediments.

I compliment you for your long efforts, as yet not fully successful, in making domestically oriented politicians and policymakers in the body politic concerned about the impacts of international affairs. Our own inflation and unemployment performance to a great extent depend on being able to separate proposition 13 from the amount of money that is going to be given to the World Bank.

I don't think people in general understand that that appropriation for the World Bank does not add to outlays and does not add to the deficit. The question of why we should help poor countries when we can't rebuild our cities is an irrelevant question. We are using other peoples' money to do the work elsewhere, and the results of these activities will give us the revenues that will allow us to rebuild the cities. It is not a trade-off.

Senator JAVITS. I certainly appreciate that statement.

I would like to finish, if I may, by saying to Mr. Bergsten that I think one of the weaknesses about the presentation of the Fund to the Congress has been the idea that we pledged the honor of the United States, and we have to keep that pledge to preserve our honor.

That is a very weak argument around here. A much more persuasive argument is that the Fund is excellent business.

We have to lay it on the line that the Fund will be an aid to business and employment, prove it, and forget about the fact that we made a pledge and that our honor is at stake. As I just said, that is a very weak argument, as has been demonstrated before.

Thank you, Congressman Reuss.

Representative REUSS. Thank you, Senator. I welcomed your philosophical discussion with Ms. Whitman about confidence. It is true, and you have been pointing this out for some time in many speeches, that the world and this country lack confidence at the moment. There has been increasing alienation between groups. In our cities, there are

vast groups of young people without any prospect of a job, who turn to crime and drugs, who cause endless social upheaval. There has been a breakdown in the confidence of the people in leaders in Government, in labor, business, and every place else.

I recall, just 1,000 years ago, in 978, the same sort of thing was going on. Everyone believed that the world was going to end in the year 1000. That was the apocalyptic date, and the world was infested with masterless men in the forests and the city streets, robbing everybody and with disaffection between the monks and the theologians and the rest of the people, and with the general breakdown of confidence in leaders, the system where everybody knew his place in life had broken down; and then, to everyone's surprise, along came the year 1000, and the world did not come to an end.

In fact, it led to a revival of culture and to religion and to the Renaissance, the Reformation, the building of the city, and all kinds of good things.

Therefore, I think the three of us can align ourselves to the side of those who do not feel the world will come to an end in the year 2000, and if we play our cards right in the next 22 years, we can avoid that possibility.

I would have one question of Mr. Bergsten, who, a few years ago, was arguing very persuasively that the dollar overhang system could be solved through some sort of a substitution account whereby unwanted dollars could be turned in for SDR's, and, as a matter of fact, I was singing the same song myself.

Are you still as persuaded that there is that kind of a need for consolidating the dollar overhang by some sort of a substitution account?

Mr. BERGSTEN. Well, Congressman, I really made that argument in the concept of the fixed exchange rate system, and also in the context of proposed reform in a basically fixed exchange rate system, where I argued, and would argue now, that the United States would be unable to take on any kind of asset convertibility in a world where there was remaining a huge dollar overhang. That would simply put an impossible strain on any level of U.S. reserves.

Now that we have moved to a system of more flexible exchange rates, I think one has to look at overhang in a somewhat different light. I basically would agree with what Ms. Whitman was saying earlier on that, with one modification, and without using the term "overhang."

I think it is true that the existence of a large outstanding stock of dollars around the world may add to the degree of fluctuation in exchange rates in both directions. In a period when the underlying U.S. situation is strong, for whatever reason, as occurred in 1975, the existence of the key currency role of the dollar may mean inflows into the dollar which might carry it on the upside beyond the level that is justified by underlying competitive conditions.

Indeed, it is our view that the appreciation of the dollar that did occur in 1975 and early 1976, which came at a time, incidentally, when U.S. inflation rates were a little higher than those of our main competitors, did have a competitive disadvantage to the United States, which explains an important part of the deterioration in your external accounts between 1975 and 1977.

It is our judgment that somewhere on the order of \$5 to \$10 billion of that total swing, which is perhaps as much as a quarter of it, does

derive from the excessive rate of appreciation of the dollar back in 1975, which hurt our competitive position.

On the other side, when you get an underlying situation where the dollar is under pressure on the downside, the fact that there is a large outstanding stock of dollar balances around the world does provide a source from which selling can occur, portfolio diversification, which may push the dollar rate lower than might be justified by the underlying economics.

But with that caveat, I would say under a system of flexible rates any problem of the dollar overhang is of a much different nature than it was in the past, and I would not put it on the front burner as a problem at this point.

Representative REUSS. I agree with you both. I am not even sure your caveat is all that necessary, because I bet if you could not put in a substitution account, and one-half of the floating dollars got substituted, I bet the financial writer would still be writing about this terrible overhang and its imminent danger to the world monetary system.

Thank you.

We have kept you much too long. You have made a memorable contribution to our semiannual review, and I am sure Senator Javits will join with me. I am going to lobby in our semiannual report for a heavy emphasis on international economics.

Senator JAVITS. As good business. [Laughter.]

Representative REUSS. Thank you all very much. The hearing is recessed.

[Whereupon, at 11:50 a.m., the committee recessed, to reconvene at 9:30 a.m., Thursday, July 20, 1978.]

[The following written questions and answers were subsequently supplied for the record:]

RESPONSE OF HON. C. FRED BERGSTEN TO ADDITIONAL WRITTEN QUESTIONS POSED
BY REPRESENTATIVE BOLLING

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., July 31, 1978.

HON. C. FRED BERGSTEN,
*Assistant Secretary for International Affairs,
U.S. Department of the Treasury,
Washington, D.C.*

DEAR MR. BERGSTEN: On behalf of the Joint Economic Committee I wish to thank you most sincerely for taking time from your busy schedule to participate in the hearings that comprise an essential part of the Committee's 1978 Midyear Review of the economy. Your testimony is an important part of the record and will be of substantial assistance to the Committee.

I am sorry that my schedule did not enable me to attend the hearing on July 19, and I apologize to you for my absence.

In order to complete the record, I would very much appreciate a written response to the following questions:

(1) How would you assess the prospects for monetary integration within the European community? Would the U.S. benefit or lose from the establishment of a common European currency? Would the establishment of a common European currency be beneficial from the point of view of the operation of our international monetary system? Would our payments system to more or less stable? What would happen to the position of the dollar as a reserve currency?

(2) With respect to the question of surveillance, does there not exist the danger that a set of rules of conduct will be established that could cause the Bretton Woods system to be resurrected *de facto*? How do we protect ourselves from such an eventuality?

Copies of the hearings and our Midyear Report will be sent to you as soon as they are available.

Thank you again.

Sincerely,

RICHARD BOLLING, *Chairman.*

DEPARTMENT OF THE TREASURY,
Washington, D.C., August 22, 1978.

Hon. RICHARD BOLLING,
Chairman, Joint Economic Committee, Congress of the United States, Washington, D.C.

DEAR MR. CHAIRMAN: This is in reply to your letter of July 31 in which you posed some questions concerning recent proposals for closer monetary integration in the European Community and concerning surveillance in the International Monetary Fund. I hope that the answers contained in the attachment will help to complete the records of the Joint Economic Committee's 1978 Midyear Review of the economy.

It was a pleasure appearing before the Committee on July 19.

Sincerely,

C. FRED BERGSTEN,
Assistant Secretary.

Enclosure.

Question 1. How would you assess the prospects for monetary integration within the European Community? Would the U.S. benefit or lose from the establishment of a common European currency? Would the establishment of a common European currency be beneficial from the point of view of the operation of the international monetary system? Would our payments system be more or less stable? What would happen to the position of the dollar as a reserve currency?

Answer. In their summit meeting in Bremen on July 6-7 the EC chiefs of state and government stated that closer monetary cooperation leading to a zone of monetary stability in Europe was a highly desirable objective. The Chancellor of the Federal Republic of Germany and the President of France presented the broad outline of a plan to create such a monetary zone. The EC leaders agreed that this plan should be used as a point of departure for further study.

The main elements of the German-French proposal include:

Exchange rate arrangements that limit fluctuations among European currencies. They also would establish a coordinated EC exchange rate policy vis-a-vis the dollar.

Pooling of a portion of European gold and dollar reserves to help finance intervention in the exchange market.

Expanded lending of EC currencies on conditions designed to encourage the harmonization of economic policies.

Creation of a European reserve asset (the European Currency Unit) to be used in official EC transactions.

Following instructions given at the Bremen summit, EC Finance Ministers met on July 24 to develop guidelines for a study to be completed by October 31, with a view toward adoption of decisions on any new monetary commitments at the next EC summit meeting on December 4-5.

Since specific EC monetary proposals have not yet been agreed to, it is premature for the U.S. to attempt any assessment of the impact of new EC arrangements. The main areas of interest have to do with the effects of possible EC arrangements on: (1) world economic growth, (2) the effectiveness of the international adjustment process and (3) the international monetary system.

The United States has long supported the objective of the economic unity of Europe. Close monetary cooperation may be an important part of this process. It is our hope that any new EC arrangements will be designed to promote economic growth in the world as a whole. We could not, of course, support a plan which prevented the dollar exchange rate from responding to underlying economic and financial factors. We will wish to be certain that any new arrangements will be administered in full conformity with the revised Articles of Agreement of the IMF and in close consultation and cooperation with the monetary authorities of other countries. We welcome the commitment of the EC countries, as expressed in the Bonn Summit communique, to consult fully with us as their thinking on the issues develops.

The monetary cooperation plans being studied in the EC are not immediately aimed at creation of a common currency in the strict sense. They do envisage creation of a new European reserve asset (the European Currency Unit) to be used in official EC transactions. It may well be that a European Currency Unit, in time, will come to play a prominent role in the international monetary system as a consequence of EC efforts to achieve greater economic harmonization and exchange rate stability within the Community. Such a development, provided it were compatible with the broad interests of a smoothly functioning, efficient world monetary system, should not be a source of concern.

Question 2. With respect to the question of surveillance, does there not exist the danger that a set of rules of conduct will be established that could cause the Bretton Woods system to be resurrected *de facto*? How do we protect ourselves from such an eventuality?

Answer. I do not believe that IMF surveillance poses a danger of a return to the rigidities of the Bretton Woods system. Quite the contrary. The amended IMF Articles and surveillance represent a marked departure from the approach underlying the par value provisions of the Bretton Woods system. The new arrangements recognize that exchange rate stability can only be achieved through policies that promote underlying economic and financial stability, and that exchange rate movements play an important role in balance of payments adjustment.

The new IMF Articles provide countries with freedom of choice in adopting exchange rate arrangements best suited to their needs, provided that the member meets its general IMF obligations. Most importantly, the Articles enjoin countries to avoid manipulating their exchange rates to prevent effective balance of payments adjustment or gain unfair competitive advantage. This new obligation says in effect, that prevention of exchange rate change, in either direction, can be undesirable and harmful, just as "competitive devaluation" was considered undesirable in the Bretton Woods system.

The amended Articles contain legal safeguards which will enable the U.S. to protect itself against the adoption of exchange arrangements detrimental to its interest. Although explicit provision is made for future IMF determination that international economic conditions permits the introduction of a widespread system based on stable but adjustable par values, an 85 percent majority vote is required. The U.S., with about 20 percent of IMF voting power, would have a controlling vote in such a determination, and par value arrangements adopted under the amended Articles would provide for substantially greater flexibility than the Bretton Woods system.

The principles and procedures for IMF surveillance are intended to help assure that the obligations contained in the new Articles are fulfilled. IMF surveillance will provide an improved means for the U.S. to protect its interests from the exchange rate practices and policies of other countries. Most importantly, surveillance will apply symmetrically to surplus and deficit countries, whereas the Bretton Woods system tended to focus largely on the practices of deficit countries. Efforts to prevent exchange rate changes, in either direction, will be examined. When intervening in the foreign exchange markets, countries are required to take account of the interests of other members including the interests of the countries in whose currency they intervene.

Neither the U.S. nor any other country can realistically expect total freedom of exchange rate behavior. The IMF Articles and surveillance recognize that exchange rates are of legitimate interest to the entire international community. They provide members with greater flexibility and freedom in exchange rate matters, while ensuring that the interests of the international community are protected. The U.S. believes that the legal framework contained in the amended Articles and IMF surveillance provide an effective means of safeguarding its interests in exchange rate matters.

RESPONSE OF MARINA V. N. WHITMAN TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE BOLLING

CONGRESS OF THE UNITED STATES.

JOINT ECONOMIC COMMITTEE.

Washington, D.C., July 27, 1978.

Ms. MARINA V. N. WHITMAN,
Department of Economics, University of Pittsburgh,
Pittsburgh, Pa.

DEAR Ms. WHITMAN: On behalf of the Joint Economic Committee I wish to thank you most sincerely for taking time from your busy schedule to participate in the hearings that comprise an essential part of the Committee's 1978 Midyear

Review of the economy. Your testimony is an important part of the record and will be of substantial assistance to the Committee.

I am sorry that my schedule did not enable me to attend the hearing on July 19, and I apologize to you for my absence.

In order to complete the record, I would very much appreciate a written response to the following questions:

(1) How would you assess the prospects for monetary integration within the European community? Would the U.S. benefit or lose from the establishment of a common European currency? Would the establishment of a common European currency be beneficial from the point of view of the operation of our international monetary system? Would our payments system be more or less stable? What would happen to the position of the dollar as a reserve currency?

(2) With respect to the question of surveillance, does there not exist the danger that a set of rules of conduct will be established that could cause the Bretton Woods system to be resurrected *de facto*? How do we protect ourselves from such an eventuality?

Copies of the hearings and our Midyear Report will be sent to you as soon as they are available.

Thank you again.

Sincerely,

RICHARD BOLLING, *Chairman.*

UNIVERSITY OF PITTSBURGH,
FACULTY OF ARTS AND SCIENCES,
Pittsburgh, Pa., August 7, 1978.

HON. RICHARD BOLLING,
*Chairman, Joint Economic Committee,
U.S. Congress, Washington, D.C.*

DEAR MR. BOLLING: Thank you for your letter of 27 July. Let me respond briefly to the questions you posed there.

1. As regards European monetary integration, several such attempts have been made in recent years, and all of the previous ones have foundered on the complexities of monetary integration among sovereign nations with very different economies, inflation rates, and stabilization goals. Whether this time will be different it is too early to say, but I hope I may be forgiven a certain cautious skepticism. The probabilities are likely to be affected, however, by the performance of the U.S. economy and the dollar; the worse these do, the more urgency the Europeans are likely to feel regarding their own monetary integration, and vice versa.

As I said in my testimony, I believe it would be premature to try to evaluate the costs and benefits to the United States of a plan whose details are not yet known, even to the participants. Our major concern should be that such a plan be market-oriented and internationalist in orientation, rather than restrictive and mercantilist, and that it *not* be used as a mechanism for exchange-rate manipulation unfavorable to the United States or to nonmember countries in general. Depending on the details of how it is operated, such a scheme might (or might not) reduce somewhat the reserve-currency role of the dollar, but I think the dollar would remain the single most important medium for international reserves in any case.

2. There is always some danger that rules of conduct regarding exchange-rate surveillance *could* become the vehicle for a restoration of pegged rates and a chronically overvalued dollar. The danger can be minimized, I believe, by making sure that the guidelines regarding exchange-rate policy be "permissive" rather than "prescriptive." That is, they should define the conditions under which direct or indirect intervention in exchange markets is (or is not) permissible, rather than when it is recommended or required. It seems to me that the IMF's actions so far in this area have been on the whole in the right direction, but it is a difficult issue, and one on which precedents will have to be developed slowly, gradually, on a case-by-case basis.

Yours sincerely,

MARINA V. N. WHITMAN.

THE 1978 MIDYEAR REVIEW OF THE ECONOMY

THURSDAY, JULY 20, 1978

INFLATION

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

The committee met, pursuant to recess, at 9:30 a.m., in room 2168, Rayburn House Office Building, Hon. Richard Bolling (chairman of the committee) presiding.

Present: Representatives Bolling, Long, and Brown of Ohio; and Senators McGovern and Javits.

Also present: John R. Stark, executive director; Lloyd C. Atkinson, Thomas F. Dernburg, Kent H. Hughes, M. Catherine Miller, and L. Douglas Lee, professional staff members; and Charles H. Bradford, Stephen J. Entin, Mark R. Policinski, and Robert H. Aten, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, CHAIRMAN

Representative BOLLING. The committee will come to order.

Several public officials, including Chairman Miller of the Federal Reserve, have declared inflation to be public economic enemy No. 1. I agree that inflation is a very serious problem, but I want everyone to remember that past fights against inflation have usually stalled the economy and produced enormous and unconscionable costs in terms of lost production and employment. In fact, the more recent of these episodes caused great pain and misery without even producing the benefit of a significant reduction in inflation.

We are still paying the price for the misguided policies of the 1970's. Capital spending has now been subnormal for over 3 years. The result is that we have now virtually no productivity growth so that any wage increase almost immediately translates itself into higher unit labor costs and prices.

As its central theme, the 1977 midyear report of the Joint Economic Committee emphasized that inflation is the most serious obstacle to the attainment of full employment and of rapid and sustained economic growth. The report cited a number of reasons, but certainly the most important was that inflation paralyzes economic policy measures. If anything, the message of that report is even more relevant today than it was a year ago.

Our first witness, Mr. Barry Bosworth, Director of the Council on Wage and Price Stability, has in his public statements echoed the

warnings of the Joint Economic Committee. Mr. Bosworth and this committee, therefore, start from a common base.

The most important question that we shall be attempting to answer today is whether it is possible to slow our rapid and apparently accelerating inflation without once again pushing the economy in recession.

As I interpret the purposes of the Council on Wage and Price Stability and the administration's deceleration program, they are to provide ways of slowing inflation without using the harsh restrictive monetary fiscal medicine that has brought about the recessions of the past.

We will, therefore, want to explore with Mr. Bosworth whether the deceleration program stands much of a chance of success. We will also value his opinion of what additional authority he needs to make the battle against inflation a successful one.

We will want to know, in short, what we in the Congress can do to help him in the struggle against inflation.

Welcome to the hearing of the Joint Economic Committee, Mr. Bosworth. Please proceed as you wish.

STATEMENT OF HON. BARRY P. BOSWORTH, DIRECTOR, COUNCIL ON WAGE AND PRICE STABILITY

Mr. BOSWORTH. Thank you, Mr. Chairman.

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

Representative BOLLING. Without objection, it will be included in the hearing record.

Mr. BOSWORTH. What I would like to do is take a few minutes to summarize for you the current status of inflation from my perspective, I'll refer to the tables in my prepared statement.

It is very clear that if our efforts are currently aimed at slowing inflation, we are not making progress. In fact, we are headed in the wrong direction.

In the first 5 months this year, the consumer price increase has reached a 10-percent annual rate of inflation. However, there are some special circumstances which took place in the first part of the year that we should properly adjust for.

First, food prices have increased so far this year at an annual rate of nearly 20 percent at the consumer level. This rate of food price inflation is even more rapid than the explosive food prices in 1972 and 1973. It is primarily reflected at the farm level, where the farm value of the consumer food dollar increased in the first 5 months of the year at a 50-percent rate of inflation.

While a few months ago people were worrying about depressed incomes for the farmers, this year should turn the farm situation around dramatically.

If you look at the bottom of the table on domestically produced farm products, you'll see that domestically produced products at the retail level are rising at a 23-percent annual rate. Farm values are up at a 50-percent rate, and the food margin is rising at about 7.5 percent a year, about the same rate of inflation as in the industrial sector.

Our main problems in the food area have been the well-known shortages of meat. In addition, heavy rainfalls on the west coast completely disrupted the fruit and vegetable crops and drove those prices up,

and there have been substantial increases in every other component of the consumer food dollar.

Thankfully, I think we can look forward in the remainder of the year to a dramatic improvement in the food area.

First, I think the speculative mood in the livestock area has now broken. Livestock prices appear to have stabilized in a range that appears relatively reasonable both from the perspective of the consumer and from the perspective of the farmer. Therefore, for the rest of the year we will not be experiencing a continuation of the sharp livestock price increases.

As new crops have been planted, there has been a substantial decline in vegetable and fruit prices. That has not yet been reflected in the Consumer Price Index, but we should see substantial moderation in food prices in the next one and the ones to follow.

I think the only major problem we have in the food area is the proposal before the Congress for an increase in sugar prices and the support levels of those.

Otherwise, the current situation should be sharply distinguished from what happened in 1972-73. Food prices went up dramatically in the first part of this year, but we are not in a situation that could lead to a continuation of this trend, because we do not have the same sort of problem we did in grains.

We have a very plentiful supply of grains. Unless there is a sharp increase in grain prices that underpins any increase in consumer food prices, I don't think it will continue for the rest of the year.

In addition, there have been rather dramatic increases in a couple of other areas in the first part of the year. First, the shift of the Federal Reserve Board toward a tighter and more restrictive monetary policy has rapidly driven up home financing charges. There has been an increase in taxes, too. There has been an annual increase of 20 percent in inflation in the first 5 months of the year in taxes. There, too, we can look forward to a substantial leveling out over the last half of the year. Finally, a rather peculiar area in the Consumer Price Index is a rapid upward movement in the price of used cars. In terms of trying to anticipate where we are going for the rest of the year, it is more realistic to look at the rate of inflation that excludes these highly erratic components.

You can see the annual rate of inflation in what we might call the industrial components of the Consumer Price Index is running at about 6.5 to 7 percent annually. While that is not 10 percent it is an acceleration from the 6 percent annual rate of inflation that we have had in the prior 2½ years.

I think the conclusion is unavoidable that—at least thus far this year—the basic underlying forces driving the inflation rate are beginning to accelerate. They have been particularly dramatic in those three areas I cited: Housing costs and food prices have been the two major components responsible for this.

I think the same story turns out to be true for the wholesale price index. At the wholesale level there has been an acceleration of the basic rate of industrial price increases—after exclusion of food prices and other erratic components—of about a percent a year.

Finally, on the wage side, the same picture comes through. What had been a fairly steady rate of wage inflation of about 7 percent a year for hourly earnings has become 8 percent.

In the last year, the average hourly earnings index shows wage earnings are up a little over 8 percent. Certainly the minimum wage increase in January contributed substantially to that increase. That will not continue in the rest of the year.

Yet I think an overall review of the wage index shows indisputably that there has been an equal amount of acceleration on the wage side.

A third factor, a long-lasting one, I think, is that in the first quarter of this year productivity, instead of increasing as it normally does, actually fell very sharply. Many of us attributed this drop in productivity to cold weather and the coal strike and assumed it would rebound in the second part of the year. However, the decline in the unemployment rate in the last couple of months and the modest growth in aggregate demand suggests that the productivity slowdown is of more long-lasting concern and is not just the result of the coal strike and cold weather.

It now appears that, even with reasonably good economic growth, we may see almost no improvement in productivity for the year as a whole. That leaves no room for improvement in the real incomes of the average American workers.

With this sort of a framework and background of where we stand, if you look at the actual rate of increases of prices and wages, we are not making any progress in trying to keep the inflation down.

I will, then, look at the program that the administration has put forth to try to summarize the major focus of it and discuss where our major problems lie. First of all, I think the conclusion has to be inescapable that the Federal Government and the State and local governments to a lesser extent must bear considerable responsibility for the actions that they have taken in recent decades that have directly contributed to the rate of inflation.

I don't think those actions have been that the Federal Government has tried to create too many jobs. I agree wholeheartedly with the opening statement of the chairman that attempts to end inflation in this country by throwing people out of work are going to be far too costly.

What we are trying to do is to find ways of slowing inflation without throwing millions of people out of work. I would point out to you that we have come to the conclusion that it would take a million people out of work for at least 2 years for every percentage point that you could take off the inflation rate.

A million people out of work implies \$75 billion loss in the GNP, and those costs mean if you try to get down to an acceptable range, the country would have to return to the double-digit unemployment rates if we relied on that mechanism.

I think the Government contributes to the inflation in a far more direct fashion. It continues inflation through tax policy and regulatory actions and it contributes to inflation through its attempts to respond to individuals and special interest groups, through trade restrictions to protect them against foreign competition, to try to guarantee minimum wage and minimum prices for those specific groups.

It is the magnitude of these sorts of activities that has become a very considerable force in inflation, and that is different from the 1960's. I pointed out that in 1978, for example, the increase in the minimum wage, the increase in the social security taxes, and in the increase in the

unemployment compensation are estimated to add nearly three-quarters of a percentage point to the inflation rate.

We estimate the Federal regulatory activities are currently adding an additional three-quarters of 1 percent annually to the inflation rate. Something in the magnitude of about 1½ percent on inflation has currently been traced to governmental activities. Many of these activities, particularly the regulatory ones, have substantial benefits but we can't ignore the fact that they are adding to the inflation problem, and we do face a serious tradeoff in that area.

We have tried to get business groups to try to follow a policy of limiting their individual price increases to a rate of increase in 1978 of less than the average of the last 2 years. But looking at the wholesale price index, there is an inescapable conclusion that most business firms are raising prices at a rate that would not allow them to meet that objective.

We have contacted firms to ask them what actions they mean to take in the last half of the year.

We have had difficulties in trying to make the anti-inflation program be effective for the wage area. I believe the greatest problem in the wage area is that it is a little absurd to ask the average American worker to hold back on wage increases when he has been getting 7 or 8 percent and he looks out and sees other people getting 9 and 10 percent annual wage increases.

Before we can expect much from the average American workers, we must find a way to bring wage increases for those people in the industrial core of the economy back in line with everyone else's. As long as this highly visible labor force continues to obtain wage increases substantially above the average worker, we cannot expect the average worker to cooperate.

I think thus far our program has not obtained the full cooperation of organized labor, and I understand their concern. A worker is being asked to sign a multiyear labor agreement with no assurances that inflation will decelerate. On the other side the businessman says, "Yes, I am willing to cooperate with the program." But if it doesn't work out in the next 30 days, he can raise his prices.

I think there are some means to try to equalize the risk for the American workers. In the large industrial contracts that risk is really not there to the extent they claim it is, because they do have cost-of-living escalator contracts. They don't protect them 100 percent, but to a substantial degree.

At this time when we are trying to reduce inflation, people can negotiate contracts for a shorter period of time. The 3-year labor contract is something we can move away from.

At the same time I think the administration realizes that some further action will possibly have to be taken and some modification of the program will have to be made. We are in the process of exploring a lot of different alternatives that have been proposed both publicly and privately to see what we can do to get some additional cooperation on the part of individuals in the private sector.

I am more impressed, I think, with the response of our own Government. I think there is a sharp increase in awareness by the Congress and the administration of the inflationary impact of Government actions. Many people in the Government are trying to find a way to deal with some of these problems.

I think our difficulties now lie primarily in the private sector in terms of getting some form of response.

At present, if you look at the Consumer Price Index, the extent of the success we have had indicates it has been a little bit limited.

Representative BOLLING. Thank you very much.

[The prepared statement of Mr. Bosworth follows:]

PREPARED STATEMENT OF HON. BARRY P. BOSWORTH

Mr. Chairman and members of the committee, I am happy to have the opportunity to appear before you today. We share a common goal—reducing the rate of inflation. All of us are deeply aware that finding a solution to the inflation problem is vital to the nation's economic future.

All of the recent figures indicate that we are not doing very well. Despite our efforts so far, the rate of inflation is increasing. I do not think, however, that the outlook is nearly as grim as the statistics of recent months suggest. They show inflation running at an annual rate of about 10 percent. Quite obviously we are not going to end the year on a note as sour as this. For 1978 the figure probably will be about 7 percent. While it is true that this is the wrong direction, inflation is not running rampant.

I have attached some tables showing recent inflation trends.

During the balance of this year we expect considerable improvement. We especially anticipate sharp moderations in food prices which were responsible for most of the large increases we experienced earlier this year. Already fresh vegetable prices have come down and I think the large increases in meat prices are behind us, with a more stable level of prices for the remainder of the year.

Beyond the second half of this year the outlook is far less certain. Much depends on the effectiveness of our anti-inflation program.

There has been criticism that this program so far has not produced any tangible results, and without question there remains a good deal of skepticism about its voluntary nature. But we did not expect the deceleration program to produce immediate improvement in a situation that has worsened for more than a decade. We have not sought a quick fix. The objective is to get a gradual but sustained improvement over the next few years. The multi-year nature of many of our wage and price contracts does not make it feasible for a voluntary program to achieve dramatic results in a short time period.

But I believe it is too early to conclude that this nation cannot solve its inflation problems through cooperative efforts or that we must again put the country through the aggregate demand restraint wringer with millions more out of work. The President announced the concept of the deceleration effort last January and then further implemented it with a number of positive steps of which you are all aware in April.

You have requested my assessment of the President's anti-inflation program. As I have indicated already, I think it is far too soon to expect major results. From the outset we were aware that it would take some time simply to make a modest start. But I will have to concede that the clock is ticking. I honestly do not feel that we have a lot of time left.

I think, however, that any assessment of what has been done so far must be viewed in terms of the alternatives.

There is no question that the amount of fiscal stimulus could be reduced to the point that inflation would end. You could hold down the money supply growth to achieve the very same result. But let's be honest about what we are talking about. Since no businessman sets prices by the size of the budget deficit and no one demands wage increases because they feel the money supply is rising too fast, what we really mean is cut government spending, cut production, throw a few million more people out of work in hopes they will quit asking for wage increases.

I agree that we could end inflation by this old-fashioned demand restraint. But let's not fool ourselves. The price, in terms of human costs, would be enormously high. The best economic estimates are that it would take an additional one million unemployed for two years just to bring down the rate of inflation one percentage point. In my opinion, that is an unacceptably high price tag. We do not have an inflation caused by excess demand and it cannot be halted by creating an even larger pool of the unemployed. And I don't see any convincing evidence now that demand pressures threaten new inflationary influences.

There was a time when just a little aggregate demand restraint applied through fiscal or monetary policy achieved results. But this is no longer true. We have

undergone a number of structural changes in our economy—such as the reduction of competition both in labor and in pricing markets and the growth of government involvement—that have markedly altered our options. The fear of unemployment and lost sales as incentives to hold down wage and price increases has become relatively ineffective for several major sectors of the economy.

There is, of course, another option—wage and price controls. But they are simply not applicable to the kind of inflation we have today. Controls are short term solutions to emergency situations. And this is not what we have. Inflation has been a problem for us and all other industrial democratic nations for several decades. The use of controls on a sustained basis would cause distortions and inequities and would not address the fundamental structural problems. The Administration has said repeatedly and emphatically that it rejects this approach. One very basic reason is that we just don't know how to operate controls. There are millions of prices in this country and when you try to set them from Washington, you inevitably make serious mistakes that ultimately lead to bottlenecks and distortions. And when you try to set wage rates in Washington I think you run the risk of creating basic changes in our political structure. The political activity of labor and business would concentrate primarily on persuading the government to approve their higher wages and prices.

In between these two extremes there is very little. We have been looking at some new incentive ideas that are loosely lumped together as Tax Incentive Plans. I believe that these options should be fully explored because they appear to address the problem of insufficient incentives for the individual firm and worker to exercise restraint in their wage and price decisions. But there are serious administrative problems. The idea certainly is well worth exploring. Significant progress has been made in identifying and solving these problems, but we do not yet have a version of such an incentive approach that is a viable option.

At present we have identified the major areas in which our anti-inflation efforts will need to concentrate and we have tried to develop for both business and labor reasonable guidelines for non-inflationary wage and price decisions.

The program has four major parts. First, the Administration recognizes that the Federal government itself is an important contributor to inflation.

The Administration is committed to working with Congress to maintain a responsible long-run budgetary policy that balances concern for sustained economic growth with a determination to avoid excessive surges in aggregate demand relative to supply. The President has reduced the size of the proposed tax cut to avoid excessive demand stimulation and has indicated that he will veto budget bills that exceed his requested levels.

In other areas the President has strengthened the review and analysis of the government regulatory process in an attempt to simplify regulations and assure that their objectives are achieved in the most cost-effective manner. It is reliably estimated that government regulations add about three quarters of a percent annually to the rate of inflation.

The President as well has frozen the salaries of the White House senior staff and has recommended a 5.5 percent ceiling on this year's Federal white collar pay raise. He has ordered the Executive branch to reduce where possible the purchases of goods and services where prices are rising rapidly.

But while the Federal government must do its share, it alone cannot solve the problem. Cooperation of the private sector is vitally needed.

The anti-inflation program is based on the premise that deceleration must be achieved in every market. To reach this goal individual industries are being asked to limit price increases to less than the average over the last two years. The objective, as well, is to assure that there is no widening of profit margins. Several individual firms already have pledged to meet this deceleration target and we are continuing a full schedule of meetings to persuade others to do the same. In this effort I am working closely with Robert Strauss, the President's special counselor for inflation.

We adopted a standard for price behavior that refers to the cumulative magnitude of price increases for the year 1978 as a whole in order to avoid encouraging a multitude of small price increases for which we did not have resources for analysis, and to encourage firms to be responsible for their own cost increases rather than accepting a pass-through of costs as adequate justification for price increases.

One consequence of that policy has been that we have not had a basis on which to comment with respect to many pricing actions in the first half of the year. During the next six months, however, many industries will be approaching the deceleration target that we expect them to meet. I anticipate that we will need to

expand the Council's activities in that area over the next few months. On the basis of price developments through June, for example, we have begun a process of contacting these firms in industries with price increases approaching the deceleration objective to inquire as to what actions they contemplate taking during the remainder of the year in order to achieve the objective. If they cannot do so, we would like to obtain a detailed explanation of the factors responsible for accelerating inflation in this industry.

The third part of the program involves gaining labor support. A moderation of prices can be sustained only if there is an equal reduction in the magnitude of average wage increases.

Quite candidly we have not done very well here. A lot of this probably is my fault. Perhaps I did not explain the labor side of the program well enough and did not address myself adequately to some special problems labor has with a voluntary program.

It is a lot easier for business to make a price commitment than it is for labor to make a wage commitment. If inflation fails to moderate, businessmen can simply pull out any time and raise prices. But labor contracts are in effect for two or three years.

So there has to be an understanding that the working man will be protected if the cost of living continues to rise.

I think there are equitable means of handling this problem. Many major labor agreements contain cost of living escalator provisions. Alternatively, they could choose to negotiate shorter-term contracts or to include provisions for annual wage reopeners. But our problem has been that, in the name of protection against inflation, some labor groups have obtained wage increases far in excess of the average American worker. These increases also exceed productivity gains plus increases in the cost of living. We cannot continue this trend toward a dual labor market where the wages of one group rise far more rapidly than those of the average worker. Nor can we ask the average worker to participate in the anti-inflation effort by restraining his wage increases when the gains of others are so much greater.

Both on the labor side and the price side the voluntary deceleration program provides for flexibility to meet specific problems and situations. This is what distinguishes it from a rigid guidepost approach. The program expects more from those industries and those workers who have done very well in recent years. And it understands that it will have to accept less from those who have done poorly.

We recognize, for instance, that firms that lowered their price-cost margins during the recession will experience a rise in those margins as demand strengthens. The program is not designed to penalize those firms who have in the past varied prices in response to market conditions. By the same token there should be flexibility to allow for uncontrollable mandated costs from government programs such as payroll tax increases, regulatory actions, tax changes and imported raw materials.

On the other side, it is absolutely true that the average American worker has not fared well because of inflation. This does not apply, however, to those workers in the central industrial core of our society. They have been receiving gains of about 10 percent annually. If we are really going to do anything about inflation, these groups must begin to moderate their gains and bring them back in line with the 7 percent average of the rest of the economy.

The final part of the program deals with those sections of the economy that present special inflation problems. These include medical care, food, transportation and housing. In general the rate of price increases in these sectors has consistently exceeded the economy-wide average.

There is before Congress a hospital cost containment bill that was designed to provide significant relief in this area. But it seems now to have almost no chance of passage. Recently the Council on Wage and Price Stability met with representatives from the American Medical Association in an effort to persuade individual doctors to hold down their rate of fee increase, which has been accelerating much faster than the general rate of inflation.

In the final analysis, I cannot guarantee you that the course we are following will do the job. And it might not be the best approach. But so far, given the options, no one has been able to come up with a better one. And God knows we have tried.

This Administration is serious. And it is committed. It will do all in its power to make the program work. But success or failure really depends on cooperation from both business and labor.

All I can guarantee you is that if we fail, the Federal Reserve will not tolerate another long spell of rising inflation. The result will be an end to the economic expansion and a subsequent recession with absolutely no guarantee that we will emerge from it in any better shape in terms of inflationary pressures.

ALTERNATIVE MEASURES OF PRICE INFLATION

	December 1977 relative importance (percentage)	Annual changes ¹		Percent change year to date ²
		1976	1977	
Consumer Price Index: ³				
All items.....	100.0	4.8	6.8	10.0
Food.....	17.7	.6	8.0	18.7
Energy.....	8.6	6.9	7.2	7.4
Home finance, insurance, and taxes.....	9.2	1.6	11.2	19.3
Used cars.....	3.0	19.0	-4.1	14.0
Other items.....	61.5	6.1	6.2	6.7
High inflation components:				
Housing.....	43.9	5.4	7.6	10.8
Medical care.....	5.0	10.1	8.8	8.7
Food.....	17.7	.6	8.0	18.7
Consumer food prices:				
Away from home.....	5.5	6.1	8.0	11.6
At home.....	12.2	-.9	8.0	2.21
Domestically produced farm food: ⁴				
Retail value.....		-3.2	5.1	23.0
Farm value.....		-10.6	4.3	50.9
Farm-retail margin.....		2.1	5.6	7.5
Imported food.....		15.9	25.7	NA
Wholesale Price Index:				
Finished goods.....	41.2	3.3	6.6	10.5
Producer.....	12.2	6.4	7.2	8.3
Consumer.....	29.0	2.1	6.4	11.1
Consumer less food.....	18.7	4.9	6.1	7.9
Intermediate less food.....	45.5	6.4	6.4	7.7
Crude less food.....	4.0	13.5	11.4	14.0

¹ December over December of prior year.

² CPI figures show December to May changes, WPI figures show December to June changes. All figures are seasonally adjusted at annual rates.

³ CPI for all urban consumers.

⁴ Domestically produced farm food comprises 100 percent of consumer food at home. Relative importance of the components of this group are: Retail food, 100 percent, farm value, 41 percent; and farm-retail margin, 59 percent.

Source: U.S. Department of Labor and U.S. Department of Agriculture.

ALTERNATIVE MEASURES OF EMPLOYMENT COST

	Average annual percentage change		December 1977 to June 1978 ²	June 1977 to June 1978
	1967-77	1976-77 ¹		
Private nonfarm sector:				
Average hourly earnings.....	6.9	7.6	9.4	8.4
Hourly earnings index.....	7.1	7.2	8.3	8.2
			1977: IV to 1978: I ²	1977: I to 1978: I
Hourly compensation (all persons).....	7.7	8.9	13.2	9.1
Labor productivity.....	1.6	3.0	-3.3	.9
Unit labor costs.....	6.0	5.7	17.0	8.2
Real wages, average hourly earnings.....	.8	2.9	0	1.4
Real spendable earnings ³.....	.3	2.2	-11.9	1.9

¹ Average annual percentage change 1975 IV to 1977 IV.

² Seasonally adjusted at annual rates.

³ Real spendable weekly earnings of a worker with 3 dependents.

Source: Bureau of Labor Statistics.

Representative BOLLING. Senator Javits, I understand you have a time problem, so I will be glad to recognize you first.

Senator JAVITS. Thank you.

Mr. Bosworth, I came especially this morning because I wanted very much to hear the administration's position in this matter.

Do you expect your particular areas of activity to be changed, modified, or intensified; or do you look forward to carrying on, as you have indicated in your four-step administration program, pretty much as you have in the past?

Mr. BOSWORTH. After 3 months of really intensive activity with respect to the inflation issue, I would not say that we are happy. I would say the administration has been placing a great deal more stress on the inflation issue since the President's speech in April.

We have provided the framework where we should constantly be considering some additional measures consistent with it to firm it up. We are well aware of the fact that we have problems, particularly with labor, where our original proposals did not go over well, and we will have to consider some alternatives. And we are.

However, we don't anticipate any dramatic changes in the near future.

Senator JAVITS. Do you feel you have the authority to make whatever recommendations you believe should be made in order to cushion inflation? For example, in your prepared statement, you say that fresh vegetable prices have come down, and the large increases in meat prices are behind us.

Now, the meat price problem is susceptible to the impact of imports. Imports can be increased or decreased, by executive branch action, and have been.

In your opinion, do you have the power to make recommendations to the President and to make public those recommendations—for example, that imports should be increased if you feel that large increases in meat prices turn out not to be behind us?

Mr. BOSWORTH. Yes, although I would point out we did make that recommendation 2 months ago and the President did increase the amount of imports. The difficulty you face on the import side is that the situation in the United States is largely duplicated in the world market. There is a worldwide shortage of meat products, and the opportunity to expand meat products was limited to the actions that the President took to import 200 million additional pounds for the rest of the year.

There is not a lot of meat out there in the world market just waiting to come into the United States.

In addition, we know that meat prices were almost absurdly low a year ago. At that price level, the American beef producer was going bankrupt. It was around \$40 a hundredweight on the Omaha market. When it started to get up to \$55, that was more reasonable.

However, when it started to get to the rate of \$60 or \$65, we got concerned. I don't think we could take many more actions to moderate meat price increases for the remainder of the year, but I think they have stabilized, the speculative elements has largely gone.

Senator JAVITS. What I had in mind is the fact that when we allow imports, they have a moderating effect on meat prices; however, the fact that we make it possible doesn't mean we will obtain the extra meat economically.

The other question I wanted to ask you is to what extent would more effective consumer advice from the Department of Agriculture help you to stabilize prices? This has been a much debated question for years, and I myself have discussed it. I have never been given

a really satisfactory explanation as to why we don't have topflight consumer services. We leave it to consumer advisers hired by NBC and CBS and so on to tell us that this morning's calf brains is a good buy.

If you are in business to moderate prices, why can't the U.S. Government, as a matter of national policy, give the consumer the break which would come from authoritative advice? The Government could say, "We don't think you ought to buy beef today because all you are doing is hurting yourselves," or "We think you should buy now because there is too much beef around."

Mr. BOSWORTH. I don't think too many people would want to take the job of saying we shouldn't buy beef. I said that a couple of months ago, and sometimes I regret I did. There are two sides to every story. There are beef producers who think the price is way too low and should be higher. But we have addressed the question more broadly with advice to consumers about purchases, and Ms. Peterson of the White House is actively trying to put forth a program they are working on to develop a more effective food information program for consumers.

Senator JAVITS. Could you send me a memorandum about the ideas you have discussed with Ms. Peterson? Often I find they die in the bureaucracy before we find out they were aborning.

Mr. BOSWORTH. Yes.

Senator JAVITS. The last question I have for you is on the issue of productivity. I notice your discussion of tax incentives to stabilize prices. I am interested, and I look at it very sympathetically and carefully. But isn't it a fact that we are "in the cellar" in productivity among the leading 10 industrial countries and the cost of domestically manufactured goods, therefore, is higher than it should be? This is very inhibiting in terms of supply and stable prices, and even to meet foreign competition. In foreign competition, we are bested materially, especially by the Japanese, and not always on what ought to be strictly economic grounds.

Chairman Bolling, with my strong urging, asked the committee to investigate the American industrial plant, and we have found it is becoming obsolescent.

Wouldn't it be within your jurisdiction to make recommendations for and to urge a major productivity drive in this country?

Mr. BOSWORTH. Our productivity does put us in the cellar. A 1-percent slowdown may not seem like much of a decrease, but when you think of it as a third of our annual growth, it certainly is alarming.

Senator JAVITS. When you say "a third," do you mean over the years?

Mr. BOSWORTH. In the fifties and sixties, we were getting a 3-percent growth. Earlier this year, we were down to 2 percent. Given the events of the first half of this year, we are even more worried that in the private nonfarm sector productivity may be as low as a percent and a half.

That would be less than half the rate we were getting a decade ago, and it is causing serious concern.

The JEC published a study about a year and a half ago, and one of the things they very dramatically pointed out is the complexity of the issue and the difficulty of even trying to explain this productivity slowdown.

The Council on Wage and Price Stability published a report earlier this year where we tried to look at the common indications, like a shift in workers' age and sex, but they did not appear to hold up. There has been a slowdown in capital formation, but it came after 1974, well after the productivity slowdown first began. So, while I am sure it is a contributing factor, it is not a complete explanation.

As we look at productivity, one thing that increasingly worries us is the Federal regulatory area, and the complexity of the regulations that we are overlaying on top of the industrial system.

In a study by Mr. Ed Denison of the Brookings Institution, he found that Federal regulations have a minor influence on productivity. The delays in licensing requests and the costs of some of these programs; after all, if you want to improve the environment, you have the outlays, and they don't show up as wage increases, and don't show up in profit margins.

That is the cost, so to speak, with the benefits being the improvement of the environment. We think a lot of those costs are excessively high.

But the administration proposed some rather substantial increases for investment, increases in the investment tax credit, and a cut in the corporate tax rate at the beginning of the year. I don't think we are going to get the measures through Congress this year, unfortunately.

We have another productivity study going on now, where we are looking at individual increases rather than the overall economy. I don't know why productivity growth has been so slow in this country in the last decade. I just don't have the explanation, and I don't think the President or anybody else has a full accounting of it.

Senator JAVITS. Mr. Bosworth, my time is up. I think with all you have given us—pleas, confessions, and avoidance—I cannot see anything except that this administration has failed. I don't accuse this one because it is a Democratic administration. Rather, as was true of others, this administration has failed to launch a national productivity drive and awaken our people in a vivid way—not by studies, because they don't register—to the erosion of American strength and economic capability and to the resulting drop in productivity.

Although one opportunity for increased productivity results from the necessary automation of American business, I rather suspect that one of the biggest problems is the morale of American workers. I strongly commend to you—I am not finding fault with you—that one of the greatest things you officials could do is to leap into this field with both feet. The heart of the matter is here—not in what you are called upon to do—but rather in what you can do to affect price levels.

Thank you, Mr. Chairman.

Representative BOLLING. Thank you, Senator.

Congressman Long.

Representative LONG. Thank you, Mr. Chairman.

Mr. Bosworth, we are happy to have you with us today. If I understood you correctly, you feel that those of us in Government are making some progress, at least with respect to our attitude toward inflation. You seem to feel that we are at least beginning to understand the problem, and are beginning to take some steps to try to reduce the effect of inflation, and that the same is not necessarily true of the private sector.

Is that correct?

Mr. BOSWORTH. In terms of attitude, I guess we could say yes.

Representative LONG. I wonder if perhaps one of the reasons for that might be that we can control and understand our own attitudes, but that we have little control over attitudes, because we have some degree of control in the private sector, or practically none.

At this time, though, we find Chairman Miller proclaiming inflation to be public enemy No. 1, and we find you, and my friend Bob Strauss, trumpeting the inflation alarm. The fact that you have seen some results in the Government sector and not in the private sector may perhaps mean that what you are doing is counterproductive, and that it is causing, or hardening, the inflationary expectations on the part of the private sector.

What is your reaction to this criticism?

Mr. BOSWORTH. I think that is a real possibility. It isn't the statements we have made that have upset the public about inflation. I think it is what has actually happened.

The price increases this year are a very real phenomena. But, for example, I'm often told that by highlighting the major union labor contracts and pointing to them, you harden their attitudes and make them dig in even more, so they are even more reluctant.

The only answer to that is to keep quite. But when we did so, the contracts were very large. Now that we are talking about them, the contracts are very large.

I think the first step in this is to get people to recognize the severity of the problem; it isn't going to go away overnight. The cost of doing that may be in the early stages that in fact you lead people to anticipate—

Representative LONG. In effect, a self-fulfilling prophecy?

Mr. BOSWORTH. Yes, and also in this area are people's concerns about controls. In the last few months I think we have been successful in calming them down; at least when I talk to businessmen and labor leaders, they take us seriously when we say, no, we are not going to go to controls, and you should not worry about that.

So any sort of speculative activities of that kind have, I think, been largely calmed.

Representative LONG. What do you think of Senator Javits' suggestion about a major productivity drive in the United States?

He had to leave and didn't give you an opportunity to comment on it, and I just wondered what your views on it were.

Mr. BOSWORTH. I think that productivity is a major part of the inflation problem, and yes, we would like to have a drive for improved productivity, but the problem is that we had better know what to tell people to do. The problem is that we don't know why productivity has slowed down.

If we asked people to improve productivity, they would say, "How?"

Representative LONG. The Senator believes a substantial part of the difficulty might be a morale problem in the United States, and that to some degree could be corrected. Do you feel the morale problem of the American worker is a substantial part of the problem?

Mr. BOSWORTH. No. The people who use the measure of worker morale try to see whether it has deteriorated. In some industries, workers have never liked their jobs, but productivity has gone up. If you

say there is room to improve productivity in the area of work rule changes and the like, that does lie in people's discretion, but the problem doesn't seem to be any worse than it was a decade ago.

In my view, there are things that could be done in that area, but they are not the reason that the rate of growth of productivity has slowed down so dramatically in the past decade.

Representative LONG. What is your educated guess on that?

Mr. BOSWORTH. My educated guess is that it is government regulations. We have made it so much more difficult to create new plants as opposed to modernizing or updating. One of the things I found most striking is the sharp dropoff in new greenfield sites in American industry, the building of a brand new plant from scratch.

We have been looking at productivity in individual industries. We have found, for example, that the opportunity to improve productivity in the steel industry from a completely new plant is an order of magnitude greater than the opportunity to improve productivity in a given plant. They get into the problems that under the new technology, the flow of the materials in the old plant is backward.

You can't lay out the assembly line in the old plant in a more efficient fashion. A lot of that goes to the tremendous difficulties of ever getting approval, particularly within the environmental area, for a new plant.

With all the license requests that they have to get, it delays things and increases the risk, you have to plan further ahead.

I think that is part of it. I think the second major factor has been the fact that this economy has been on a roller coaster for the past decade. Whenever we have a boom, everybody switches and worries about inflation; and then we go into a recession, and everybody gets upset about the unemployment rate.

With that type of up-and-down behavior of the economy, no businessman can make an intelligent decision about what future output requirements will be.

A lot of the mistakes have been made because people have wrongly anticipated the magnitude of demands made on their industry, and a lot of resources have been misallocated because of the performance of the overall economy.

That is compared to the 1960's, where we had a slow but sustained increase in economic activity. Then, people could make much better projections of what their investment needs were going to be.

The fundamental reason we are not getting more investments today is that nobody believes the expansion will continue. They know inflation is accelerating, and the Federal Government is restricting, and we are headed for a recession. So, they reason, "I don't need to build a new plant now." I would say that factor and government regulations lie behind it, not shifts in the age and sex composition of the labor force.

Representative LONG. Some of these regulations have been moderated, some quite recently, as you well know. Do you think they have been moderated to any extent that is measurable, or will become measurable, as a counterirritant, so that the regulations will allow productivity to rise again?

Mr. BOSWORTH. I don't think they have to be moderated. The problem isn't that we have been asked to improve the environment too much. The problem is the way we are going about doing it.

The problem is caused by the bureaucratic system, the licensing requirements, administrative procedures, and noneconomic decisions that we are forcing people to make to get to goals which, when looked at in an economic perspective, are reasonable. The regulators need an understanding of the economic impacts of what they are doing.

In that area, in the last year there has been a change in attitude on the part of the regulatory agencies. They are making much better efforts than they were before.

I think the Congress could do more by writing into the laws specific requirements saying this is the intent of Congress. Some regulators say, "Congress didn't want us to look at the economic impact." It would help if you put in the laws that they have to be cost-effective. By doing that you could streamline the whole process, speed it up, and not have the negative effect on productivity.

Representative LONG. I was thinking the same thing. I think as regulators gain more experience with the problems that regulations have helped to create they will make some changes in recognizing the economic impact, and in many instances, the utter absurdity of what their regulations require.

Thank you, Mr. Chairman.

Representative BOLLING. Senator McGovern.

Senator MCGOVERN. Mr. Bosworth, it is said frequently, and I gather this has also been said by you, that one of the major factors in the inflation problem is farm prices.

I am at a loss to understand that, because when we talk with farm people and go over their prices as well as their costs, they make a pretty compelling case that prices are too low.

You know the city was filled with farmers here earlier this year who convinced a good many Members of Congress that farm prices were too low, as over against the cost of production.

What evidence is there that farm prices are out of line?

Mr. BOSWORTH. First of all, if you ask me what has contributed to inflation, my answer doesn't have a value judgment about whether the price increase was justified or unjustified. Look at the rate of inflation, and see what prices are going up rapidly. Food prices have been a problem, because they are rising at over twice the rate of every other price.

Now, the question is, whether that is necessary or desirable for other reasons.

Senator MCGOVERN. What is causing the increase in food prices?

Mr. BOSWORTH. The factors I went over at the beginning of my testimony were concerned with the large increase in meat prices. Then I pointed out the current inflation in food prices has been heavily driven by this increase in meat prices.

If you look at the wholesale level, livestock prices were about \$40 a hundredweight last year.

They were abnormally low, and they had to come back up, if the herds were going to be maintained and rebuilt over the next few years.

That is still inflation. When the prices went up from \$40 per hundredweight to \$55 or \$60 a hundredweight, they were rising a dollar every couple of days, and that is when we took action.

They have now stabilized in the area of \$55 a hundredweight, which seems to be reasonable.

Senator MCGOVERN. Would it be accurate to say, in order to get at the heart of the problem, that a year ago farm prices were too low, including cattle prices.

Mr. BOSWORTH. From an economic point of view, yes.

Senator MCGOVERN. In order for a producer to at least regain his cost of production, his prices had to go up.

Mr. BOSWORTH. Even when the new farm bill went into effect, grain prices were allowed to rise, so, from an economic perspective, some of those rises are in line with costs.

Senator MCGOVERN. So the remedy for those who are concerned about controlling inflation, and I assume that includes all of us, does not point in the direction of a deliberate effort to lower farm prices?

Mr. BOSWORTH. I think the focus on farm prices should not be that they are too high or too low, but that they are erratic. From the first half of the year, they exploded up at a 50-percent annual rate of inflation. We should be trying to provide some continuity and stability.

I think that the new farm bill passed last fall by Congress was a minor step in that direction, because the fundamental pinning of food price inflation is grain prices.

What the Congress has moved to do is to establish a stabilization reserve to make sure prices don't go exploding upward too rapidly. Then you set a minimum price based on the cost of production, just variable costs, and that is reasonable.

So prices are free to fluctuate within that band, but they can't drop below it, and they can't go above it. That seems to me a reasonable approach.

Now, if we had stabilized like this in 1973 and 1974, we wouldn't have the meat shortage problem today. It may strike you as a long way back to go, but it really is the explanation for why meat prices are going up so much today.

The sharp rises in meat prices in 1973-74 touched off a consumer boycott. They stopped buying. The market broke, and the meat producers panicked and started over a 3-year period to unload their herds. They finally ran the herd down, and then they moved to rebuild the herds. Thus less meat will come to market and the prices will have to rise again.

I think the answer to that is not to say that we want them either low or high, but we want a level, and government policy should focus on making sure they don't fluctuate too much in the short run.

Senator MCGOVERN. I agree basically with what you are saying. I certainly recognize the fact that the cattle cycle runs for several years at a time.

It does seem to me, though, that there are times when the administration's actions ignore that.

For example, the recent decision to open up beef import quotas: To people engaging in the production of livestock, who are trying to recover, now, over the next 2 or 3 or 4 years from the unsatisfactory prices they have received for the last 2 or 3 years, they see a move like that as a punishment to their efforts to rebuild their herds.

How could they interpret it differently?

Mr. BOSWORTH. I have found beef producers' attitudes towards meat imports are irrational. Meat imports in this country are 7 percent of beef production, and a couple of percent of overall meat consumption. What the administration did was raise the level slightly.

There is no way that could have a dramatic real impact on prices.

Senator MCGOVERN. Doesn't it have an important psychological effect?

Mr. BOSWORTH. It signaled a change in policy that broke the speculative boom. The prices gradually went from \$40 a hundred-weight to \$55. That is not an unreasonable price.

Then they started to move very dramatically up into the midsixties range for no apparent reason. It looked like more pure speculation in the market.

If this had continued and had been passed through to the retail level, I think the farmers should have worried about consumer boycotts and rebellion against those prices and a repeat of what happened in 1973 and 1974.

What the administration did was take an action which in the long run can hardly do anything to prices. It broke speculation on prices; they fell sharply, then they recovered, and they are now in the range of \$55 a hundred weight, and are stable.

It seems to me that we stopped the speculative boom that would have done nobody any good. Now the market is trying to operate, and 200 million pounds of imports is not going to hurt the American farmer. It isn't even the right type of meat. It is hamburger and lean meat that goes into McDonald-type hamburgers, not the type of meat produced by the American farmer.

I think he worries about something that has almost nothing to do with what his own returns are going to be and—

Senator MCGOVERN. I disagree with you on being the wrong kind of meat. We probably should be eating more of this lean, grass-fed beef. [Laughter.]

Mr. BOSWORTH. I expected somebody from the Dakotas to say that.

Senator MCGOVERN. No; that isn't my concern. Our producers produced the corn-fed fat beef that we call "choice beef." I would prefer, for health reasons, that we produce and consume leaner meat. I recognize, Mr. Bosworth, what you say is true. A couple of hundred pounds of beef in itself is not going to break the American market.

It is questionable whether we are going to get those imports anyway, but it certainly has a psychological impact on the market just at the time when producers appeared to be recovering from the long, painful losses that they had suffered in recent years.

That is the only point I am making.

Mr. BOSWORTH. The price did come back up again.

Senator MCGOVERN. I'm sorry, I missed your response.

Mr. BOSWORTH. The price did come back up. The low prices lasted about 2 weeks, when it overshot. It is back up.

The farmers were upset about 10 or 14 days after the action, but then the prices recovered, and came to that reasonable range again.

Senator MCGOVERN. I certainly agree with the point you make about the grain prices being crucial to what happens to meat prices. I do hope we can be more successful, both in establishing reserve policies that will stabilize grain prices and in holding the prices at a more equitable level. It just makes no sense at all for the United States, Canada, Australia, and Argentina—four countries that are producing 85 percent of all the grain that moves in international markets—to sell grain below the cost of production, because they don't cooperate in terms of the reasonable price.

They are undercutting each other.

I'd like to pursue another matter, Mr. Bosworth. If you have gone into this, don't repeat the answer, but I have been very much interested in Mr. Okun's argument—Arthur Okun's proposal—to use the tax structure as a means of tamping down inflation, provide tax concessions to industries and to workers who agree to hold the line on wage and price increases.

Have you discussed that matter this morning?

Mr. BOSWORTH. No, we have not. I think it is fair to say that I am very interested in it as well, and so are several other people in the administration. We have spent quite a bit of time in the past year looking fairly intensively at different forms of tax incentive type programs.

We have now narrowed it down to two basic problems with two different types of programs we have evaluated.

First are the administrative problems; and, quite frankly, we have not solved them. Even though the idea is an interesting one, there are still enough of the administrative difficulties so that we can't yet come up here and say, "Here is a plan you might look at, and it is all worked out."

However, we have solved quite a few of these administrative problems. Over the next few months, I hope we can work on answers to the rest of the problems. Then we could say, "If somebody wanted to do this, this is what a plan would look like in detail."

The other problem is whether or not it will have any impact. There are some questions about whether or not there would be much impact from taxes, but I do think the basic idea is a good one.

If you are saying that there has been a reduction in the degree of competition in the economy today to the extent that the fear of losing one's job doesn't hold down on wage increases and the fear of loss of sales doesn't hold down prices, and you have a concentrated labor and producer market, then the idea of putting in some other play like throwing people out of work and trying to make the risk of unemployment higher is not a good one. Let's, instead, put in some other incentive that makes it more in a person's interest to hold back on wage increases.

It sounds like a good idea. The problem is, if you look at it and work out an economically rational plan, it isn't much of an incentive.

Suppose we put \$10 billion out there. A \$10 billion tax cut. On wages, the effect of the relative impact would be about a half of a percentage point.

The worker faces a trade-off, to take the wage increase and reduce it by half a percent every year into the future. So if he takes a cut in the magnitude of his wage increase, you are going to lower his income every year all the way up.

The present discounted value of that income swing, even with a high discount rate, is probably seven or eight times, if there is no wage cut, and he compares that to a little tax cut in the first year, which he doesn't get thereafter. It is not a very powerful incentive to induce somebody to give up the sure thing of a wage increase that they are going to be able to keep forever. And you are coming back and saying, "You have a tax return for 1 year."

Senator MCGOVERN. He gets the prospect of lower prices.

Mr. BOSWORTH. That is true, but the individual says, "If I do it on my own, nothing will happen to prices."

If everybody says, "I would be willing to hold down on my wage increases if prices would come down. However, even if I do it, nobody else will do it, and prices won't come down," this program still wouldn't increase his expectations that others will do the same thing.

The problem is that individuals on wages are completely independent of what is going to happen to prices.

Senator McGOVERN. The problem is that voluntary restraints don't work very well.

Mr. BOSWORTH. That is the problem we have today. We talk to individuals and say, "Why don't you hold back on your wage increases?" And they say, "Nobody else is going to do it."

Other proposals have the same problem. We are at the stage where we haven't quite made up our minds. All I am trying to point out is that there are some pros and cons to these things, and they don't look to me like they are a magical solution that will eliminate inflation problems. However, they still may have a high enough value to be worth trying.

We are trying to put out specific versions. We have fully discussed the incentive effects, and the budget loss.

Representative BOLLING. You said earlier, Mr. Bosworth, that you had been successful or relatively successful in convincing people that we are not going to go to wage and price controls, and I think it is important for the sake of the record that you discuss that a little bit more; why, overall, wage and price controls, which I oppose for my own reasons, which stem not from anything political but the experience of having to deal with the legislation during the Korean war when nobody else seemed to be interested in touching it with a 10-foot pole, and not feeling we had a very good experience with it even in that situation.

What are your reasons for feeling that we should not have on the shelf, let us say, a standby wage and price law?

Mr. BOSWORTH. Let me just take the issue of the controls themselves without going to standby.

Representative BOLLING. All right.

Mr. BOSWORTH. First, I think there is a major difference now, compared to 1971. In 1971 you had a lot more support from the people you were going to control, and, if you are going to have opposition to controls from the very group of people you are going to try to control, they are going to fight it every step of the way. So you are going to have even more difficulties than we had that time; and at that time the outcome was not very promising.

Second, I would diagnose the fundamental inflation problem as one of changes in modern industrial economies, and the basic industrial structure of them, which is a permanent, longrun problem.

Inflation is not something that has been with us for a few years, that we solved once and can make it go away again. Controls can be used for a short period of time, and then people find a way to get around them. Then Government bureaucrats make mistakes.

It is awfully damned hard to figure out what the right wage or price should be, and we do begin over time to distort the structure, and we get involved in shortages and black markets and things like that. So you run into a lot of difficulties.

Third, as I mentioned earlier, the tax incentive program has some administrative problems, but controls have even more administrative

problems. Just trying to measure price increases is not an easy thing. They change the quality of the product, and they introduce new products, and how do you link them?

So there are an amazing number of administrative difficulties in trying to keep track of what people are doing that we don't believe we can solve. I don't think we could find a way, in effect, to really administer price controls.

Wage controls raises lots of political problems. If people thought Washington, D.C., was going to determine wages, then the whole game would shift here. It would be a negotiation between labor groups and the Federal Government, and I don't think that is a good trend.

Representative BOLLING. In effect, the last thing that you didn't say, but implied it, is that you really corrupt the society if you propose to have controls over a long period of time.

The incentive is to find a way around the controls, and when that is compounded by the economic distortion and inevitable failure of administration—not overall failure, but partial failure of administration—you tend to force the society to corrupt itself.

I think that probably almost surely happened in World War II, but nobody has made that study, and I don't know that the material would be available now if you wanted to.

Mr. BOSWORTH. We know that black markets became quite a problem in World War II. We know they are quite a problem in other countries that do have price controls. You simply substitute standing in a longer line for a higher price.

Representative BOLLING. Then a similar problem, the program we have been trying to get through the Congress on energy is obviously very inflationary. The argument is made by some who oppose that program that we ought to have rationing. I will leave out the standby.

What is the relationship between rationing as an instrument of price control?

Mr. BOSWORTH. It is a system of price controls, using something other than the price mechanism to try to allocate resources. I think, if we had another oil embargo, we could make a case for rationing. In a very short period of time of an embargo, you don't like to use prices alone to determine who is going to get a scarce commodity. But over a long period of time you have to worry about allocating.

Representative BOLLING. The same set of problems.

Mr. BOSWORTH. Yes, you'd have the same set of problems as in price control.

Representative BOLLING. You discussed the impact of regulation and the administration of regulations on the economy. I suppose it is really too late to make it worthwhile to raise the question. But, has a thorough look been taken at the different approaches that are always possible in dealing with similar situations, the environmental situation overall? You can approach it by regulation, or you can approach it by incentives or disincentives.

Has any serious work been done on that, a comparison of the approaches?

Mr. BOSWORTH. There are some academic studies, particularly in the pollution abatement area, which put forth specific proposals about how incentive programs, for example, a tax program, would actually work.

It is not feasible in all cases. If you pursue either approach to the extreme, you can get situations in which neither will work. But I think

we should place much greater reliance on incentives. We have current ones. One that we are debating right now is air rights, and it's a big mess.

In areas where they do not meet the standards, you have to sell off the rights. How do you do that?

It is like owning land. If you have the right to build a plant in an area, the pollution right is the same thing as owning land. The policy has been to give it away to first come, first served; 20 years from now, it is something like \$50 billion in rights.

Representative BOLLING. \$50 billion?

Mr. BOSWORTH. Yes. Now, you are going to hand those out by administrative needs? I think that route is fraught with corruption and the potential for scandal. Who is going to get it first?

If in a city you want to come to you can afford to build only one plant, what plant is going to be built?

We know of a situation where somebody wants to build a steel plant. In order to do that, you need a public utility to supply more energy. You can't build both. Right now the public utility has the air rights, but if you don't build the steel plant, you don't get the public utility. But if the steel company got the air rights, they wouldn't have power to run their plant. Are you going to let EPA hand them out to whomever—

Representative BOLLING. After we find a saint to administer it.

Mr. BOSWORTH. Yes; and since you won't find a saint to administer it, I worry about the potential implications of such systems.

Why don't we set up a market? You could sell off these air rights. You could take them to the highest bidder, the industry that needs it the most. You can have local authorities, if you like, planning the direction they want to go, but you can't hand these things out willy-nilly, first come, first served.

They are going to have an enormous impact on regional distribution of industrial production in this country.

Representative Bolling. Thank you.

One of the things that worried me about deceleration in the beginning was that it seemed too simple.

Mr. BOSWORTH. It hasn't been simple.

Representative BOLLING. I know it hasn't been simple in terms of your relationship to it, but isn't it as you implied—and I don't have any desire to put words in your mouth—but I think you implied in some of the discussion, isn't it so simple that it has, in effect, left the question where it is almost inevitable that the people who get the highest wage increases continue to get them. The people who have the most market power over prices continue to have whatever you want to call it, the most market power. Is there some modification or variation that would be better?

Mr. BOSWORTH. Well, to tell you how we arrive at it, what we were originally after was some way to have an objective on the price side. If you go back to the 1960 guideposts, for example, they were just a standard for wages. On the price side they didn't say anything. Business passed through cost increases. A concept of cost passthrough, we think, is very inflationary. The businessman can raise his prices with no incentive to hold down on costs, and particularly no incentive to improve productivity.

So what we were after was a standard of price behavior independent of that. We obviously couldn't go through industry by industry and just pull a standard out of a hat, because every industry has different rates of productivity increases and different rates of cost increases.

What we did instead was to go back to the last 2 years of stable economic recovery, 1976 and 1977, where you could see the dependence on energy price increases and on labor costs, et cetera. So the way to arrive at a reasonably sound price increase for individual industries was to use the average of the last 2 years as a starting point.

We could have used a longer time, but we didn't want to take 1975 because that was a recession year, and we didn't want to go back before the oil embargo because it didn't reflect the differences between industries and the importance of fuel supply.

So we said that the price increases in 1978 relative to the averages of the past 2 years was not an unreasonable industry-by-industry standard.

The problem comes up, as you point out, on the labor side. Deceleration makes no sense, applied on a wage-by-wage basis, because it says the guys who have been getting 10 percent wage increases get 9.5 or 9 percent, and people who have been getting 2 percent get 1 or 1.5 percent.

We modified that. We said, "No; what we seek on the wage side is that realistically there must be much greater deceleration by those people who have been getting wage increases above the average."

So, in recent months we haven't really done or said anything about people whose wage increases have been below the average.

We have been seeking to bring the people with large wage increases back in line with what everybody else is getting. That means the major union round of negotiations. It means the industries in the large industrial core of the economy which are highly concentrated with not much competition. In many cases they have trade restrictions to make sure that they don't have to face up to foreign competition, and the regulated sector of the economy has the ICC and that type of regulation.

We focused on those wage increases, to bring them back in line with the average. Somehow or other we have to bring these disparate wage increases back in line. We cannot continue the trend of the last half decade, which is the enormous disparity in terms of increases in wages. Some groups are getting 10 percent more a year, and others almost nothing. It will give you a dual economy.

Representative BOLLING. Don't we already have a dual economy?

Mr. BOSWORTH. I think to some extent it has gotten to the point where the relative wage differentials—

Representative BOLLING. We also have an economy beneath the regular economy which must be related to the people we lose in the census and the number of people working off book. I don't know anything about it.

Mr. BOSWORTH. That is a different thing. The distinction you can make today is between income gains in the so-called noncompetitive industrial area compared to the wage gains in the more competitive sectors. Look, for example, at a steelworker compared to an apparel worker. The steelworker has had 10 percent a year, and the apparel workers are down around 3 or 4 percent a year.

Representative BOLLING. You picked an interesting industry, because, if that is an industry that is not competitive abroad——

Mr. BOSWORTH. Which one?

Representative BOLLING. Steel.

Mr. BOSWORTH. But it is protected from competition.

Representative BOLLING. But you get all these skews and they are multiplied by other skews, and the inability to compete with other countries' steel production. It is not only unreal, it is "unsane."

I am certainly not blaming it on you. I have been around a lot longer than you have, and I am probably more at fault than you are. But I want to pursue two aspects of this. Since 1971, there has been a doubling in the automatic effect, because I understand that 60 percent of workers covered by major labor contracts have an automatic cost-of-living clause today, where in 1971 there were only 28 percent.

I don't know how those figures come out in bodies, in numbers, but they must be relatively close to double.

Now, that situation has gotten substantially worse, and this merely substantiates the point that you have been making, but how do we deal with it?

Mr. BOSWORTH. Well, first of all, on the cost-of-living contracts, I think you can argue that two ways. One is that you can't expect workers to sign 3-year contracts today for small wage increases just because somebody tells them, "Well, the Government is going to lower the rate of inflation."

I have heard that line before, and the Government hasn't done it before. There are two conditions workers need: One is to get protection from inflation. If they don't, they will just assume that the rate of inflation will not come down, and they will negotiate a 10-percent fixed wage increase. That is what is happening in the cement industry, the petroleum industry, and the paper industry.

At least the cost-of-living escalator gives rise to the possibility that, if inflation moderates, so will the wage increases. But the problem we face is that the extent of this coverage is very uneven. Some workers have it, and some don't, and by pure accident in 1973-74, when nobody anticipated those fuel price increases, those workers who had cost-of-living escalators saw their wage increases carried up into the double-digit level, while other people were held down to the historical rate of wage increases they had been receiving.

That opened up a big difference between wage increases that continues today.

So, I feel two ways about cost-of-living escalators. To some extent they can be helpful because, if you are moderating prices, wages will come down in steps. On the other hand, if inflation accelerates, they add to the problems, because they force the wages up as prices go up and keep the spiral going.

I think the more important problem is that some have them and some do not. Under that situation we are developing a spread in the wage structure that others are trying to catch up to.

Representative BOLLING. One more question for me.

What about the case of setting specific guides such as those of President Kennedy, which is applicable to today's conditions?

Mr. BOSWORTH. I think there are elements of the 1960 guideposts that are applicable today. If you take the 2-percent growth, and some

adjustment for the cost of living, it might work. If we want to get the rate of inflation down, however, you can't get 100 percent compensation for the cost of living, because that keeps everything going up.

But some of the very best escalators in labor contracts call for about 80 percent of compensation. Under that, you can derive a general wage standard that takes account of productivity growth, makes an allowance for inflation, but says we want to get it down so we won't go the full amount of the past rate of inflation. You could put out a guidebook.

The difficulty we have is that there could be no exception to that standard if we put it out. Think of the conflict you are going to run into in the major unions. They are getting 10 percent and we would be putting out a number that, if we did it, would be close to the average rate of wage increases, somewhere around 7 or 8 percent. So this protected group opposes such an idea.

Representative BOLLING. Thank you very much.

Senator McGovern.

Senator McGOVERN. One further question on wage and price controls.

Mr. Gordon Ganule said the other day that every public survey he has seen in recent years shows the clear majority of the American people favor wage and price controls.

That, of course, puts the majority of the public in opposition to what I gather the strong majority of the professional economists, and most of us in politics think, but I have thought more and more in the last year or so that everything else we have talked about in terms of controlling inflation turns out not to work very well.

With all due respect to the points that have been made about the shortcomings of the 1971-72 period when we were under wage and price controls, and some of the corruption that developed in the Korean war and during World War II, it seems to me a pretty good case can be made that they weren't failures entirely, that, on balance, they accomplished more in protecting the American consumer and stabilizing the American economy than anything else that was proposed as an alternative.

What is your reaction to the recommendations of Mr. Galbraith and others, and studies made for this committee by economists, indicating that you might have greater success with wage and price controls if they were confined to the so-called monopoly industries, the larger, more concentrated industries?

It strikes me that that kind of system might have some merit.

Mr. BOSWORTH. Well, I think part of it is that people always favor controls in the abstract, but before you put them in, they assume they are going to apply to somebody else. The support falls off quite rapidly when controls are in.

I do tend to agree that controls were not a complete failure in 1971 or 1972. The circumstances changed so dramatically. They were put in in an economy with excess capacity and administered price inflation. Then you had a commodity food shortage that drove up prices. So they were outrun by events.

I guess I can understand the frustration and, quite frankly, I have never heard an economist who ever convinced me that he had a solution to the inflation problem. I think it does lie with the institutional structure of a modern industrial economy.

We are not that competitive anymore, but we obviously can't go back being a competitive society of small farmers either.

The difficulties I have with controls is that I believe inflation is a long-term problem, and I don't see how the controls can be applied any longer than a short period of time before you find out that the bureaucracy of the Federal Government would do just as bad a job as the bureaucracy of big business and big unions.

Senator MCGOVERN. The motives are certainly different.

Mr. BOSWORTH. I think everybody has good motives.

Senator MCGOVERN. I am not sure they do. I think you have a situation today where you have great concentrations of economic power in corporate board rooms where the fundamental objective is to maximize profits. That is not necessarily an evil impulse, but it certainly ought to be different than the impulse of the public servant whose purpose ought to be to protect the public, and not to maximize profit.

Can't we find people who are fair enough in terms of recognizing that industry and labor are entitled to a fair run, but also the public is entitled to something?

Why is it so difficult to find people to administer a program of wage and price controls equitably?

Mr. BOSWORTH. Partly, I think, because fairness is in the eye of the beholder.

If we had a universal definition of fairness, that would be all right, but we don't. If you set prices too low, there would be no expansion and you'd have shortages. What would you do then?

Senator MCGOVERN. We could make adjustments. If you have a board that is setting wage and price controls, presumably changes could be made. There are changes made by the industry price setters, too. Maybe they lose their jobs if they make too many mistakes. The same thing could happen to people in the Government.

Representative BOLLING. Would the Senator yield?

My own experience has been that very fine people do what everybody does. They get a vested interest in their own thing, and very fine people in the Government do the same thing that people in industry and labor do. They get so committed to their own mistakes that they are in concrete, and the dilemma is, and I think perhaps this point is proved by those who still tend to favor wage and price controls.

Most of them in the economic field are people who worked with that at one time or other, and I think they naturally feel that they did a good job, and there is nothing wrong with that. Even Mr. Nixon was involved in that.

Senator MCGOVERN. I always thought that was one of the more sensible things he did. [Laughter.]

Representative BOLLING. Relatively speaking.

Senator MCGOVERN. That is correct. [Laughter.] I don't see the evidence that it was a failure. I think there may have been some failure in the—

Mr. BOSWORTH. But even when the controls were put on in 1971 and 1972, people said, "These are temporary, and we are going to work to structural changes so that in the future we don't have inflation problems." And then when they were asked, "What structural changes?"—they came up empty-handed.

Certainly, if those controls had continued a couple more years in a relatively smooth world, they would have run into some distortion

problems. In retrospect, we can look at industries today where we have problems, and we see their problems started in that period of controls.

The aluminum industry was one. Today we have a capacity shortage. You can't correct that easily. You must remember that the decision to build a new plant takes 10 years from the time they decide to do it until the time that the plant is operating. It is not that easy to correct the mistakes. We can't make a mistake and correct it today and tomorrow the costs are gone.

Instead, you set off very long-term trends. You held down food prices, as you were pointing out, in 1973, and it turned out to be very costly.

Representative BOLLING. We are about to run out of time in any event.

I want to express my gratitude to you, Mr. Bosworth. I have enjoyed this session as I have enjoyed few dealing with this subject.

With that, we will recess the hearing of the committee, to reconvene in a minute or two.

[A brief recess was taken.]

Representative BOLLING. The committee will be in order.

Our Joint Economic Committee hearing on the subject of inflation continues with a very distinguished panel of experts, Mr. Robert Gordon and Mr. Joseph Pechman have provided excellent counsel and guidance for the committee in the past, and Mr. Seidman's innovative ideas on inflation control will, I am sure, cause us to seek his assistance again in the future.

The Joint Economic Committee wants to stop inflation, but wants to do this without slowing the growth in production and employment. What we want from you quite simply is the magic formula for accomplishing this miracle.

Specifically, we would value your counsel on the following issue. Can we control inflation without excessive monetary and fiscal restraints? Is the President's deceleration program adequate and is it workable, and will a tax-based incomes policy succeed in slowing inflation, and can such a program be designed in such a way that makes it politically feasible and acceptable?

If we can't stop inflation, which is the impression I have been getting from recent hearings, should we try to make it less painful and destructive on indexing?

Before I go on, I will say that I will have to leave somewhat early. If Congressman Long is here, he will preside. I also have Mr. Dernburg of the staff to take the Chair.

I will now ask you to begin your testimony. Let us proceed in alphabetical order. Mr. Gordon, will you please begin.

**STATEMENT OF ROBERT J. GORDON, PROFESSOR OF ECONOMICS,
NORTHWESTERN UNIVERSITY, AND RESEARCH ASSOCIATE,
NATIONAL BUREAU OF ECONOMIC RESEARCH**

Mr. GORDON. Thank you.

It is a pleasure to be here. My approach takes a general view of what is wrong; and what the problem is.

The acceleration of inflation during the last half of 1978 has made a mockery not just of the administration's own forecasts, but all the private forecasters who make their living from making predictions.

I looked at a forecast made only 3 months ago which said that the CPI would grow at 6 percent in the second quarter, in contrast to the 9 percent which in fact occurred. It is a situation reminiscent of 1973 in that much of the problem is an unexpected rise in food prices. If you break down the CPI at an annual rate between November and May, an 8.9 percent total rate of inflation would have been 7.5 percent if food prices had grown at the average of all the commodities. But that 7.5 inflation of nonfood items still represents an acceleration of a full percentage point versus the year prior to last November.

So you see we have had an acceleration which is not due just to food problems.

Now, the inflationary surprise in 1978 highlights two unfavorable structural changes that have taken place in the economy in the last 5 years, one of which is well known and one of which has received little comment.

The first, which has received little comment, and which is little understood, is the longrun price deterioration in the price performance of the food industry. Between 1947 and 1971 food prices went up at a rate one-fourth slower than nonfood prices, but since 1971 up through May 1978 food prices have gone up 50 percent faster than nonfood prices.

Now, the second structural change is much better known, and Mr. Bosworth referred to it this morning, and that is that long-term productivity growth has slowed far more than anyone would have imagined 2 years ago.

From 1972 to 1978 productivity grew fully a full percentage point slower than it had in the previous 15 years. The implications of this are dire and serious. First of all, it means a given rate of wage rate translates into faster price increases. It means the economy is growing slower, and Federal revenues will grow more slowly.

Finally, it explains a reversal, which is quite surprising to me. Since last summer I thought, looking at the future over the next 2 years, we were likely to run into a shortage of plant capacity before we ran into a shortage of skilled workers. In fact, production has grown slowly over the last year and employment has grown by leaps and bounds. As a result we are closer to a shortage of skilled workers and there has been virtually no change in capacity utilization.

In normal business cycle recoveries industrial production grows about three times as fast as employment. In this past year, industrial production has crept ahead of employment by only a hair. This is a sign of the peculiar nature of this recovery, and also a sign of the slowdown in productivity growth to which I referred earlier.

Now, why is the United States stuck with such an inflation problem which not only fails to improve on schedule, but grows worse? I will refer in passing to the fact that Germany and Japan, since 1975, seem to have been able to solve a problem which we have failed to solve, and I think one way to focus our question on future policy is to ask: What are their secrets?

One standard answer is to start out and say that everything is due to overexpansive aggregate demand policy. That is. Federal deficits have been too high and monetary growth has been too rapid. This is too easy an answer to the puzzle.

If low unemployment in the late 1960's and again in 1973 are responsible for getting us into this mess, and responsible for the acceleration

of inflation, then why did high unemployment for 1975 and 1977 not slow inflation down? In fact, we had 31 straight months when unemployment was above 7 percent, and yet there was no permanent deceleration of inflation during that period.

Well, my answer is that prices are determined by two blades of scissors, not just demand, but also supply. The demand forces determine the growth in total spending, total dollar GNP. Supply forces determine how that is divided between inflation and changes in real output.

When we look back over the last 5 years, we have had exactly a 10-percent annual growth in total spending; that is, total dollar GNP has grown at a 10-percent rate per year for 5 years on average.

How has that been divided up between real output growth and inflation? All we have achieved is 2.4 percent real output growth. The remainder has gone in higher prices. So the great dilemma of anti-inflation policy is not only that the average division between output and prices has been so unfavorable, but the short-run impact of slowing down spending tends to fall heavily on output with very little response in prices.

If we had a different supply system in which a 100-percent slowdown in spending went into prices, then a cure for inflation would be a breeze. It could be handled entirely by the Federal Reserve.

The supply process in the United States is crucial, not only in designing an inflationary policy, but in understanding disagreements among economists. Inflation would be purely a demand problem, and monetarists would be right, if 100 percent of any slowdown in expenditure went into a slowdown in prices, but monetarists would not be right if zero percent went into a slowdown in prices and all went into a slowdown of real output and employment.

Now, supply forces; that is, all the things that determine how much businessmen charge to produce a given amount of output, and how much workers insist on to go to work instead of striking, those supply forces give us a partial answer to the puzzle I pose. That is, why did inflation accelerate, but then refuse to slow down?

We have had a continuous increase in the cost of production due to things other than just excessive aggregate demand. These were relatively minor before 1972, and have become very important since then. So let's enumerate the sources of what I call supply shifts or supply shocks in order to understand what has happened and try to see how we might counteract them, or design favorable supply shifts instead of having to put up with negative supply shifts.

I have four categories, the first of which is taxes. Increases in tax rates raise the wedge between the price the consumer pays at the supermarket and the amount of money that is left over out of total purchases for workers to take home after all taxes and deductions have been paid; this includes the sales tax, excise and customs duties, payroll taxes, corporate income taxes, and personal income taxes.

Now, these things don't all have the same effect on prices. Empirical research indicates that sales taxes which directly affect prices, as well as customs duties and payroll taxes, have a bigger effect on the price level than the corporate income tax or the personal income tax.

We have had major increases in payroll taxes, as we all know, in the last decade, which are a major culprit in continuing to push up the rate of inflation, both when we had excessive demand and when we had in-

sufficient demand. The most important tax of all was the OPEC price increase which had exactly the same effect. It takes out money which the consumer pays, but is not available to the worker to take home in terms of aftertax income.

The second category is price-raising legislation. Here I noted some omissions in Mr. Bosworth's catechism—all the things the present administration has done to raise prices. We have a large number of candidates for criticism in this category, ranging from farm price supports, environmental legislation, the OSHA situation, and if we have an energy plan which terminates price controls on oil, that would be price-raising legislation, although as I will point out later such legislation has beneficial side effects that make it desirable in any case.

Mr. Edward Denison, Mr. Pechman's colleague at Brookings, has quantified part of this type of legislation. He claims that environmental, occupational, and health legislation, plus the rise in crime in the United States, taken together by 1975, will reduce our long-term productivity growth rate by a full half a percentage point. In other words, half the mystery which you posed as a question to Mr. Bosworth earlier is in the area of Government regulations.

Now, of course, this also means that if we have a continuous increase in wages, firms are going to have to raise prices faster than without that legislation, because their workers are increasing their output at a slower rate.

Something else is obvious also, and that is that if workers continue to demand higher wage increases, in a way they are casting their vote, saying that environmental and safety legislation is not giving them a payoff that is worth the cost to the employer.

Someone should ask Gallup and Harris to run a poll to find out how much people are willing to pay on their automobiles, on their steel, on everything that they buy in order to have the high level of environmental quality which we are enjoying now compared to a decade ago.

Next we have, as the third category, the consequences of the depreciating dollar. This doesn't just raise the price of imported goods, but contributes to rises in farm prices, because farm products are exported, and Germans can buy more American products when the dollar appreciates and that raises the demand for farm products.

Also competing goods go up in price. One knows if Datsun and Toyota raise prices, the Ford Pinto and the Chevette can't be far behind.

Finally, we have labor market institutions which are a problem which has received very little attention, although I notice in his discussion Mr. Bosworth kept coming back to these institutions. The major difference between the United States and other countries is our 3-year wage accounts with staggered expiration dates. If we had 1-year contracts with a common expiration date, there would be room for a deal as happens in some countries between the unions and the central banks.

Unions could be told: "You cooperate and you can have your jobs; but if you don't cooperate, you lose them." And we will make this decision all at one time.

Of course, now no single union has anything to gain by moderation. Prices are being pushed up continuously. A wage slow-down by any

single union will have only a negligible effect on the cost of living. This unfortunate feature of U.S. labor markets helps to explain how other countries have achieved greater success in holding down the inflation rate. Demand growth has been translated into more moderate price increases in these countries.

While debates on anti-inflation policy always start out with monetary growth and the Federal budget, I would put this in a category of solutions which hold little promise for dealing with the inflation problem if we rely on them alone.

With the unexpected decline in unemployment over the past year and the sluggishness in growth and GNP, certainly caution is advised.

On the monetary side, a delicate balance must be maintained in order to sustain modest real output growth without an actual recession, a task made more difficult by the contradictory signals that have been given out by the rapid growth in M-1 and the sluggish growth in M-2 over the past half year.

I found in a study that M-2 was a much better predictor of spending growth than M-1 than in the 1970's, and so the excessive concentration in the media on M-1 might force the Fed into more restriction than is desirable.

There are more solutions which lack promise, but, first, I would like to make a couple of comments on the Federal deficit which, despite postponement of the administration's tax cut program and the reduction of its size, still, according to the most recent calculations I have seen, leaves us with an increase in the full-employment deficit in 1979 as compared to 1978.

In the first place, the full-employment deficit is severely understated, because it is calculated on the assumption that we can achieve a 4.9% employment rate and that potential output is faster than it is. So the figures in terms of budget projections for next year are unrealistic.

In contrast, I think it would be desirable to have a steady shrinkage in the full-employment deficit, to help encourage a shift in capital market funds toward investment.

More important for fiscal policy, however, is the composition of that expenditure and those taxes. Are they the kind of expenditure which deal with our employment and inflation problems? Are they the kind of taxes which can raise prices, or those which tend to have a smaller effect on prices? Those are the important things to be considered, and we will get back to those in terms of the recommendations.

First, let's look at two proposals, one of the great interest in this morning's testimony, to curing or helping to deal with the inflation problem, and that is, first of all, jawboning; and, second of all, tax-based income policy. Attempting to slow down inflation with jawboning is like trying to hold back a tidal wave with a toothpick.

Unions have every incentive to try to achieve higher wage increases in the next negotiations, not lower rates. Wage claims are being pushed up by Government measures, payroll tax increases, increases in the minimum wage, farm price supports and import restrictions as well as by the rapid reduction of unemployment itself, which increases labor's bargaining power.

Because of the U.S. system of staggered long-term wage contracts, no one union or labor group will be willing to be a sacrificial lamb to help out in the struggle of the administration's jawboning effort. Tax-

based incomes policy has been of great interest to some of the members of this committee and staff, and certainly some of the people sitting at this table, but so far the economics profession shows no indication to jump on the band wagon.

If you think about the plan that Mr. Seidman is going to tell you about in some detail, on the one hand, the firms that have already negotiated wage increases would find that they would have an increase in their taxes, and they would try to recoup some of this by higher prices. The tax wedge could be raised, and would lead to faster inflation. At best, there would be no impact.

In the second place, those firms that are currently negotiating and trying to resist the unions are going to find themselves faced with the greater likelihood of strikes, because the unions have no incentives. All the penalty or reward goes to the employer.

Finally, I think if prices don't go up as a result of these increased taxes which will surely come as a result of the penalties, we would have a decline in investment, something which we scarcely need now in light of the productivity problem.

The alternative would be to bribe workers with tax rebates. This would achieve some moderation, I think, particularly in the low-wage workers who fall within the ceiling, but remember that any kind of carrot scheme or any kind of bribe to workers costs Federal money, and I ask as my simple reaction to this idea, why not spend the Federal money where we know it will do good in holding down inflation; that is, postponing or holding down payroll tax increases?

There are areas that hold promise. I will mention some that are politically feasible and others that are politically more controversial.

In the first place, the scheduled increases in the minimum wage scheduled for January 1979 and January 1980 should be postponed. Better yet, we should have a two-tier system of minimum wages which exempts workers under a certain age.

The administration seems to have lost the favor of the unions anyway, so why not take this time when George Meany is mad at the administration to push through something George Meany despises, and that is a two-tier minimum wage.

The second proposal is that scheduled increases in social security taxes be postponed. I believe that the total is \$16 billion in social security taxes, which are scheduled now for 1980 as opposed to 1978. Rather than just postponing them, better yet would be to shift the funding of some major portion of the social security system into general revenues. This is based on the results of research, which is not definitive, but suggests that payroll taxes have a greater impact on prices than personal income taxes.

So why not just lessen inflationary cuts in taxes?

Third, I think we should have more discussion, something to his credit, that Mr. Okun proposed back in the era of the oil increase, that we should bribe States to cut their State sales taxes. We know those are taxes which have an immediate impact on the consumer price index, and would benefit the inflation process doubly, because holding down the CPI holds down wages through the cost-of-living escalators.

Next, we have the problem of environmental protection and occupational and safety administration, and I think here the comments made earlier this morning about bureaucracy are very apt. I think that bu-

reaucrats in these agencies have to promulgate some rulings in order to extend and maintain their own power base, with very little place for the American people to come in and say how much of this price-raising regulation they really want.

The politicians should realize that interference in the price system through higher taxes or minimum wages don't involve taking money from Peter to pay Paul. That is, we lose because there is a tax situation that interferes with the freedom of workers and prices.

Low income levels and inadequate steel attainments could be a factor with income supplements or negative income tax and manpower training programs.

I have gone on too long, and let me stress the last section of the prepared statement. All of the measures I am suggesting deal with inflation through the supply side, and will take time to have an effect. They will have only a gradual effect.

As prices are lowered, it takes waiting for the next wage negotiations for those price reductions to get into wages.

We will have to live with a high rate of inflation for a long time, and there are a number of things that the Government should be doing. I said the same thing in the summer of 1971. To help this economy live with inflation, and particularly the small savers and the people who stand to lose the most, we should have index tax brackets and exemptions, as in Canada. We should exempt from taxation capital gains due to inflation, and the interest income on that portion of interest rate which is due to inflation.

We should not allow people to deduct from their income tax the portion of the interest rate they pay on their borrowings, which is due to inflation, and as well, the Government should issue an index bond. These measures, taken together, will not cure inflation, but they would cause dramatic increases in the funds available for productive investment and would end some of the distortions that contribute to inflation and have sapped the Nation's potential for growth in the last 5 years.

Representative LONG [presiding]. Thank you.

[The prepared statement of Mr. Gordon follows:]

PREPARED STATEMENT OF ROBERT J. GORDON

Aggregate Supply and the Inflation Process

Another inflationary surprise

The acceleration of inflation during the first half of 1978 has made a mockery of earlier forecasts not just of Administration economists, but of all the private forecasters who make their living from their predictions. As recently as three months ago, one of the leading private firms forecast an increase in the CPI in the second quarter at an annual rate of just 6 percent, in contrast to the 10.4 percent rate which actually occurred between February and May.

The recent surprise is reminiscent of 1973, in that much of the problem stems from an unexpected upsurge in food prices. The 8.9 annual rate of increase in the CPI in the six months through May would have been a more moderate 7.5 percent if food price increases had equaled the average of other goods and services. But even this lower figure represents an acceleration from the 6.4 percent rate for non-food items observed during the preceding year.

The inflation surprise of 1978 highlights two unfavorable structural changes which have come about in the past decade. First, the notorious volatility of food prices is well known, as is the lamentable inability of even the best private forecasting firms to predict their twists and turns. Less noticed is a long-term deterioration in the price performance of the food industry, including both farmers

and the farm-to-market chain: between 1947 and 1971 food prices increased at a rate about one-quarter slower than nonfood prices. But from 1971 through the present, food prices have risen 50 percent faster than nonfood prices.

The second long-term structural change is better known. The over-all rate of long-term productivity growth in the U.S. has slowed down in recent years more than anyone had imagined would occur. The productivity growth rate in the period since 1972 has fallen a full percentage point short of the rate experienced in the decade and a half prior to 1972. This means that any given rate of wage increase translates into faster increases in labor cost and prices, and that the growth rate of potential real GNP is slower than previously thought. The rapid decline in unemployment during the past 12 months, a period during which the annual growth rate of actual real GNP has been only 4.4 percent, is the counterpart of the inflationary deterioration of America's productivity performance.

Lagging productivity has created another surprise. A year ago it looked as if the present expansion might run into bottlenecks of industrial capacity before any labor shortages emerged.

But in the last year industrial production has barely grown faster than employment, in contrast to the 1970-73 expansion when industrial production grew at a rate three times faster than employment. As a result, we find ourselves with unemployment rates for skilled workers which have fallen close to the tightness zone, while capacity utilization has barely changed since last summer.

Sources of the present inflation: Demand and supply

Why is the U.S. economy stuck with such an intractable inflation problem, which not only fails to improve on schedule, but has actually grown worse? The standard answer is to blame overexpansionary aggregate demand policy: federal deficits which are too high, and money supply growth rates which are too rapid. But this too-easy answer presents a puzzle: if low unemployment rates in 1966-69 and 1973 caused inflation to accelerate, why did high unemployment rates in 1975-77 not contribute to a marked deceleration in inflation? Why, after 31 straight months of unemployment above 7 percent, did we fail to achieve a permanent deceleration of inflation?

The answer is that prices are determined by two blades of a scissors, not just demand but also supply. Demand forces determine how fast total spending can rise.

But supply forces determines how that spending growth is divided between inflation and increases in real GNP. Only by studying the supply side can we understand why the 10.0 annual rate of nominal GNP growth achieved by demand expansion over the past five years have been translated into only 2.4 percent annual growth in real output, leaving 7.6 percent remaining as the average rate of inflation.¹

The great dilemma of anti-inflation policy is not only that the average division between output and prices has been so unfavorable, but that the short-run impact of any attempt to slow down demand growth tends to be a decline in output with very little response of prices. With a different supply mechanism, in which 100 percent of any expenditure change was immediately reflected in prices, the ending of inflation would be a breeze and could be handled entirely by an expenditure slowdown.

An understanding of the peculiarities of the supply process in the U.S. is crucial not only in designing an effective anti-inflationary policy, but also in assessing disagreements among economists. Monetarists who claim that inflation is a demand problem whose only solution is slower monetary growth would be absolutely right if 100 percent of expenditure changes went directly into prices, but not if zero percent went into prices and 100 percent into output changes. It is the lack of responsiveness of price change to monetary tightness and other demand measures which make the monetarist prescription inadequate and forces consideration of supplemental measures.

The role of supply forces provides an answer to the puzzle posed earlier—why did low unemployment in 1966-69 and 1973 cause inflation to speed up, yet high unemployment in 1975-77 fail to achieve a deceleration? The answer is that adverse supply forces worked continuously and independently of demand policy to push up the inflation rate, with a relatively minor contribution in the late 1960s and a very major contribution since 1972. If we begin by enumerating these sources of "supply shift," which have raised the price level independently

¹ Annual compound growth rates between 1973: Q2 and 1978: Q2.

of demand pressure, we can simultaneously identify the anti-inflation measures which will make a contribution under present circumstances, and those which will not be effective. All of the following are adverse supply factors which raise the aggregate price level which firms and workers require to be willing to produce a given level of real GNP:

1. *Taxes.* An increase in any tax rate inserts an additional "wedge" between the price the consumer pays to the firm, and the amount the firm has left over to contribute to the take-home pay of workers. Sales, excise, payroll, corporate income, and personal income taxes, as well as customs duties, are all part of the "tax wedge". Empirical research suggests that indirect sales, excise, customs, and payroll taxes have a greater impact on consumer prices than direct income taxes, and also isolates payroll tax increases over the past decade as a major source of upward pressure on the overall price level. The increase in oil prices achieved by the OPEC cartel was, however, the most important single "tax" imposed on the U.S. consumer.

2. *Price-raising legislation.* Under this category fall numerous measures—arm price supports, environmental protection, OSHA, and the minimum wage. The termination of oil price controls, which previously held down prices, as proposed in recent energy legislation, falls into this category. Edward Denison has estimated that environmental, occupational, and health legislation, together with a worsening of the crime problem, contributed by 1975 about half a percentage point of the slowdown in secular productivity growth.

3. The *depreciation of the dollar* raises the prices of imports and many exports, especially farm products, but also boosts the prices of closely competitive goods. When Datsun and Toyota are forced by the cheaper dollar to raise prices, one knows that the Chevette and Ford Pinto will not be far behind. The effective exchange rate of the dollar has declined by fully 6 percent in the past year, adding an additional source of the inflationary surprise of 1978.

4. *Labor-market Institutions.* A major difference between the U.S. and some other countries is our institution in many industries of three-year labor contracts with staggered expiration dates. If we had one-year contracts with a common expiration date, there would be room for a "deal" between the unions and the Federal Reserve—a direct trade of jobs for a wage deceleration. But now, no one union has anything to gain by moderation. Prices are being pushed up by all of the previous agreements, which set a standard for emulation, and a wage hold-down by any single union will have only a negligible effect on its own cost of living. This unfortunate feature of U.S. labor markets helps to explain why other countries, particularly Japan and Germany, have achieved greater success in slowing down their inflation rate. Monetary tightness and slow demand growth have been translated into more moderate wage and price increases to a greater extent in those countries than in the U.S.

Proposed solutions which lack promise

Debates on anti-inflation policy always begin with monetary growth and the Federal budget. With the unexpected decline in unemployment over the past year, and the corresponding sluggishness of growth in potential GNP, caution is advised. On the monetary side a delicate balance must be maintained in order to sustain modest real output growth without an actual recession, a task which is being made even more difficult by the contradictory signals being given by rapid growth in M1 and sluggish growth in M2 over the past half-year. During the 1970's M2 has been a more reliable predictor of GNP than M1, leading to concern that the current excessive concentration on M1 will cause too much restriction.

Current administration proposals will lead to an increase in 1979 in an already excessive (and understated) full-employment Federal deficit, rather than the steady shrinkage in that deficit which is appropriate at this stage in the business cycle, and which is desirable to help shift capital market funds toward fixed investment. Even more important is the composition of expenditure and tax changes which are approved; below we shall outline an agenda of changes which not only are anti-inflationary in impact, but which will help people live more comfortably with the inflation which remains.

Many economists have expressed an endorsement of, or at least an interest in, either jawboning or tax-based incomes policy as potential solutions to the inflation dilemma. Attempting to slow down inflation with jawboning, however, is like trying to hold back a tidal wave with a toothpick. Unions have every incentive to try to achieve higher rates of wage increase in the next round of negotiations, not lower rates as the Administration is trying unrealistically to achieve. Wage

claims are being pushed up by government measures, particularly payroll tax increases, minimum wage boosts, farm price supports, and import restrictions, as well as by the rapid reduction in unemployment itself. Because of the U.S. system of staggered long-term wage contracts, no one union or labor group will be willing to be a sacrificial lamb and to suffer a reduction in its real income to help out a struggling Administration jawboning effort.

Tax-based incomes policy (TIP) has been of great interest to some members of this committee and its staff, but so far the economics profession has shown no inclination to jump on the TIP bandwagon. One version of TIP, the Wallich-Weintraub plan, would tax firms which negotiated wage increases above some norm. This would raise the "tax wedge" and lead to faster inflation as firms attempted to recoup lost net profits. At best there would be no impact. The Okun alternative would bribe workers through tax rebates to accept lower wage increases. This would achieve some moderation, particularly among the low-wage workers who fall beneath Okun's ceiling and find it to their advantage to accept his offer, but only at the expense of monstrous administrative problems and an increase in the Federal deficit. The money spent on Okun's scheme could be much better used to reduce payroll taxes, and my guess is that the impact on inflation per Federal budget dollar would be considerably greater with a payroll tax reduction. Further, the staggered nature of U.S. wage contracts might cause the scheme to boomerang. Coal miners and others who have already achieved high wage increases would suffer major increases in income taxes if penalties were imposed for above-norm wage increases; the miners might then try at the next round to recoup the unexpected loss in real after-tax income.

Solutions which hold promise

The U.S. inflation problem has been aggravated by adverse supply shifts. Government policy should henceforth devote its main thrust to creating favorable supply shifts which reduce the tax wedge between market prices and after-tax labor income. Most obvious of these shifts would be postponement of scheduled increases in the minimum wage and in payroll taxes. Present Administration plans to cut personal income taxes should be redrafted to channel the funds to the payroll tax, which most research shows to have a greater impact on inflation.

The use of growing Federal income tax revenues to bribe states to cut their sales taxes, rather than using the same dollars to cut Federal income tax rates, should be given much more active consideration. Further, politicians should realize that the bureaucracies at EPA and OSHA have developed a life of their own and have begun to promulgate tough rulings in order to extend and solidify their own power base. They will have to be forced by Congress to tone down their goals and postpone their timetables. Gallup and Harris should be asked to poll the American people on environmental, safety, and health legislation—is it worth continuing to increase the tightness of regulations at the cost of slower productivity growth, slower output growth, and faster inflation?

Politicians should realize that interference in the price system through higher taxes or minimum wages does not just involve taking money from Peter to pay Paul, but imposes on both Peter and Paul a so-called "dead-weight loss." That is, society loses just because there is a tax or regulation which interferes with the free workings of the price system. If the problem is inadequate income for farmers, or for workers who have low skill levels, there are better solutions than inflationary wages and price supports. Low income levels and inadequate skill attainments can be attacked directly with income supplements, a negative income tax, and manpower training programs, none of which have the same direct price-raising impact.

International events influence domestic inflation. The failure to pass energy legislation has contributed to the decline in the dollar in the past year. Those Congressmen trying to protect the American consumer by opposing increases in domestic energy prices to the world level have in effect robbed the American consumer by forcing him to pay the higher prices of imports and goods competing with imports as a result of the depreciation of the dollar. Attempts to patch up the U.S. trade problem by imposing tariffs or quotas on goods other than oil have also contributed to inflation by raising domestic prices.

Living with inflation through government reforms

The philosophy stressed here is to encourage favorable shifts in supply. As they take effect, the growth of the money supply and of aggregate demand can be slowed. But this approach will moderate inflation only gradually. In the meantime the American economy needs a host of reform measures to help it "live with

inflation," and to counteract the adverse effects of inflation which sap consumers incomes and which distort investment and saving decisions. Tax exemptions and brackets should be indexed to the CPI, as in Canada. The government should issue an indexed bond to help small savers keep up with inflation. Illusory capital gains due to inflation should be exempt from taxation, a far more constructive proposal than the present hatchet-like movement to cut capital-gains taxes across the board. Savers should be exempt from taxation on the inflation component of their nominal interest return, and borrowers should not be allowed to deduct the inflation component or their interest payments. These measures, taken together, would cause a dramatic increase in the funds available for productive investment, and would end some of the distortions which have contributed to inflation and sapped the nation's potential for growth in the past five years.

Representative LONG. Mr. Pechman.

STATEMENT OF JOSEPH A. PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Mr. PECHMAN. I will also summarize my prepared statement, Congressman.

Representative LONG. Without objection, your prepared statement will also be made part of the record.

Mr. PECHMAN. Recently, the Brookings Institution had a meeting of its panel on economic activity, at which both of these gentlemen, Mr. Robert Gordon and Mr. Lawrence Seidman, were present. The meeting provided a thorough review of anti-inflation policies and gave a great deal of prominence to some of the things Mr. Gordon has said on the supply side: In addition it provided what was, I think the first thorough discussion of tax-based incomes policies, which had been sadly missing, until now.

I have a copy of the published volume. I know the staff is familiar with it, and I hope they will at least read the summary by the editors, Mr. Arthur Okun and Mr. George Perry, who did a very good job in organizing and chairing the meeting.

I am very sympathetic to the idea of incomes policies. I wish I could be enthusiastic about tax-based incomes policies because they seem, at least in theory, to provide a solution which voluntary or other means don't seem to give. However, I am a tax expert, and I view tax proposals very seriously when they are recommended.

After having my arm twisted by my colleagues at Brookings and by Mr. Seidman, I regret to say that I have concluded that tax policies of this kind are not practical, and I urge Congress to look at them carefully before adopting them.

As Mr. Gordon said, there are two types of proposals. There is a penalty and a carrot approach. The penalty approach is exemplified by the Wallich-Weintraub proposal, which would provide for an increase in the corporate tax rate or some other penalty for firms that give higher than average or guideline wage increases to employees.

Mr. Okun recognizes that it is very difficult to apply penalties of this sort, and so he has turned it around and suggested, "why not reward people if they do the right thing?"

I must say that Mr. Okun's proposal is attractive, but on reflection it turns out to be quite impractical. The members of the Brookings panel, in distinguishing between the two approaches, concluded that the penalty approach is more practical than the carrot approach, and I will say more about that later.

Let me go to the specific problems: First, coverage. I leafed through the various Statistics of Income provided by the Internal Revenue Service for the year 1975, and found that there are at least 13 million employing entities in this country. Most of those entities are very small: Farmers, small businessmen, corner grocers, druggists, and so on. It is very difficult for me to imagine a policy which would apply penalties or, for that matter, carrots on the basis of average, or changes, in average wages.

Aside from keeping records, which might be a burden on those people, the fact of the matter is that employment in many of these firms is episodic. I doubt whether you would want to differentiate between small businesses which have very substantial changes in the composition of their labor force over the period of a year, and because of these changes would have changes in average wage rates that have absolutely no relationship to the changes in the wage rates that are given to a particular employee. For example, suppose the corner drugstore replaces a couple of teenage youngsters who work part time with a full-time worker who is much more qualified to do the work in that drugstore. You might find that even though that particular worker did not get any more than a 6-percent increase over his earnings in the prior year in another firm, the average wage increase for this particular firm turned out to be higher than 6 percent.

I don't think anybody would ever want to penalize such a firm or would want to deny it a subsidy.

For that reason, under the carrot approach, you would have to give the subsidy to all of the small businesses right off the bat. Under the penalty approach, you probably would want to simply exempt most of the firms in the United States and limit your tax-based incomes policy to the top 500 or 1,000 or 2,000 firms. The authors of the penalty approach recognize this, and I think they still would support the penalty approach on this ground alone.

Now, another thing that my economist friends, who are nontax experts, fail to appreciate is that the economic unit that bargains for or makes deals with employers on wages is very different from the tax-paying unit that appears on tax returns.

What you would have to do is somehow make rules which would permit the employer to translate what he does in practice in the wage field onto a tax return. To give you an example, suppose you have a multiproduct firm with offices and subsidiary corporations located all over the country.

This firm now files a consolidated return. In many cases the large firms also file consolidated returns with branches and with subsidiaries abroad. Let's omit the foreign employment problem, which is tough enough, but let's think about the executives of this firm trying to decide what its policy would be with respect to wages in the year 1979 if the tax-based incomes policy were to be put into effect for that year.

It would have to know or evaluate what the prospects for wage changes are in every one of the myriad of categories that it has, and somehow or other make a decision as to whether it will or will not be able to resist wage increases or provide lower wage increases under a carrot approach with respect to all these particular units. Frankly, I just don't see how this can be done, and if businessmen do come to

Congress and say that they would be overinvolved by the problem, I think they are right.

Now, Mr. Okun compounds the problem. I think it is bad enough to do it retrospectively after the year is over and the firm has all the records, but Mr. Okun's plan is prospective. He would ask all employers to make a decision with respect to wages in the calendar year 1979 in the month or months right before 1979 opens. I am not talking about the problem of simply reporting man-hours, which I think for these particular firms would be surmountable.

I know of no large firm that would be able to come to an agreement or to some sort of understanding with all of the trade unions that it negotiates with in such a short period. I regret to say that my friends have not come to grips with this particular practical problem.

I also would like to add the fact that there are some difficult problems even if the business managers feel they could somehow make such decisions. In a complex dynamic economy, many changes occur during a particular year which make comparisons of anything about the firm from year to year extremely difficult and hazardous. This is called in tax language "The excess profits tax problem."

We have had a number of excess profit taxes in the United States during wartime. We confine it to wartime, because most people agree that an excess profits tax is very difficult. The fact of the matter is that every time we have tried to compare profits during a particular year with profits in some sort of base period, Congress has recognized the fact that changes occur which have nothing to do with the particular tax purpose, and therefore they provide alternative methods of calculating excess profits.

There are numerous mergers and spinoffs, and what-have-you. I don't think the Congress is ready to consider all of the problems that would arise if you wanted to tax as normal wage increases or provide subsidies to below-normal wage increases.

I give an example in my prepared statement. Some economists have suggested that, with new firms, you could use as a base the average earnings in particular occupations as estimated by the Department of Labor. I doubt that anybody would accept the rather gross statistics that the Bureau of Labor Statistics have on average wages. They could not possibly be applied to any one firm in this country for purposes of taxation.

Finally, with respect to the timing of either the penalty or the subsidy, obviously the subsidy would be prospective, and I have already indicated the problems there. The penalty would be retrospective, and there I think the problem is that most firms, if they are asked about this, I could really say that there might be too many prices at the end of the year that would subject them to penalties which they did not expect.

For example, it is conceivable that a firm—suppose the guideline is 6 percent—after the year is over finds that its average wage has risen above the 6-percent guideline, and yet every employee in the firm got wage increases of 6 percent or less. That can occur because the firm happened to employ during that year relatively more high wage workers than it did the prior year. I can assure you that, if that ever happened, this firm, and others like it, would be coming to Congress for a relief provision simply to prevent an injustice from being done.

In brief, excess profits taxation is difficult, and that is why it is limited to wartime situations.

In conclusion, while I am sympathetic to the objective of these policies, I would like to caution the Congress that it is a difficult approach, and in my view has not been thought out well enough to be implemented within the foreseeable future.

Thank you.

Representative LONG. Thank you very much, Mr. Pechman.
[The prepared statement of Mr. Pechman follows:]

PREPARED STATEMENT OF JOSEPH A. PECHMAN¹

Problems of Implementing Tax-Based Incomes Policies

As inflation has become more and more serious, it has become fashionable to talk about tax-based incomes policies as a possible device to moderate it. I am very sympathetic to the idea of an incomes policy, but I find it difficult to see how a tax-based incomes policy can be implemented. The problems were thoroughly explored at the April 1978 meeting of the Brookings Panel of Economic Activity. I urge the committee to review the papers and proceedings of this conference (Brookings Papers on Economic Activity, 2: 1978). My remarks this morning are based on a comment I made at the conference.

Coverage

About 13 million firms filed federal tax returns in 1975, including 10.9 million sole proprietorships, 1.1 million partnerships, and 2.0 corporations. In addition, there were 0.5 million returns of nonprofit organizations and over 78,000 governmental units. Most of the business firms had no employees, many report no net income, and all but a relatively small number of large businesses keep personnel records. Yet, if a tax penalty or tax subsidy is to be designed, the law must be explicit about how every one of these units is to be treated.

A penalty would be easier to administer than a subsidy, because it would be possible to limit the penalty to large firms. But this should not be meant to imply that the problems of a penalty can be overlooked. As I shall indicate below, I am not persuaded that it is feasible to measure average wage changes for all economic units in a manner that would be satisfactory for a tax-based wage penalty or subsidy.

As for the subsidy approach, I assume that we would not ask the average farmer, or the average corner drugstore owner, or most self-employed professionals who have a few employees, to report manhours on a tax return. Moreover, with only a few employees, many firms might be denied a subsidy if they happened to shift to higher paid workers. To avoid the problems that the small firms would have, the wage subsidy would probably be given to all employees in such establishments and to the owners of these establishments as well. This is not fatal for the wage subsidy plan on administrative grounds, but it would mean that a substantial fraction, if not a majority, of all workers would get the subsidy whether they conformed with the wage guideline or not.

The economic unit

The unit for tax accounting purposes is a legal entity which, in our complex economy, often bears little relationship to the unit which enters into wage bargains with their employees. Large corporations generally file consolidated returns that include the operating results of many, but not necessarily, all of their subsidiaries. So far as wages are concerned, the branches or subsidiaries of a large firm in this country often bear no relationship to one another or to the parent firm. Accordingly, the rules would have to be flexible enough to permit the unit of calculation to be relevant to the wage setting process. Under wage controls, the business firms themselves made this decision and I assume the control agency could modify that decision if it was deemed necessary. But for purposes of a wage subsidy or penalty, definite rules would have to be set out either in the legislation or in the regulations so that labor and management knew exactly what wage bargains they were dealing with. However, I am not aware of any usable guides on how such rules can be written.

¹ Director of economic studies, the Brookings Institution. The views expressed are my own and do not reflect those of the officers, trustees, and other staff members of the Brookings Institution.

It would be necessary to prescribe other rules to make inter-year wage comparisons for new firms, mergers, spinoffs, sales of facilities, changes in product mix, and other types of abnormal situations in which the wage data would not accurately reflect changes in average wages. This is what is referred to in tax language as "the excess profits tax problem": that is, the problem of estimating the tax base when it depends upon events and conditions in two or more adjacent years. The decisions made for the excess profits taxes in the United States were the subject of extensive and time-consuming litigation every time the tax was used, and no one on the government or the business side was ever satisfied. I can imagine a set of arbitrary rules that economists or tax administrators might agree to, but Congress would find it difficult to accept such rules. (One example: it has been suggested that, for new firms, a base year wage structure might be constructed from averages for other firms in the same industry. But the only data of this type that do exist are those of the Bureau of Labor Statistics and they could not possibly be applied to a particular firm.) In the end, the legislation would be complex and, like the excess profits tax, would impose unforeseen costs on business which would lead to further legislation and litigation to moderate such costs.

Timing of penalty or subsidy

From an administrative or compliance standpoint, it would be much easier to impose a penalty or provide a subsidy after the end of the accounting period. If the proposal is for a penalty based on profits it should be possible to rely on the business firms to take the penalty into account in its wage decisions.

Just the opposite is true for a subsidy to workers accepting a wage increase below the guideline percentage. To appeal to workers to accept the constraint, the subsidy must be prospective and must be incorporated in the current tax withholding tables so that the workers will have immediate tangible evidence that their disposable income will not be impaired by the policy. (Two sets of withholding tables would be required, but this is only a minor complication compared to others.)

The basic problem is that labor and management would find it extremely difficult to incorporate a prospective subsidy in their wage bargaining and, incidentally, to come to an agreement in a few weeks before the beginning of each year. Unless the bargaining unit were coterminous with the unit for determining the subsidy, no worker or group of workers would know whether the deal they made will actually trigger the subsidy until negotiations are completed with the other bargaining units in the same firm. Management would have the same problems: how can it be sure that the construction workers will accept a wage increase that, together with the agreement with coal miners, will trigger a subsidy to both groups?

I conclude that a retrospective penalty on profits based on wage changes is feasible. For prospective subsidies to workers, there are numerous pitfalls and I frankly do not see how they can overcome to the satisfaction of labor and management.

Prices

The original tax-based incomes policies were to increase profits taxes of firms with excessive wage increases, so that prices were not involved at all. Others have suggested that, to be even handed, it would be necessary to provide penalties against firms with above average price increases. Unfortunately, any kind of tax penalty or subsidy that depends upon a change in average prices of particular firms is simply impractical. All of the problems of constructing price indexes would emerge—treatment of new products, quality change, measurement of costs to be passed through, etc.—and there is really no solution to most of them. I leave it to the Committee to judge whether a tax-based incomes policy can be applied to wages and not to prices.

Controls versus tax-based incomes policies

I believe it is not productive to argue whether tax-based incomes policies are another form of controls or not. The question is which approach is feasible, and what are their relative costs.

It is true that a tax-based incomes policy can be disregarded by any firm and its workers if they wish. But the rules and regulations must be written to be sure that all economic units in the country understand them and make their decisions accordingly. Even if it is agreed that some of the rules must be arbitrary, I doubt that it will be possible to arrive at such arbitrary rules through the tax legislative process as we know it today.

Under controls, Congress avoids the hard decisions and lets the controlling agency make the arbitrary rules. One reason controls seem to be more acceptable than tax penalties or subsidies is that relatively few firms are ever involved in disputes under controls, whereas a tax penalty or a subsidy would apply to all or a large number of firms and the perceived hardships and disputes will be numerous. Both devices lead to capricious results, but I am at a loss to understand why their proponents believe that tax-based incomes policies would be more acceptable to labor, management, the public and Congress.

Representative LONG. Mr. Seidman.

STATEMENT OF LAURENCE S. SEIDMAN, ASSISTANT PROFESSOR OF ECONOMICS, THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Mr. SEIDMAN. Congressman Long, in the interest of time I will be reading only part of my prepared statement.

During the past 4 years I have been engaged in research concerning the theory and design of a tax-based incomes policy (TIP). I recently presented a paper on tax-based incomes policies at the Brookings conference devoted to that subject.

The aim of TIP is not to place blame on labor or business, but to permanently restructure financial incentives so that the outcome is best for the public, labor, and business.

I offer this package tentatively to serve as a concrete starting point, and as a basis for my analysis this morning. The TIP package consists of three parts: Wages, prices, and profits. I will consider each in turn.

When I say wages, I really mean compensation, including salaries, fringe benefits, and executive pay. Incidentally, I mean the salaries of university professors, as well as the wages of factory workers. Economic theory, econometric evidence and commonsense all strongly support the conclusion that a smaller wage increase, and therefore a smaller unit cost increase, will result in a smaller price increase.

Today, the average annual wage increase is 8 percent, but because the trend growth rate of productivity-out per man-hour is only 2 percent—and varies little from this figure—the average unit cost increase is 6 percent. Our basic inflation rate, therefore, is 6 percent.

The best way to predict the inflation rate is to observe the average wage settlement and subtract 2 percent for the productivity growth rate.

The only way to bring the inflation rate down to zero percent is to stop the advance of unit labor costs by gradually reducing the growth rate of wages from its current 8 percent down to 2 percent, the growth rate of productivity.

Suppose TIP sets, as its initial target, a wage inflation rate of 6 percent—instead of the current 8 percent—and a price inflation rate of 4 percent, instead of the current 6 percent. Then TIP might consist of the following two incentives.

The first, employer incentive. A firm that grants a wage increase in excess of 6 percent would receive a surcharge on its income tax for that year in proportion to the size of the excess. If it grants less than 6 percent, it would enjoy a proportionate tax cut. If it grants 6 percent, its tax rate would remain at the base; currently 48 percent for many corporations. For example, if a firm grants 7 percent, and

the TIP multiplier is 6, its tax rate would rise to 54 percent. If it grants 8 percent, its tax rate would rise to 60 percent.

The second, employee incentive. Employees at a firm that grants an average wage increase in excess of 6 percent would receive a tax increase for that year in proportion to the size of the excess. If the firm grants less than 6 percent, they would enjoy a proportionate tax cut. If it grants 6 percent, their tax rate would remain at the base. The penalty or reward would depend only on the average wage increase at the firm, so that individual promotion is not discouraged.

One method of implementing the employee incentive would be to use the income tax withholding system. If the firm grants a wage increase in excess of 6 percent, it would be required to raise the actual withholding rate, yet employees would only be credited the standard rate on their W-2 forms.

Symmetrically, if a firm grants less than 6 percent, it would be required to reduce the actual withholding rate, yet employees would be credited the standard rate on their W-2 forms. In this way, the incentive would be fully implemented by the employer, so that there is no additional compliance burden on individual employees. But on each paycheck, and on the W-2 form, employees would be informed of the TIP surcharge or credit, so they would know the penalty or reward that has resulted from the wage increase at the firm.

It is crucial to understand how these TIP incentives differ fundamentally from controls. For both incentives, the tax penalty for exceeding 6 percent must be stiff, but not prohibitive, for either the employer or employees. Where market forces, and the special conditions of the firm or industry, call for a relative wage increase, it is essential that the firm still be able to exceed 6 percent, though by less than it would have without TIP.

For example, suppose firm A faces a sharp rise in product demand, and thus a labor shortage, while firm B faces a decline in demand, and thus a labor surplus. Without TIP, A might grant 9 percent and B, 7 percent, for an average of 8 percent. With TIP, A might grant 7 percent, and B, 5 percent, for an average of 6 percent.

TIP would not replace the market forces working on each firm, and would not prevent the relative wage increase required by A to attract additional labor. Both A and B would be free to set their wage increase without having to seek regulatory approval.

Now contrast the situation of A and B under controls. Under controls, all firms would be prohibited from exceeding the wage target of 6 percent, unless a firm could prove to a regulatory board that it deserved special treatment. Under TIP, the employer and employees at firm A, through collective bargaining, would be free to set a 7-percent wage increase, and accept the tax penalty.

Under controls, the employer and employees at A would not be free to arrive at their own decision. They would have to submit their case to a regulatory board. Their collective bargaining agreement would in effect require Government approval.

The outcome would not depend on their own assessment of the particular situation in their industry, but on the assessment of a board reviewing a large volume of cases, a board which would therefore be far less informed about the merits of their case.

The appeal process under controls would be time consuming, costly, frustrating, and inefficient. TIP would entirely avoid this regulatory interference in collective bargaining decisions. It would preserve the freedom of business and labor at each firm to make their own decisions.

TIP differs from controls exactly as the investment tax credit and accelerated depreciation differ from Government controls over each firm's investment. Like these tax incentives, TIP would change the profitability of particular firm decisions. But each firm would be free to respond as it wishes, without seeking approval from regulators or regulations. The IRS would investigate a sample of firms according to its usual procedure.

Let me pause here to reply to Mr. Pechman's comments. I have great respect for him, and he has raised important and practical problems which require careful consideration. But we have to keep the practical problems in perspective.

Suppose today we were considering enacting for the first time an income tax on individuals and corporations. I have no doubt that if Mr. Pechman were assigned the task of assessing potential practical problems, he could leave us quite discouraged by asking the very same questions he asks concerning TIP. For example, who would be covered under the income tax? All individuals or households? All businesses? Could small businesses provide adequate records and be expected to comply.

How would business income be measured? Surely there should be an allowance for depreciation of capital, but there is no actual transaction. Rules would have to be developed for determining asset lives. Would only straight-line depreciation be allowed? Again, would we expect small business to comply?

For individuals, what about capital gains? When they accrue, or when realized? What about artificial gains due to inflation? Capital gains would depend on events in 2 adjacent years. What about the imputed rental income of home owners? For business, what would be the economic unit. For large conglomerate firms? How would subsidiaries be treated? What would be the timing of tax payment on the income tax? What about rules for withholding and estimated taxes? If there are underwithholdings, won't taxpayers object when they make up the difference? And so on.

My point is not that TIP is immune from difficulties. Rather, I am arguing that it would be premature to allow a listing of problems to prevent serious consideration. We must proceed to the next stage, drafting legislation, and attempting to write IRS regulations and circulate these to tax and collective bargaining experts.

Our income tax to this day has significant unsolved practical problems, and yet it has been the centerpiece of our tax system. The workability of TIP must not be judged against a mythical ideal tax, but against the other highly imperfect, yet tolerably, feasible taxes that now exist.

The above TIP package contains both an employer and employee incentive, and combines both penalty and reward. I want to emphasize that in my view the most crucial ingredient in the package is the income tax penalty on the employer, the original Weintraub-Wallich incentive. In a technical paper that will be appearing in the next issue

of the Brookings Papers on Economic Activity, I present the economic theory and econometric evidence that I believe leads to this conclusion. I will briefly summarize the central argument.

An employer can ignore the opportunity to earn a tax cut; and employees can ignore either the penalty or reward, provided the penalty is not prohibitive. An employer, however, cannot afford to ignore the imposition of a stiff tax surcharge on its income tax.

If the TIP package, together with proper monetary and fiscal policy, succeeds in reducing wage inflation to 6 percent, and price inflation to 4 percent, then the dividing line between penalty and reward under TIP should be lowered to 4 percent, and ultimately—after several years—to 2 percent, the average growth rate of labor productivity, and therefore the rate required to keep inflation near zero.

As disinflation steadily occurs, the unemployment rate can gradually be brought down perhaps to near 4 percent. Econometric evidence suggests that without TIP a 4-percent unemployment rate would cause wage and price inflation to gradually accelerate, so that 4 percent could not be maintained. With a permanent TIP, exerting permanent downward pressure on wage increases, it should be possible to keep wage increases equal to productivity growth at a 4-percent unemployment rate.

The monetary growth rate prescribed by monetarist economists would then be essential, on average, to maintain 4 percent unemployment and near zero percent inflation. It will be easier for the Federal Reserve to gradually reduce the monetary growth rate to its target if the full employment budget is brought approximately into balance, so that pressure on interest rates from fiscal policy is reduced.

At first glance, it might seem natural to suggest tax incentives for price increases, just as TIP provides tax incentives for wage increases. Tax incentives for price increases, however, are almost certainly administratively unfeasible. Most firms make a variety of products, with a variety of quality levels. It is extremely difficult to distinguish a price change from a quality change.

Fortunately, tax incentives on prices are unnecessary. As explained earlier, theory and evidence strongly suggest that prices are tied to unit costs, and a decline in the growth rate of unit costs will automatically bring down the growth rate of prices. Nevertheless, labor deserves insurance.

I would, therefore, suggest that "real wage insurance," first proposed by Mr. Okun in 1974, be included in the TIP package. Suppose wage inflation declines from 8 percent to 6 percent in the initial year under TIP, but price inflation declines from 6 percent to only 5 percent—although theory and evidence expect a decline to 4 percent—then Congress would authorize in advance compensatory tax cuts for employees to make up the difference.

These tax cuts could be varied with the wage increase at each firm, so that those who exercised greatest wage restraint would receive the largest tax cut. The expected cost to the Treasury of real wage insurance is zero, because the decline in price inflation should automatically match the decline in wage inflation. Nevertheless, it is important to guarantee protection. Real wage insurance should be enacted as part of the TIP package, so that the compensatory tax cuts would be assured in advance.

As in the case of prices, tax incentives for profit restraint at each firm would have harmful effects. The firm's incentive to improve its efficiency, from which consumers ultimately benefit, could be weakened by reducing the profit reward. The practical experience with the excess profits tax has not been encouraging.

Fortunately, as in the case of prices, tax incentives on profits are unnecessary. As long as price inflation stays approximately equal to unit labor cost inflation, the ratio of capital income to labor income must remain fairly constant. If price inflation declines 2 percent when unit labor cost inflation declines 2 percent, then unit profit inflation must decline 2 percent. Nevertheless, labor deserves insurance.

I would, therefore, suggest that the following proposal, offered by Mrs. Lawrence Klein and Vijaya Duggal of Wharton Econometric Forecasting Associates at the University of Pennsylvania, deserves careful consideration. According to their proposal, if the ratio of after-tax profit to labor income for the whole corporate sector rises above some threshold when wage inflation declines, then the base corporate tax rate can be raised equally for all firms to keep the ratio at the threshold for that year.

To reassure labor, this adjustment can be enacted in advance and made automatic. It should be emphasized that their proposal would not attempt to define and tax "excess" profit at each individual firm. Only the ratio for the whole corporate sector—or economy—would be of concern. Their proposal would, therefore, avoid the difficulties of past excess profit taxes.

In conclusion, I would recommend that a tax-based incomes policy should be adopted. TIP, together with monetary and fiscal restraint, can reduce inflation and unemployment simultaneously and permanently. Labor, business, and the general public would, therefore, all benefit greatly from TIP.

Thank you.

Representative LONG. Thank you for a provocative statement.

[The prepared statement of Mr. Seidman follows:]

PREPARED STATEMENT OF LAURENCE S. SEIDMAN

A Tax-Based Incomes Policy

My name is Larry Seidman. I am an Assistant Professor of Economics at the Wharton School, University of Pennsylvania. During the last four years, I have been engaged in research concerning the theory and design of a tax-based incomes policy [TIP]. I recently presented a paper on tax-based income policies at the Brookings Conference devoted to that subject.

This morning, I want to explain why I believe a tax-based incomes policy should be adopted, and offer specific suggestions for its design. A permanent tax-based incomes policy [TIP] complemented by proper monetary and fiscal policy, offers the prospect of permanently reducing both inflation and unemployment. Moreover, I believe it is the only policy that will enable us to reduce inflation and unemployment simultaneously. Labor, business, and the general public would therefore benefit greatly from a tax-based incomes policy.

TIP is fully compatible with our market economy, its institutions. In contrast to either persuasion or controls—the two traditional methods of incomes policy—TIP would harness the instrument that has proved its effectiveness in our market economy: financial incentives. Business and labor would remain free to bargain collectively, and weigh the particular features of their own situation against the TIP incentive, arriving at the wage and price decisions they regard as best, without government interference.

It must be emphasized that TIP does not seek to blame labor or business for inflation. Employees, or their unions, who seek higher wages and salaries to catch-up with inflation, to stay ahead of it, or to improve their standard of living, are simply reacting to protect their own self-interest, exactly as managements do when they seek profits. Since labor is responding to the same incentives that drive all economic agents in our economy, fault-finding is unjustified. Similarly, when business firms grant wage increases in excess of productivity increases, and pass the higher unit costs on to consumers through higher prices, they are protecting their own interest in response to the constraints they face. The aim of TIP is not to place blame on labor, or business, but to permanently restructure financial incentives so that the outcome is best for the public, labor, and business.

The logic of TIP can be simply explained. When the average firm grants, and its employees receive, a wage increase in excess of its productivity increase, the result is an increase in its unit cost, which the firm must cover by raising its price. This behavior imposes a cost on society in either of two forms. If monetary and fiscal policy accommodate such wage-price behavior, the social cost takes the form of inflation. If monetary and fiscal policy tries to combat such behavior, the social cost takes the form of unemployment and recession.

Yet today neither the employer nor employees have an incentive to take this external social cost into account when their own wage increase is set. Many economists would diagnose this as a standard "externality" problem, and therefore recommend the standard remedy: "internalize the externality." The employer and employees at each firm should bear a private cost whenever they impose a social cost, in the form of higher inflation or unemployment, on the rest of society. They should either incur a financial penalty, or forego a financial reward, when they engage in such behavior. The aim of TIP is to provide such a financial incentive.

Even advocates of TIP have not yet agreed on the best design. Today, I want to set out tentatively a TIP package that promises to restrain wages, prices, and profits. It combines elements from the original employer TIP, first proposed by Drs. Henry Wallich and Sidney Weintraub in 1971; and the recent employer-employee package suggested by Dr. Arthur Okun. Moreover, it contains specific guarantees and protections for labor concerning prices and profits, similar to those that have been offered by Dr. Okun, and Drs. Lawrence Klein and Vijaya Duggal, among others. I offer this package tentatively, to serve as a concrete starting point, and as a basis for my analysis this morning. The TIP package consists of three parts: wages, prices, and profits. I will consider each in turn.

WAGES

When I say "wages" I really mean compensation, including salaries, fringe benefits, and executive pay. Incidentally, I mean the salaries of university professors, as well as the wages of factory workers. Economic theory, econometric evidence, and common sense all strongly support the conclusion that a smaller wage increase, and therefore, a smaller unit cost increase, will result in a similar price increase. Today, the average annual wage increase is 8 percent; but because the trend growth rate of productivity-output per manhour—is only 2 percent (and varies little from this figure), the average unit cost increase is 6 percent. Our basic inflation rate, therefore, is 6 percent.

The best way to predict the inflation rate is to observe the average wage settlement and subtract 2 percent—the productivity growth rate. Table 1 shows that over the last thirty years in this country, in most years the inflation rate has been approximately equal to the difference between the average wage increase and the average productivity increase. For example, in the early 1960's, the average wage increase was 4 percent, the average productivity increase was 3 percent, and the inflation rate was 1 percent. This rule of thumb is one of the most stable empirical relationships in economics. There is no mystery about this. Every business must cover an increase in its unit cost by raising its price. Moreover, the degree of competition in each industry—whether high or low—establishes a specific relationship between unit cost, and the price firms charge, so that price and unit costs move together. Both theory and empirical evidence strongly reject the view that sustained price increases can occur without accompanying increases in unit labor costs. Today, unit labor costs are raising 6 percent per year, and therefore, so are prices. The only way to bring the inflation rate down to 0 percent is to stop the advance of unit labor costs, by gradually reducing the growth rate of wages from its current 8 percent down to 2 percent, the growth rate of productivity.

TABLE 1.—PRICE—UNIT LABOR COST RELATIONSHIP

[Percent change from the previous period]

Year	Output per hour	Compensation per hour	Unit labor costs	Implicit price deflator
1948	3.1	8.9	5.6	6.6
1949	3.6	3.1	- .5	1.0
1950	6.1	5.5	- .6	1.7
1951	2.4	8.8	6.3	6.8
1952	2.2	5.5	3.2	1.7
1953	2.1	5.7	3.6	2.2
1954	1.8	3.2	1.3	1.6
1955	3.4	3.5	.1	2.1
1956	- .3	5.9	6.2	3.2
1957	2.3	5.7	3.4	3.5
1958	3.1	3.7	.6	1.0
1959	3.2	4.6	1.3	2.2
1960	.7	3.9	3.2	1.6
1961	3.4	3.3	- .1	.8
1962	4.1	4.2	0	1.5
1963	3.1	3.6	.5	1.3
1964	3.6	4.8	1.2	1.3
1965	2.6	3.6	1.0	1.7
1966	3.1	6.2	3.0	2.8
1967	1.7	5.7	3.9	3.1
1968	2.6	7.4	4.7	4.1
1969	- .4	6.7	7.1	4.7
1970	.6	6.8	6.1	4.9
1971	3.4	6.8	3.3	4.7
1972	3.4	6.2	2.7	3.1
1973	2.0	7.8	5.7	4.2
1974	-2.4	9.5	12.2	10.1
1975 ¹	1.9	18.9	18.0	19.9

¹ Projected by Bureau of Labor Statistics.

Note: All data are for the private, nonfarm economy.

Source: Bureau of Labor Statistics, Department of Labor. Presented in table B-31 (p. 207), The Economic Report of the President, January 1976.

Suppose TIP sets as its initial target a wage inflation rate of 6 percent (instead of the current 8 percent), and a price inflation rate of 4 percent (instead of the current 6 percent). Then TIP might consist of the following two incentives.

(A) Employer incentive

A firm that grants a wage increase in excess of 6 percent would receive a surcharge on its income tax for that year in proportion to the size of the excess. If it grants less than 6 percent, it would enjoy a proportionate tax cut; if it grants 6 percent, its tax rate would remain at the base (currently 48 percent for many corporations). For example, if a firm grants 7 percent, and the TIP multiplier is 6, its tax rate would rise to 54 percent; if it grants 8 percent, its tax rate would rise to 60 percent.

(B) Employee incentive

Employees at a firm that grants an average wage increase in excess of 6 percent would receive a tax increase for that year in proportion to the size of the excess. If the firm grants less than 6 percent, they would enjoy a proportionate tax cut; if it grants 6 percent, their tax rate would remain at the base. The penalty or reward would depend only on the average wage increase at the firm, so that individual promotion is not discouraged.

One method of implementing the employee incentive would be to use the income tax withholding system. If the firm grants a wage increase in excess of 6 percent, it would be required to raise the actual withholding rate; yet employees would only be credited the standard rate on their W-2 forms. Symmetrically, if the firm grants less than 6 percent, it would be required to reduce the actual withholding rate; yet employees would be credited the standard rate on their W-2 forms. In this way, the incentive would be fully implemented by the employer, so that there is no additional compliance burden on individual employees. But on each paycheck, and on the W-2 form, employees would be informed of the TIP surcharge or credit, so they would know the penalty or reward that has resulted from the wage increase at the firm.

It is crucial to understand how these TIP incentives differ fundamentally from controls. For both incentives, the tax penalty for exceeding 6 percent must be

stiff, but not prohibitive, for either the employer or employees. Where market forces, and the special conditions of the firm or industry, call for a relative wage increase, it is essential that the firm still be able to exceed 6 percent, though by less than it would have without TIP.

For example, suppose firm A faces a sharp rise in product demand, and thus a labor shortage; while firm B faces a decline in demand, and thus a labor surplus. Without TIP, A might grant 9 percent, and B, 7 percent, for an average of 8 percent. With TIP, A might grant 7 percent, and B, 5 percent, for an average of 6 percent. TIP would not replace the market forces working on each firm, and would not prevent the relative wage increase required by A to attract additional labor. Both A and B would be free to set their wage increase without having to seek regulatory approval.

Now contrast the situation of A and B under controls. Under controls, all firms would be prohibited from exceeding the wage target of 6 percent, unless a firm could prove to a regulatory board that it deserved special treatment. Under TIP, the employer and employees at firm A, through collective bargaining, would be free to set a 7 percent wage increase, and accept the tax penalty. Under controls, the employer and employees at A would not be free to arrive at their own decision. They would have to submit their case to a regulatory board. Their collective bargaining agreement would in effect require government approval. The outcome would not depend on their own assessment of the particular situation in their industry, but on the assessment of a board reviewing a large volume of cases—a board which would therefore be far less informed about the merits of their case. The appeal process under controls would be time-consuming, costly, frustrating, and inefficient. TIP would entirely avoid this regulatory interference in collective bargaining decisions. It would preserve the freedom of business and labor at each firm to make their own decisions.

Dr. Henry Wallich, a respected conservative, has written:

"The essence of TIP is that it differs fundamentally from the usual kind of wage and price controls. Business and labor are free to bargain for any wage increase they choose. Only the weight of market forces is changed, with the tax doing the weighting."

TIP differs from controls exactly as the investment tax credit and accelerated depreciation differ from government controls over each firm's investment. Like these tax incentives, TIP would change the profitability of particular firm decisions. But each firm would be free to respond as it wishes, without seeking approval from regulators or regulations. The IRS would investigate a sample of firms according to its usual procedure.

TIP would complicate the tax code. But so do the investment tax credit and accelerated depreciation. For example, IRS must develop service lives for many classes of assets, often requiring arbitrary judgments. Businessmen clearly do not regard such tax incentives as controls. Despite their complexity, these incentives leave each firm free to make its own decisions. It cannot be over-emphasized that TIP is a tax incentive, to which firms can respond as they wish.

The practical difficulties of implementing TIP have nothing to do with controls, or the interference by government in the decisions of business and labor. Instead, they are exactly analogous to those encountered with accelerated depreciation. IRS must carefully draw up rules that firms must follow in computing their tax liability. Under TIP, IRS will have to define how the wage increase, including contributions to fringe benefits, is to be computed for tax purposes.

The most serious technical problems that have been raised against some versions of TIP can be completely avoided if TIP is properly designed. For example, the question has been raised: Whose estimate of the cost of a labor contract will be accepted? This problem, however, disappears if TIP is based on the labor expenses actually paid by the firm in a given year, rather than attempting to estimate what the negotiated contract implies. Tax liabilities are based on actual income earned, not on a forecast of prospective income. What must be grasped is that TIP is a tax incentive, and should be implemented according to standard principles of taxation, not according to the methods of controls.

Moreover, if a firm actually pays 9 percent more per manhour this year than last, it should not matter how much of this is the base wage, a cost-of-living adjustment, or a contribution to health or life insurance, or pensions. The important fact is that actual total labor expense per manhour has increased 9 percent; this is what counts for the firm's costs, pricing, and inflation, and is therefore the basis on which TIP should be computed.

The most valid objections have been raised against a TIP that would provide penalties or rewards based on prices or profit margins. These objections will be

reviewed later. A TIP that provides incentives for wages only avoids these problems. Later, I will show how prices and profits can be restrained effectively without direct tax incentives.

In summary, TIP differs fundamentally from controls. Indeed, in my view TIP is our best hope for avoiding controls.

The above TIP package contains both an employer and employee incentive, and combines both penalty and reward. I want to emphasize that in my view, the most crucial ingredient in the package is the income tax penalty on the employer—the original Weintraub-Wallich incentive. In a technical paper that will be appearing in the next issue of the *Brookings Papers on Economic Activity*, I present the economic theory and econometric evidence that I believe leads to this conclusion. I will briefly summarize the central argument.

An employer can ignore the opportunity to earn a tax cut; and employees can ignore either the penalty or reward, provided the penalty is not prohibitive. An employer, however, cannot afford to ignore the imposition of a stiff tax surcharge on its income tax. In the above TIP package, the employer incurs a tax penalty if he grants a wage increase above the 6 percent target. Suppose instead, under a reward-only TIP, he were offered a tax cut for reducing his wage increase below today's average of 8 percent—but his tax rate would remain 48 percent if he grants 8 percent or higher. It is possible that the opportunity for a tax cut will induce him to reduce his wage increase below 8 percent. But if he does not, he will be no worse off than he is today. It is therefore uncertain whether he will respond. Suppose under the penalty proposed in the above package, his tax rate would rise to 60 percent if he grants 8 percent (6 percentage points for each 1 percent excess). If he insists on granting 8, he will be significantly worse off.

In my view, there is significant econometric evidence that when the profit rate declines below normal, business firms grant below-normal wage increases, reflecting their reduced ability-to-pay. The income tax penalty would threaten a squeeze in after-tax profit if the firm grants the same wage increase. The evidence suggests that this threat would cause managements to stiffen their resistance and reduce the wage increase towards the target to avoid the potential after-tax profit squeeze.

It must be emphasized that if firms respond to the potential penalty by reducing the wage increase to the TIP target, their tax rate will remain unchanged, and no after-tax profit decline will actually occur. A central feature of the employer penalty TIP, in contrast to an increase in the ordinary corporate tax rate, is that it can threaten a profit squeeze if firms fail to respond; but will not cause an actual one if firms respond as expected.

In response to this argument, the following question can be raised: Is it possible that firms will ignore penalty-TIP, grants 8 percent, accept the tax increase, but pass on the higher tax cost to consumers through higher prices, thereby avoiding a decline in their after-tax profit? Let me explain why this possibility will not undermine penalty-TIP.

Since the tax penalty is on the income tax of the firm, in effect "IRS goes last." First, the firm raises its price, hoping to increase its before-tax profit enough to offset the TIP tax increase. Then, IRS taxes a fraction of this gross profit. If the TIP penalty multiplier is made stiff enough, the firm will be unable to avoid an after-tax profit decline if it grants 8 percent, no matter how great its market power. For example, if the TIP multiplier is 6, so that the firm's tax rate increases from 48 percent to 60 percent, the firm would have to be able to raise its before-tax profit by 30 percent to avoid a decline in after-tax profit (without TIP, the firm would keep 52 percent, which is 30 percent greater than the 40 percent it would keep under TIP if it grants 8 percent). If the multiplier were 13, so that the firm's tax rate increases from 48 percent to 74 percent, the firm would have to possess the ability to double its before-tax profit to avoid a decline in its after-tax profit (since it keeps 52 percent without TIP, but 26 percent with TIP if it grants 8 percent). Finally, if the TIP multiplier were 26, so that the firm's tax rate increases from 48 percent to 100 percent, it would be literally impossible for the firm, no matter how great its monopoly power, to avoid an after-tax profit squeeze if it grants 8 percent. Of course, so extreme a TIP multiplier is neither desirable nor necessary. The extreme example is given to illustrate that, regardless of the degree of oligopoly power of the firm, there is a TIP penalty stiff enough to force the firm to respond by reducing its wage increase.

Even if it is understood that raising prices cannot fully protect the firm, it may be asked: Won't firms try to cover part of the tax cost by raising price, and won't

this worsen inflation? The answer is as follows. As long as the average firm reduces its wage increase to the target, the average tax rate will remain at the base (today, 48 percent for most corporations), and there will be no tax increase to pass on. Suppose, pessimistically, that the average firm exceeds the target, and incurs a tax increase. The result will at worst be a one-time increase in the average firm's mark-up, and price. Once the price is adjusted to the higher tax rate, price will again follow unit labor cost. The pass-on can only occur once, because the tax rate will at worst only increase once. Thus, even under the worst scenario, penalty-TIP will soon permanently bring down the inflation rate.

Moreover, it is far from certain that firms can raise prices and before-tax profits significantly in response to TIP. Even under industry-wide collective bargaining, where the firms are large oligopolists, import competition may limit the ability to raise gross profit by raising price. It is therefore important that if TIP is introduced, firms clearly understand that the government will refuse to protect them from import competition if they ignore TIP, grant a wage increase above the target, and try to pass on the tax cost through higher prices.

The shifting problem just described will not undermine TIP if the penalty is on the income tax, because in effect, "IRS goes last," after the firm tries to raise its gross profit by raising price. If the penalty were on the payroll tax of the firm, in effect IRS would "go first," and the shifting problem would be more serious. After paying the tax, according to the size of its wage bill, the firm could then try to maintain its after-tax profit by raising price. There would be no guarantee that the firm would suffer an after-tax profit squeeze if it granted 8 percent.

The version of TIP that would disallow excess wages as a deduction when the firm computes its tax liability can be shown to be equivalent to a payroll tax surcharge. Because it is less vulnerable to the shifting problem, the income tax surcharge is preferable to the deduction disallowance.

In summary, the threat of an income tax penalty will force firms to respond by "digging in" at a lower wage increase in order to avoid an after-tax profit squeeze. Today, the average firm "digs in" at 8 percent. If the TIP target is 6 percent, the average firm will "dig in" with the same intensity at 6 percent.

The employer penalty is most readily applied to the private, profit sector. I would suggest, however, that the penalty should also be applied to large firms in the non-profit sector, such as universities, to the regulated sector, and to state and local governments. For the latter, general revenue sharing could be reduced the larger the wage increase. Both equity and efficiency require as broad a coverage for TIP as is consistent with administrative feasibility. In light of the cost of compliance and administration, small firms might be given the option of inclusion or exclusion from TIP.

Some of my colleagues who have suggested tax rewards, instead of penalties, agree with my conclusion that the employer income tax penalty is likely to be the strongest, and most reliable ingredient in a TIP package. They have settled for a tax reward because they fear that the patient will refuse to accept stronger medicine, and that you will not have the political courage to enact a tax penalty.

Our anti-inflation policy has suffered from an unwillingness to recommend anything that may be temporarily unpleasant to the patient. The result of this timidity has been that the disease has grown worse, and the patient feels worse than before. The time has come to recognize that the best medicine does not always taste best. It is understandable that the patient seeks to avoid unpleasant medicine. It is the responsibility of the physician, however, to prescribe what will work.

Your willingness to enact an employer tax penalty will not only provide the key ingredient for reducing inflation. It will do more to reduce the expectation of higher inflation than any other single action you can take. The public is justifiably alarmed when it observes political leaders and policy-makers "running for cover" when some one complains that he will refuse to consider any medicine with an unpleasant taste. What is required is a TIP package, containing penalties as well as rewards, together with monetary and fiscal restraint, to restore public confidence, reduce the expected inflation rate, and begin to wind down the actual inflation rate without subjecting the economy to a severe recession.

If the TIP package, together with proper monetary and fiscal policy, succeeds in reducing wage inflation to 6 percent, and price inflation to 4 percent, then the dividing line between penalty and reward under TIP should be lowered to 4 percent, and ultimately (after several years) to 2 percent, the average growth rate of labor productivity, and therefore, the rate required to keep inflation near zero.

As disinflation steadily occurs, the unemployment rate can gradually be brought down perhaps to near 4 percent. Econometric evidence suggests that without TIP,

a 4 percent unemployment rate would cause wage and price inflation to gradually accelerate, so that 4 percent could not be maintained. With a permanent TIP, exerting permanent downward pressure on wage increases, it should be possible to keep wage increases equal to productivity growth at a 4 percent unemployment rate.

My own analysis suggests that a permanent TIP would cause a significant structural change in the economy. TIP would permanently reduce the non-accelerating-inflation rate of unemployment (NAIRU) of the economy—from perhaps 6 percent to 4 percent. It would then become possible to run the economy at 4 percent, instead of 6 percent, without generating a rise in the inflation rate. This reduction in the NAIRU would yield large social benefits each year. According to Okun's Law (a 1 percent reduction in unemployment yields a 3 percent increase in real GNP), if the economy can be run at a 4 percent unemployment rate, real (inflation-adjusted) GNP, labor income, private investment, and profits, will all be 6 percent higher each year than if the unemployment rate were 6 percent.

The monetary growth rate prescribed by monetarist economists would then be essential, on average, to maintain 4 percent unemployment (the new NAIRU under TIP), and near 0 percent inflation. It will be easier for the Federal Reserve to gradually reduce the monetary growth rate to its target if the full employment budget is brought approximately into balance, so that pressure on interest rates from fiscal policy is reduced. Thus, TIP is a complement to, not a substitute for, responsible monetary and fiscal policy. Of course, periodic disturbances will move the economy away from its targets, and flexible, countercyclical monetary and fiscal policy will remain necessary. Nevertheless, a permanent TIP should significantly reduce the frequency, and degree, of stagflation in our economy.

Why can't we use monetary and fiscal discipline alone? Why must we also adopt TIP? Monetary and fiscal discipline, if applied long enough, and severely enough, can eventually cause enough unemployment and low profits to reduce wage increases, until cost increases, and therefore price increases. Those who advocate a balanced budget and slow monetary growth as a substitute for TIP seldom indicate, specifically, the process by which wage increases are eventually to be brought into line with productivity increases. They leave the impression that there is a mysterious link between such discipline, and prices firms set. But firms will raise prices as long as unit costs increase; and unit costs will increase as long as wage increases exceed productivity increases. So the issue becomes: How can we bring down the growth in wages?

Monetary and fiscal restraint, alone, can only do it in one way: By causing a severe enough recession. This is precisely the policy that was tried in 1974 and early 1975. Tight monetary and fiscal policy helped cause a sharp decline in aggregate demand, and the most severe recession since the 1930's. The impact on wage inflation, and therefore, price inflation, was meager. Wage inflation was reduced from just above 10 percent to 8 percent; therefore, price inflation declined no further than 6 percent. Despite the loss to our society of billions of dollars worth of output, the inflation rate declined only a few percentage points to 6 percent. Sole reliance on monetary and fiscal discipline is not a new approach waiting to be put to the test. It was just tried, with dismal results. Let advocates of discipline-only tell us what went wrong in 1974 when their experiment was attempted. How long, and severe, a recession do they recommend to bring down the inflation rate?

This traditional method of reducing wage inflation is indirect, ineffective, and enormously harmful. TIP provides a direct incentive to reduce wage increases, and therefore, cost increases and price increases, instead of relying on a severe recession to do it. Monetary and fiscal discipline are then required to reinforce TIP, so that its disinflation effect is permanent. It is true that TIP cannot succeed in the absence of monetary and fiscal restraint. But who asserts that it can? The real choice is between TIP plus monetary and fiscal restraint; vs. monetary and fiscal restraint alone. The choice is therefore between reducing inflation and unemployment together; vs. reducing inflation through high, prolonged unemployment.

Moreover, even if restraint, after years of recession, eventually brings down the inflation rate, it will not change the NAIRU—the unemployment rate required to keep the inflation rate from accelerating. We would have to accept an unemployment rate of 6 percent or higher to prevent a rise in the inflation rate. Thus, the traditional approach asks us to endure years of high unemployment to reduce inflation, and a permanent unemployment rate of perhaps 6 percent in order to maintain low inflation. In contrast, TIP offers the prospect of reducing the NAIRU perhaps to 4 percent. Thus, in the longer run, the choice is

between running the economy at a 4 percent unemployment rate without inflation, vs. running the economy at a 6 percent unemployment rate without inflation. TIP therefore deserves to be regarded as an anti-unemployment, as well as anti-inflation policy.

PRICES AND PROFITS

At first glance, it might seem natural to suggest tax incentives for price increases, just as TIP provides tax incentives for wage increases. Tax incentives for price increases, however, are almost certainly administratively unfeasible. Most firms make a variety of products, with a variety of quality levels. It is extremely difficult to distinguish a price change from a quality change.

The key practical distinction between wages and prices is that the manhour—the unit of labor input—is well defined, while the unit of output is not. To compute the wage, total compensation can be divided by total manhours, where the latter can in principle be measured unambiguously. Price is revenue per unit of fixed output; but the latter is not well defined. For example, support McDonald's keeps the nominal price of a Big Mac constant, but somewhat reduces the quantity of beef, while changing the sauce. Has the true price of a Big Mac increased? Similarly, suppose it keeps the quantity of beef the same, but improves its quality, and also improves the quality of the sauce. If it raises the nominal price of a Big Mac a dime, is this a price increase, or simply a quality improvement? If it were regarded as a price increase under a tax incentive, quality improvements would be discouraged.

Furthermore, a guidepost for prices is less justified than for wages. Although wage increases are not identical for all firms, most increases are not too far from the average, because labor mobility and perceptions of equity force most wage increases to stay close to the general pattern. Wide disparities in productivity change, however, across firms—caused by diverse rates of technological innovation and capital formation—cause wide disparities in unit cost changes, and therefore, price changes. Although the average price increased 6 percent in 1977, some prices were cut sharply, while others increased sharply. These disparities serve a vital function. They signal consumers where costs are falling, and where costs are rising, so that consumers are encouraged to shift towards products with falling costs, and away from products with rising costs.

Fortunately, tax incentives on prices are unnecessary. As explained earlier, theory and evidence strongly suggest that prices are tied to unit costs, and a decline in the growth rate of unit costs will automatically bring down the growth rate of prices. Nevertheless, labor deserves insurance. I would therefore suggest that "real wage insurance," first proposed by Dr. Okun in 1974, be included in the TIP package. Suppose wage inflation declines from 8 percent to 6 percent in the initial year under TIP, but price inflation declines from 6 percent to only 5 percent (although theory and evidence expect a decline to 4 percent). Then Congress would authorize in advance compensatory tax cuts for employees to make up the difference. These tax cuts could be integrated with employee-TIP, and implemented through withholding at each firm. Moreover, the withholding tax cut could be varied with the wage increase at each firm, so that those who exercised greatest wage restraint would receive the largest tax cut. The expected cost to the Treasury of real wage insurance is zero, because the decline in price inflation should automatically match the decline in wage inflation. Nevertheless, it is important to guarantee protection. Real wage insurance should be enacted as part of the TIP package, so that the compensatory tax cuts would be assured in advance.

As in the case of prices, tax incentives for profit restraint at each firm would have harmful effects. The firm's incentive to improve its efficiency, from which consumers ultimately benefit, could be weakened by reducing the profit reward. The practical experience with the excess profits tax has not been encouraging.

Fortunately, as in the case of prices, tax incentives on profits are unnecessary. As long as price inflation stays approximately equal to unit labor cost inflation, the ratio of capital income to labor income must remain fairly constant; if price inflation declines 2 percent when unit labor cost inflation declines 2 percent, then unit profit inflation must decline 2 percent. Nevertheless, labor deserves insurance. I would therefore suggest that the following proposal, offered by Drs. Lawrence Klein and Vijaya Duggal of Wharton Econometric Forecasting Associates at the University of Pennsylvania, deserves careful consideration. According to their proposal, if the ratio of after-tax profit to labor income for the whole corporate sector rises above some threshold when wage inflation declines, then the base corporate tax rate can be raised equally for all firms to keep the ratio at the threshold for that year. To reassure labor, this adjustment can be

enacted in advance and made automatic. It should be emphasized that their proposal would not attempt to define and tax "excess" profit at each individual firm. Only the ratio for the whole corporate sector (or economy) would be of concern. Their proposal would therefore avoid the difficulties of past excess profit taxes.

CONCLUSIONS AND RECOMMENDATIONS

(1) A tax-based incomes policy (TIP) should be adopted. TIP together with monetary and fiscal restraint can reduce inflation and unemployment simultaneously and permanently. Labor, business, and the general public would therefore all benefit greatly from TIP.

(2) TIP differs fundamentally from controls. It would harness the instrument that has proved its effectiveness in our market economy: financial incentives. It would leave business and labor free to make their own decisions without government interference.

(3) The employer and employees at a firm that grants a wage increase above the TIP target should both incur a tax penalty; the employer and employees at a firm that grants a wage increase below the target should both receive a tax reward. The tax penalties must be stiff, but not prohibitive. Where market forces, and the special conditions of the firm or industry, call for a relative wage increase, it is essential that the firm still be able to exceed the TIP target, though by less than it would have without TIP.

(4) The most crucial ingredient in the TIP package is the income tax penalty on the employer who grants a wage increase above the target. It is most likely to be effective. The best medicine does not always taste best.

(5) Although TIP focuses on wage increases, this does not mean that employees (or their unions) who seek wage increases in excess of productivity increases, or employers who grant such increases, should be blamed for inflation. Both labor and business are trying to protect their own position in response to the incentives they now confront. The aim of TIP is not to place blame, but to restructure incentives, so that the outcome is best for labor, business, and the public.

(6) Economic theory and econometric evidence strongly suggest that the price inflation rate approximately equals the wage inflation rate minus the productivity growth rate (2 percent). Thus, if TIP reduces the wage inflation rate gradually to 2 percent, it will automatically reduce the inflation rate to zero. Tax incentives for prices or profits are therefore unnecessary. Moreover, they would have harmful effects.

(7) Labor should be protected by "real wage insurance," which would guarantee automatic tax cuts for employees if the decline in price inflation fails to match the decline in wage inflation for the whole economy; and possibly by an automatic upward adjustment of the corporate income tax rate for all firms should profit inflation fail to decline with wage inflation.

(8) A permanent TIP may be able to reduce the non-accelerating-inflation rate of unemployment [NAIRU] of the economy. If so, it would be possible to run the economy at perhaps a 4 percent unemployment rate without causing a rise in the inflation rate. TIP should therefore be regarded as an anti-unemployment, as well as an anti-inflation policy.

Representative LONG. What is your thinking about the administrative feasibility of a plan such as this, Mr. Gordon?

Mr. GORDON. I would defer to Mr. Pechman on administrative details, since that is something he has done a lot of thinking about and I haven't. I would perhaps perform some service by emphasizing the points that he made that I think are the most important.

The first is the possibility of having a carrot or rewards scheme without giving it to everyone. Of course, the small firm will holler bloody murder if it isn't given a subsidy.

Second, the penalty schemes. I think those are perhaps imaginable if you do it after the fact, as he said. But then the horse is out the barn door, because as I emphasized in my statement, we are stuck with the 3-year wage contracts. That is a unique problem we have.

What good is it going to do if a firm finally figures out in 1980 that its wages went up too much in 1979 and it has to pay a big tax? It has

already negotiated its 10-percent wage increase, which Mr. Bosworth objected to so strongly. So what? All it is left with is a higher tax bill.

What is that going to do? Two things in some combination.

It will try to recoup that through higher prices, or the profits will be squeezed and will have an effect on investment. Using Mr. Seidman's own scheme and numbers, he makes the penalty sound pretty modest by giving an example of a firm which, with a 6-percent norm, actually negotiates a 7-percent agreement.

What happens with the coal mining firm that already is stuck with a 3-year agreement with a 10-percent average rate of wage increases? His corporate income tax goes up from 48 to 72 percent; 72 percent is a wartime type of confiscation, and it is bound to cause a crisis in coal mining or raise coal prices, and I suspect it would mainly raise coal prices.

I think this is something Mr. Seidman's scheme continually evades, because of a hope that when the coal miners come up next time and they see the poor struggling coal mining firm, which has been forced to pay a 72-percent tax rate the last time, they are going to feel sorry for it and they are going to be very modest.

They are going to be modest after the teamsters got 10 percent and the railroad workers got 10 percent and the auto workers got 10.5 percent? I don't think that is the way the world works.

The unions are looking at what the last guy got, and it is the staggered set of wage contracts. One guy expires in March and the next guy who expires in May is trying to get as much as the guy who expires in March. That is one of the reasons our inflation is so hard to slow down. It would create a revolution if Congress tried to do something about that.

That is where the heart of the problem lies, and we might as well put it on the table and begin to grapple with that. I hate to say this, because it is conventional in political circles. We always say we have big business and big labor, but the consequences of Mr. Bosworth's testimony this morning—his problem is big labor, finding a way to get labor to slow down its wage demands.

Mr. PECHMAN. I didn't know my friend, Mr. Gordon, had latent abilities as a tax expert. It is clear that his analytical abilities in these areas are very good.

I did want to respond to what Mr. Seidman said about the analogy between the tax-based incomes policy and the income tax. Unfortunately, the analogy is just not correct. The analogy should be to a tax based upon events that occurred in two different years, and that is a very different thing.

If you had asked me in 1913 whether the United States should introduce an excess income tax, I would have said "no," but I would have said that an income tax based on a single year would have been possible.

As I indicated before, in the case of excess profits taxation, we have done it during wartime and every time it was used, it was agreed that it was messy. The litigation extended over a period of 20 or 25 years after World War II, and perhaps over 10 years in the Korean war. I was in the Treasury Department at that time, and we tried hard to take care of the abnormal cases. However, the litigation extended for a long time after the Korean war.

Another example of this approach was a proposal to provide a carrot for firms that had a larger amount of investment than the amount of investment in the base period. Congress rejected that out of hand in the early 1960's even though economists were unanimous in saying that a differential investment credit would be more effective than a flat credit.

The only part of the income tax that I can remember that relates to 2 different years was the capital gains tax, and the committee will recognize right away that that part of the code is the most complicated and has given us the most headaches.

Most economists would say that the realization principle that is used for capital gains taxation is wrong, that what you should do is base the tax upon changes in the value of assets between two periods of time. Every country in the world has rejected that approach on simple practical grounds, because it is extremely difficult to value assets between two periods of time, and even if you could, you wouldn't want to impose a tax, because there would be a payment problem.

So if you want analogies, you should take the correct analogies. I submit to you that, on the basis of the history of taxation in this country and abroad, experience does suggest that this kind of approach is extremely difficult to implement.

Representative LONG. Mr. Seidman, you have stimulated some thought, as I can see, through the economic circles. Do you have anything you would like to add at this time?

Mr. SEIDMAN. Let me briefly respond, first, to what Mr. Pechman said.

I agree with his point about the two separate events and the 21 different year comparisons involved, but most of his statement involved the other reasons I was addressing. If you look back on his statement, the first issue was coverage. That would have been an issue if we were to issue under the income tax.

The second is the economic unit. That would be an issue under the income tax. Timing the penalty or subsidy. That would have been an issue under the income tax.

So a good part of the problems he is raising—I think they are important problems—would also be problems if we were sitting here contemplating whether we should enact an income tax. Only one of the problems he is raising is different, although not completely different, because there is the analogy of capital gains.

Again, I am not a tax expert. My only point is this: Up to this point, there is not unanimity of the tax experts who have looked at this. Richard Slitor, who did a careful study of TIP at the request of Henry Wallich, came to much more positive conclusions, concerning the feasibility, and I would urge you to read his comments in the Brookings volume on TIP.

Emily Sunley and Larry Dildine at the Treasury raised a number of problems. I don't know if you would say they are more positive or less positive than you. I think it depends on which part. What we need is to go further. We must go to the next stage of having legislation drafted, to write regulations, and have a larger sample of tax and collective bargaining experts, begin to scrutinize the points and see.

The only point I am making is that the accumulation of a list of potential problems should not let us become overly discouraged. There

are few taxes that we have enacted that you couldn't have gotten prematurely discouraged about as well. That is my only point.

With respect to Mr. Gordon, the first point is on the phasing in. There is certainly no consensus among advocates of TIP to apply the tax rate to previously negotiated deferred wage increases if we began TIP at the beginning of the next year. Obviously we have to think carefully of the phase-in problem and what do you do about contracts already negotiated, but certainly I am sure most advocates of TIP would not say that you should simply impose a tax penalty on them because they had already negotiated the contract and then let them have to bear that high penalty.

So we need to think about the phase-in, and not assume that that is what we would do.

Also, the other implication you draw that puzzles me is that, certainly, the penalty version of Weintraub-Wallich does not depend on unions feeling sorry for management's profit squeeze.

My basic view is that the clash of the push of labor and the resistance of management determines the wage outcome. Today that average comes out at 8 percent. There are very few workers who do not believe sincerely that they deserve more than what they get, and they press for more and would like to have more.

At some point management's resistance, because of the consequence for after-tax profit, becomes greater than the push for labor and some equilibrium point is reached. Today the average is 8 percent.

What the TIP penalty is trying to do is make the point where management digs in, and became, say, 6 percent, instead of 8 to change the push-resistance balance point. But it surely does not depend on saying that workers are now supposed to feel sorry for management. If we depended on that, it wouldn't work.

Representative LONG. Congressman Brown.

Representative BROWN of Ohio. Thank you, Congressman Long.

I am impressed with a couple of suggestions made by Mr. Gordon, and I want to pursue those.

You talked about the cost of regulation. Mr. Bosworth talked about the cost of regulation. We have had some figures presented to the committee by Mr. Murray Weidenbaum where he quantified the cost of regulation in total dollar amounts. They may be debatable, and they may or may not be close to the mark, but they represent the first definitive study on the subject.

The question is, what kinds of supply-side impacts would be made in terms of termination in some of these regulations or even holding the line in the development of regulations? Do you have any figures or statistics on that?

Mr. GORDON. Yes, I can give you a specific example of the kind of research that needs to be done on a broader scale. This is in the area of how much regulation has increased the cost of operating automobiles.

Now, the figures, as I read them in the press, Mr. Weidenbaum referred to the extra devices required by the Government to be placed on an automobile. There is something else that turns out to be even more important over the last 10 years that has been done to the automobile by Government regulations, and that is the lost fuel economy of antipollution regulations.

Now, we have done a study of the whole question of gasoline economy from 1949 to the present, and we found out something that is really hidden in the statistics entirely. That is, it looks, in the crude data, like gasoline mileage didn't improve at all between the late 1940's and the late 1960's. That is because cars were getting bigger.

If you correct for the quality of automobiles, we had an almost 30-percent improvement in fuel economy, and then almost a 20-percent decline as the antipollution laws took effect.

If you take the difference between what we could achieve and what we did achieve, it turns out to be \$300 per automobile, and that is more than the BLS figures for the actual cost of devices placed on the automobiles.

Now, we have a whole new set of regulations essentially trying to counteract that by trying to force the cars to become smaller. The fact is that that is a measurable cost, and something that could be undone by loosening the regulations. I am not saying we don't need regulations, but I think the American public has no idea of the operating costs and the capital costs in the case of the automobile that is being imposed on them.

I think the choice put to them is that the error you have enjoyed, and it is a very hard question to ask, is, is it worth that much? Would you vote for—well, we know that diminishing returns are reached at the wells. Each dollar produces less and less in the form of better air as you tighten regulations.

So maybe only 80 percent effective regulations instead of 99 percent effective would give you a tremendous payoff. It would come out in improved gas mileage, and so forth. That would go right into the CPI in the year it happened.

Representative Brown of Ohio. Would you have any suggestions as to specific legislative approaches that might be taken in this area?

Mr. GORDON. I think there has been a lot of testimony by economists dating back to the economic summit in the fall of 1974 when Mr. Houthakker had his 41 points, which I thought of as Martin Luther nailing the theses on the door of Congress.

Since I have a particular interest in the airline industry, I have been astonished to see how airline executives, who thought the demand elasticity for air travel was very low, suddenly found the Government forcing them to reduce fares and putting a gold mine in their hands. This kind of effect of creating a more competitive economy, which economists are all lecturing Congress about, could go into numerous other areas, whether it is truck transportation or maritime transportation.

You have to realize you have lobbies down in the corridor that have something to lose and the whole competitive economy, the consumer-at-large has something to gain, but they are not out there in the corridors.

I wanted to stress one more thing which I think I said briefly in the testimony. If you look at the energy bill, for instance, there are a number of Congressmen who are against raising prices because they worry that that would aggravate inflation. Look at how much inflation has been aggravated by the decline in the dollar. The turnaround in the dollar that would occur with an energy plan that cuts consumption will give us a bonus in the slower increase in the price of imports.

I was reading an advertisement by the Government of Japan in Business Week magazine, and they point out their GNP in real terms has gone up more than ours has, and yet they are using no more energy now than they were in 1973. That is, of course, because they have allowed the price to go up with world prices, whereas we have not.

Representative BROWN of Ohio. I want to pursue a comment Mr. Gordon made, and I am having difficulty finding it here, about the fact that we have had very low productivity increases, and in recent years employment has gone up without a substantial increase in productivity. I don't find the statement.

Representative LONG. That is the essence of the statement.

Mr. GORDON. Yes.

Representative BROWN of Ohio. My question is: How do you put that together with the political—

Mr. GORDON. You are referring to the structural change that I said was better known?

Representative BROWN of Ohio. Yes. Industrial production grew at a rate three times faster than employment in 1970-73, but currently we are improving our production not as fast as employment.

Mr. GORDON. Over the last 12 months production has gone up 5 percent and employment has gone up 4 percent. So it has barely stayed ahead.

Representative BROWN of Ohio. What do you do with that when we still seem to have more unemployment than we like? There is a political difficulty in suggesting that we ought to put a premium on improving the productivity of plants by tax incentives or real cost depreciation systems, or enhancing savings at a time when we have unemployment.

Mr. PECHMAN. It indicates that public policy should bend in the direction of stimulating additional productivity. I am not sanguine about—

Representative BROWN of Ohio. Even at the cost of increased unemployment? Wouldn't that result in increased unemployment? Or would it?

Mr. PECHMAN. No; not if your demand policies are geared to provide enough demand for the workers. I don't fear productivity. After all, if productivity rises—

Representative BROWN of Ohio. But if we have increased productivity, aren't we likely to wind up with more goods than we have demand for?

Mr. PECHMAN. Not if aggregate monetary and fiscal policies are geared to clearing the shelves at the higher production level. The important point you are raising is whether we now should use tax policy or any other policy to promote increased productivity and more investment.

The answer is yes. I don't think there is any economist who would disagree that in the next tax bill, and I do hope you will have a tax bill this year—

Representative BROWN of Ohio. That could be said about so many bills. [Laughter.]

Mr. PECHMAN [continuing]. And that a substantial portion of the tax bill should go to business in the form of rate cuts or investment credits to promote investment.

I am still a little conservative, I must say, about the proposal that has been made to index taxes. It is the same story that I mentioned earlier. Indexing the tax system means that you are trying to undo something that happened between two periods of time, and, once you get into that area, you are in a morass.

Take the question, for example, of indexing capital gains. If you did that, you would be generating real losses in many cases where the taxpayer reports a nominal gain. A taxpayer might report a \$50,000 capital gain, which in the end might turn out to be a real loss of \$25,000. What do you do with that \$25,000?

Representative BROWN of Ohio. Please explain that to me.

Mr. PECHMAN. Well, suppose he bought the asset for \$100,000 and sold it for \$150,000. That is a nominal capital gain of \$50,000. Suppose in the same period prices increased 75 percent, so that the real cost of the asset was \$175,000. So his real gain is negative; actually, it is minus \$25,000. One would think the answer is that we should not tax the \$50,000 gain. But what do we do with the losses?

There are many other taxpayers in the system who report gains and have real losses. Take the saving and loan depositor who has been receiving a 5-percent rate of return on his deposits in a period when inflation is 7 percent. He has been taxable on the 5 percent in full, yet he had a real loss averaging 2 percent a year.

Representative BROWN of Ohio. You might even mention the steel industry, which had shown a nominal profit for some years, although its plants has deteriorated.

Mr. PECHMAN. That is right. That is a comparable situation.

The point is that, trying to adjust part of the system, as some people want to do—say adjust for capital gains alone, or provide some measure of replacement costs for depreciation—is not the answer, because you will create a great many more inequities that will come back to haunt you.

I think the answer is either stick with the present system and try to combat inflation. That is my preferred answer. Alternatively, if you go to the full indexing system, you will incur the many administrative problems.

Representative BROWN of Ohio. But you mentioned the administrative problems in your testimony, and I was impressed with the point that the administrative problems are just overwhelming.

Mr. PECHMAN. I agree, and I also think the administrative problems of indexing are very difficult.

Representative BROWN of Ohio. I get terribly concerned about the fact that we now have two categories of natural gas and in the proposed natural gas pricing arrangements there will be 23 different categories of natural gas, and I don't have a gas well in my district. I don't know what Congressman Long here has. He must get hysterical.

How is the Federal Government going to determine all those different things?

Mr. PECHMAN. I agree that the sooner we get out of regulated prices, the better. But there is a problem with how to get them from here to there, as I indicated in my discussion of the problem of how to get to indexing.

Representative BROWN of Ohio. Let me pursue that, and I am not trying to entrap you, but, if we don't regulate prices of commodities,

and we don't regulate prices of labor, and we don't in effect regulate the taxes through indexing—and I think tax indexing is a form of regulation of taxes—then the Federal Government is saying that you keep your taxes down there where they belong; there seems to be no other solution.

Mr. PECHMAN. There are only two solutions, and I think the economists are agreed on that. One solution is simply to run a tight enough monetary fiscal policy and put the economy through a wringer to inhibit demand and pay no attention to how much unemployment you create, but wring the inflation out of the system.

There are people who honestly believe that it would be better to run an economy with 8 or 9 or 10 percent unemployment for 5 years than to keep unemployment down at 6 percent and have a 7-percent inflation.

Representative BROWN of Ohio. Can I throw in a paragraph there?

It occurs to me that that is a little bit like what Mr. Seidman has proposed, because what he has said is that we are not going to inhibit demand by holding the money supply down. We are going to, if they get a 7-percent increase, but should they only have a 6-percent increase—we are going to take it away from them in taxes. I think it has something of the same impact, doesn't it?

Mr. PECHMAN. Mr. Seidman's proposal comes in the class of the second alternative, which is also difficult and unpalatable to many people; that is, to do something about the wage- and price-setting process.

If we had competition in industry and labor markets, the effect of the first policy would be more immediate, and you wouldn't have to go through the course I refer to to stop inflation.

The people who believe the second point of view argue that the cost of stopping inflation by traditional methods is just too high and, therefore, would somehow get into the wage and price setting process so that labor and business conduct their affairs in the public interest, which would wind down the wages and prices. These are the two alternatives.

Representative BROWN of Ohio. You had me all excited, because I thought you were going to give me a solution, and you gave me two alternatives, both of which seem to be unacceptable, and I am now depressed again.

Mr. PECHMAN. I regret it, but the two alternatives are depressing.

Representative BROWN of Ohio. You don't think there are any other alternatives?

Mr. PECHMAN. No.

Representative LONG. Which one would you choose?

Mr. PECHMAN. I would choose general income policies which would not be tax based.

Mr. GORDON. I think my statement states alternatives three and four, which I think should be laid out on the table for some discussion.

At a given amount of demand we can produce the wedge of taxes and other things which will force up prices in relation to what the worker gets. That is the minimum wage, payroll taxes, regulations, and the other things I mentioned.

The final thing is that I don't think any of these three alternatives for dealing with inflation demanding restriction, controls, or supply-side measurement is going to have an immediate drastic effect. We are not going to go from 7 percent inflation this year to 2 percent inflation

this year. We might go from 7 to 6.5 to 6 percent. That is still a 6-percent inflation that the small saver has to cope with.

Representative BROWN of Ohio. In the same way that we don't jump from 3 percent inflation to 100 percent inflation. We jump from 3 to 10, and then we get used to 10, and then we jump to something else. Is that what you are suggesting? Does it work the same way going down as up?

Mr. GORDON. I think I suggested why we have found ourselves with 7 percent, whereas in 1970 or 1971 we had 5 percent, and that is cumulative—

Representative BROWN of Ohio. And we put on wage and price controls to cure 5 percent and wound up with 7 percent.

Mr. GORDON. That is right.

Representative BROWN of Ohio. We cured 5 percent, anyway.

Mr. GORDON. I have seen almost 10 studies on wage and price controls which agree with the conclusion I reached as early as 1972, which is that price controls squeeze profits temporarily and the moment they were lifted, prices came back to where they would have been.

Anyway, to get back to the train of thought, if we are going to be stuck with the 6 percent, I think there is every reason to go into the areas of living with inflation which I mentioned, and I do not think that the administrative obstacles of simply upgrading the exceptions and the tax brackets with CPI are onerous at all. They are already doing it in Canada.

The question of capital gains is tougher, because, as Mr. Pechman says, any kind of capital gains taxes have some of the same administrative problems.

I was thinking how you could write a tax rule to prevent me from deducting all my interest payments, or the portion that is due to the increase in the cost of living. In other words, I go out and borrow, and buy now because things would cost more next year, because the Federal Government encourages me to do that. That is, encourages borrowing and discourages saving.

We could start out as an approximation by letting people deduct only half of the amount they borrow. That would be better than doing nothing.

Representative BROWN of Ohio. If I had a 4-percent mortgage on my house, or 5¼ percent on my house, versus the guy who has a 10.5-percent mortgage on his house—

Mr. GORDON. You are making a killing and he is not.

Representative BROWN of Ohio. But he gets a bigger tax break than I do.

Mr. GORDON. That is right; but you have essentially a windfall which now is not being taxed at all.

Representative BROWN of Ohio. You mentioned alternatives three and four?

Mr. GORDON. Three is dealing with inflation directly by trying to reduce cost-raising items, both those introduced by the Federal Government and those that are not, particularly taxes that are inflationary, like the payroll tax, minimum wage, and so on. That is what I call supply-side solutions to the inflation problem.

Representative BROWN of Ohio. In other words, don't raise the minimum wage and don't add to social security taxes.

Mr. GORDON. And what I said before you came in, that the timid, politically acceptable solution is to postpone the increases for 1 year.

The second is that I said ignore George Meany and have a two-tier system and get rid of the minimum wage for people under 25.

The fourth category is living with inflation. That is the fact—let's realize nothing is going to work immediately and let's try to minimize the burden and impact on society in terms of reduced investment and the reduced savings.

That is where the indexing comes in, and it includes an indexed bond, by the way.

Representative BROWN of Ohio. I thought you might come up with a fifth choice, or maybe I have mistaken this in three and four, and that is to provide some long-range stimulation for greater production of goods which, you know, in the old Henry Ford sense, we seem to have lost track of. That is, build a better mousetrap and the world will beat a path to your door. Instead of raising the automobile prices 8 or 10 percent a year to keep up with inflation, we should encourage investment in cost-saving techniques, because it reduces the price.

That seems to me to be a lost art in this country, and perhaps abroad. I am not sure.

Is there anything cheaper than it used to be?

Mr. GORDON. Let me tie this together a little bit and show how a number of these measures can deal with productivity, which is the direct method of coping with inflation.

The entire regulation discussion means that a steel firm is putting money into smokestacks and filters which could be put into more productive steelmaking.

Mr. Bosworth mentioned this morning, at about 10:30, that he was struck by the fact that there were virtually no "greenfield," as he called them, investment projects going on, people setting up new steel plants, which is the best way to increase productivity.

Representative BROWN of Ohio. In this country that is not happening. It is happening in other places.

Mr. GORDON. That is part of the problem. The reason it is not happening comes from two sources. We were doing it 10 years ago. Why not now?

In the first place, the tax system itself has created these distortions which we referred to that means that firms are being taxed on a phony basis. Your steelmaking firms would have made losses in the years if they had had true inflation costs and depreciation.

Representative BROWN of Ohio. Or if they had, getting to the subject of jawboning, from every President from Eisenhower right on through—

Mr. GORDON. That is true. I am against any controls and jawboning. I think you end up with distortions.

The Government has made it expensive to build a new steel plant. That is the second point. You put that together, and the uncertainty, the worry about whether controls are going to be put on, that makes steel presidents say no, whereas otherwise they might say yes.

Representative BROWN of Ohio. I just came from a hearing on nuclear powerplant licensing. In the testimony, it was conceded to be 10 to 12 years from the time you decide you are going to build a plant until you get a plant on line, and that has killed nuclear power in this country because of the economics of it. A utility cannot afford to

carry that financing for that long and pass it onto its consumers, because it does not work out economically.

In fact, the recent figures are not 10 to 12 years, but between 12 and 16 years. It seems to be getting worse.

Mr. GORDON. If I could interject there.

Living in Chicago, where almost half of the electricity comes from nuclear power, we have been beneficiaries on two occasions, and we looked at the problems of New York and felt somewhat smug, and we looked at the problems of Ohio and felt somewhat superior. We had a certain built-in capacity which is not heavily resource using, which fortunately was built at the low prices of years ago. It is too bad that we have this very strong political movement in this country that is anti-nuclear. That is not my specialty.

Representative BROWN of Ohio. Would you make a brief reply, Mr. Seidman and Mr. Pechman?

Mr. SEIDMAN. I agree with the way Mr. Pechman characterizes the choices as being fundamentally two.

Three and four, that Mr. Gordon puts forward, let's look at them.

No. 4 is living with inflation.

Representative BROWN of Ohio. But our country has, for years and years, with some aberrational jumps and some low points, lived with 3-percent inflation. Is that much different from living with a 10-percent inflation, or 40-percent inflation?

You know, it strikes me that it is a little like Bernard Shaw's conversation with the actress. It is not really what you are; you are just haggling about the price. We have lived with inflation in the past at 3 percent. It seemed not to be oppressive. Couldn't we live with 7 or 10 percent?

Mr. SEIDMAN. Sure. We may have to if we don't do something about it.

My only point is that policies to reduce inflation, there are basically two choices.

As a matter of fact, some of the fine studies that Mr. Gordon himself has done on the relation of prices and wages reinforce this general empirical relationship. If you have wages going up at 8 percent a year, but productivity going up 2 percent, then unit labor costs are going to rise 6 percent, and there is no business that can avoid raising its price 6 percent to cover it.

You have got to get wage increases down to the level of the increase in output per worker, or you are not going to be able to get inflation under control. It is one of the necessary conditions.

I am not saying it is the only thing to fight inflation, but it is central. It is key.

Representative BROWN of Ohio. Now you have answered why we can't live with 7- to 10-percent inflation. We could live with it if we had a 7-percent increase in productivity.

Mr. SEIDMAN. Which we are not going to have.

Representative BROWN of Ohio. Or maybe we could live with a 2-percent increase in productivity and a 7-percent increase in inflation if nobody else had a higher productivity rate than we do. But, if somebody else does, then we get impacted by their ability to produce more rapidly than we, and tend to lose our employment to them. Is that right?

Mr. SEIDMAN. Let me repeat my point. My point is that if we have money wage increases, wage and salary, and I am talking about executives and university professors, as well as factory workers, at a rate of 8 percent, when we are only producing in real terms 2 percent more per year, then what happens is that the unit costs go up by the difference, 6 percent, and businessmen will raise prices to cover that, and we will have an inflation rate of 6 percent, which is basically describing the current situation.

There is no way that we can get the inflation rate down unless we bring wage and salary increases down into line with productivity increases, which are roughly in the neighborhood of 2 percent. If we can get productivity increases up to 3 percent, then we would only have to bring it down to 3; but basically the question is how do we bring it down to get it into line.

There are only two ways. Mr. Pechman said you can slow the whole economy down by tight monetary and fiscal policy, for example, throw enough people out of work and lower profits so that workers won't press as hard for wage increases and businesses won't be able to afford to give them.

The strategy of zero-balanced budget and tight monetary policy alone must work that way.

If you press any of the economists advocating that course, they will concede that the scenario requires a rise in unemployment which they feel will be temporary, but when pressed will admit it could be 4 or 5 years.

The only other alternative would be an incomes policy. There are only three kinds of incomes policies. One is voluntary persuasion. The current administration policy is that. The other extreme is controls.

Representative BROWN of Ohio. Curing inflation with the jawbone of Mr. Strauss?

Mr. SEIDMAN. That is right.

The intermediate one, the one I am suggesting, is to use tax incentives. That is the only approach to incomes policy that hasn't been tried yet. It is more flexible than controls on the one hand, but tougher than persuasion on the other.

Mr. Pechman is right. There are practical problems with a tax incentive approach, but there are also great difficulties with the other two. Persuasion doesn't have the teeth to work; and controls, on the other hand, have all the rigidities and administrative difficulty that I say are much greater than under a tax-based incomes policy.

As Mr. Okun said, we don't arrive at TIP because we think it is a perfect, beautiful policy. We support it because it is the least worst of all the other feasible alternatives.

Representative BROWN of Ohio. But why would you ignore the other side of the problem? I feel obliged to raise a question which I am sure Senator Javits would raise if he were here. That is, why don't you increase productivity?

That seems to me to be the other side of the problem that you say is unaddressable. One of the things we worried about at the end of World War II was that we didn't have the jobs for all the men and women who were coming out of service, and suddenly we realized that we had the productivity and the pent-up demand, and when they all came out of the service, instead of making jeeps, they were making Chevrolets.

It seems to me that if you have that productivity increase through the capacity to get investment into modernization of plant, which we talked about a minute ago, that you would then have the jobs for the young, the blacks, and the people who are now not employed. You could also say to the working man, "More power to you. Ask for more money next year because we will be producing more and will be able to give you more money next year."

Mr. SEIDMAN. One reason you have had such poor productivity performance is that because of the concern about inflation we have used tight monetary and fiscal policy several times in the last decade to slow the economy down.

Representative BROWN of Ohio. Maybe that was a mistake.

Mr. SEIDMAN. No, I think given the lack of an effective incomes policy, there was no other choice.

Representative BROWN of Ohio. The Germans haven't had this problem because the Germans have had a savings rate much higher than ours. Therefore, they have stimulated the production of more goods, more efficiently, by the fact that they had high savings and therefore a high investment in the increase of plant and capacity.

Mr. SEIDMAN. Everybody is for increasing plant and capacity and productivity, but there is no one who thinks you can get our productivity growth rate up to 8 percent, which is the growth rate of wages and salaries.

Even in the 1960's, when we were doing much better, we were growing 3 percent in productivity per year.

Representative BROWN of Ohio. I understand that our productivity has been as high as 5 percent. Is that right?

Mr. PECHMAN. No.

Mr. GORDON. Only in cyclical recovery.

Mr. SEIDMAN. Let's do the things we can to raise productivity, but let's not use that as a convenient escape from the problem. It is politically easy to say, "Let's raise productivity." It is politically difficult to say, "Let us restrain our wage and salary increases to get them into line with whatever productivity we have been able to achieve."

We can't ignore that difficult issue by trying to focus on the thing that is popular.

Representative BROWN of Ohio. Let me go back to Henry Ford. When you had an inflation rate of, say, 3 percent, and the cost of the automobile is going down, didn't you have a rather peculiar circumstance there because you had productivity in that industry at a rate in excess, certainly, of 3 percent?

Mr. GORDON. The cost of IBM computers has gone down 20 percent over the past few years.

Representative BROWN of Ohio. But the industry created the—

Mr. GORDON. That allows them to cut prices even if their wages are going up with Mr. Seidman's 8 percent.

Representative LONG. Gentlemen, we have about 2 minutes.

Mr. GORDON. The third solution, which Mr. Seidman is attempting to rule out, comes very neatly into his own numbers. With his 8-percent wage increases and his 2-percent productivity, he gets 6-percent inflation. If we get productivity up to 2.5, inflation goes to 5.5 percent.

Next year, the workers would have their wages held down by the contracts. The inflation will slow down gradually.

If the employer gets a payroll tax cut, he can raise prices less.

Congressman Brown, you came in late so you missed a reference I made to Germany which is of some interest to you, and why they were able to hold down their inflation and slow it down by tight monetary policy, and we weren't.

The big difference between the two countries does not have to do with the high savings rate, but rather with the labor market institutions, where they have renegotiation of contracts every year; and, if we could have all the unions of this country come into a room with Chairman Miller of the Federal Reserve and work out a deal once a year where labor is going to promise them stability—

Representative BROWN of Ohio. The difference is that Germans accept productivity advancement and modernization of plants.

Mr. GORDON. And lower wages.

Representative LONG. Gentlemen, thank you for a provocative discussion.

The hearing is recessed.

[Whereupon, at 12:53 p.m., the committee recessed, to reconvene at 9:30 a.m., Tuesday, July 25, 1978.]

THE 1978 MIDYEAR REVIEW OF THE ECONOMY

TUESDAY, JULY 25, 1978

LOCAL DISTRESS, STATE SURPLUSES, PROPOSITION 13: PRELUDE TO FISCAL CRISIS OR NEW OPPORTUNITIES?

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON THE CITY OF THE HOUSE BANKING,
FINANCE AND URBAN AFFAIRS COMMITTEE
AND THE JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committees met, pursuant to recess, at 9:35 a.m., in room 2128, Rayburn House Office Building. Hon. Henry S. Reuss (chairman, House Subcommittee on the City) and Hon. William S. Moorhead (member of the Joint Economic Committee) copresiding.

Present from the Subcommittee on the City: Representatives Reuss, Pattison, Cavanaugh, Mattox, Watkins, Kelly, McKinney, and Fenwick. Present from the Joint Economic Committee: Representatives Moorhead and Long; and Senators McGovern and Javits.

Joint Economic Committee staff present: Deborah Norelli Matz and Paul B. Manchester, professional staff members; Louis C. Krauthoff II, assistant director; Allen Stone, assistant to Senator McGovern; and Charles H. Bradford and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE REUSS, COPRESIDING

Representative REUSS. Good morning. The joint session of the Joint Economic Committee and the Subcommittee on the City of the House Committee on Banking, Finance and Urban Affairs will be in order for its consideration of "After Proposition 13, What?"

I am honored to be joined by Representative William S. Moorhead of Pennsylvania, who will share with me the chairmanship of today's joint hearing. We have until noon, or a little after noon, today, to do an awful lot of work, so I want to get right to it.

The antitax sentiment that surfaced recently in California is sweeping across the Nation posing challenges to Government at all levels.

The message from Proposition 13—opinion polls, and the campaign that brought President Carter to the White House—is that Americans want to halt wasteful and ineffective programs.

Economizing, as the President has discovered, is easier said than done. The fat and frills decried by some, are defended by others as essential. So what services to cut or which agencies to consolidate are tough decisions, and taxpayers need more credible and persuasive

explanations of the trade-offs. Yet the choice is clear: Officials must find orderly ways to cut costs, or await the day when irate citizens impose crude and insensitive instruments of their own.

The prospects aren't all dismal. Some States use their revenues to provide local tax relief. A number have made property taxes more acceptable through such devices as circuitbreakers and abatements for rehabilitation.

When the library in the California town of Ojai was slated to be shut down recently for lack of funds, citizens rallied with volunteer staffing and donations. This approach may have limited applicability, but it indicates the resourcefulness and creativity of Americans that communities can capitalize on.

We two committees are meeting today, concluding the Joint Economic Committee's Midyear Review of the Economy. When Congressman Moorhead and I learned that we were separately planning to touch on closely related issues, we agreed, in the spirit of economy and efficiency to combine forces.

I'm happy that Representative Moorhead will be cochairing this hearing.

Today's hearing comprises three panels of witnesses. The first will discuss the rationale of measures such as Proposition 13 and how they will affect cities, counties, and the States.

The second will examine the fiscal status of State and local governments, how extensive their surpluses are, and what it implies.

The third will look at the prospects for curbing local government spending, developing new revenue sources, and devising more efficient governmental structures.

Tomorrow, the Subcommittee on the City meets again to focus on local government productivity and how to cut costs without sacrificing essential services. Further hearings and reports on these vital issues will be scheduled in the months ahead.

The first panel will focus on the subjects of why the taxpayers are in revolt, and what are the consequences for local government and their citizens. The panel consists of Professor Neil H. Jacoby of the Graduate School of Management at UCLA, and a former and respected member of the Council of Economic Advisers; the Honorable Jason Boe, president of the Oregon State Senate and National Conference of State Legislatures; Stephen B. Farber, who is director of the National Governors' Association; and Fred F. Cooper, county supervisor of Alameda County, Calif.

Congressman Moorhead, would you like to make an opening statement now? Or would you like to wait until the second panel?

Representative MOORHEAD. Thank you, Mr. Chairman, I would like to proceed now, if I may.

OPENING STATEMENT OF REPRESENTATIVE MOORHEAD, COPRESIDING

First, I would like to thank you for the courtesy you have extended us in joining forces.

It is fortunate that we both serve on the Joint Economic Committee and the House Banking, Finance and Urban Affairs Committee, of which you are, of course, the chairman. There is a slightly different thrust to these studies of our respective subcommittees, but I would

agree with you, Mr. Chairman, there is so much overlap that we would have to call some of the witnesses twice if we held separate hearings.

The focus of the Joint Economic Committee's hearings is the fiscal condition of State and local governments. The future of many State and local governments is at a critical threshold. I have seen estimates that in 1978 direct aid, as a percent of own-source general revenue, will be on the order of 53 percent in Philadelphia, 60 percent in Cleveland, and 58 percent in Phoenix, and as high as 76 percent in Detroit.

More than 40 months into the recovery, many localities are still faced with reduced levels of employment, reduced capital expenditures, and great reliance on Federal aid.

Those chronically ill municipalities have experienced reductions in employment and population which have resulted in declining revenue bases.

The situation is further exacerbated by a capital stock which is in disrepair. Unfortunately, the list of such problem localities is all too long. At the same time—and this is our dilemma—the National Income Account data indicating large surpluses in the State and local sectors tend to reorient the focus of national attention away from the problems of fiscal distress.

The media, in particular, have used the surplus to suggest that municipal fiscal strains are now part of history; that we can turn our attention to other national problems.

I regret that I cannot share in this opinion. The NIA data indicate that in 1977, the State and local sector had a surplus of \$29 billion. I am extremely concerned about what this surplus really means. Can the mere existence of a surplus be equated with a healthy local economy? Are the surpluses widespread? Are local units of government in surplus States sharing its wealth?

I hope the witnesses today—particularly in the second panel—can shed some light on these important questions.

In the coming months, we in Congress will begin to consider a host of intergovernmental assistance proposals. This task is never easy, but at this point in time it is particularly difficult because of the confusion the State and local government budget surplus data has generated.

Congress will have to grapple with and ultimately decide whether States themselves should be eligible for additional assistance. Or should it, in fact, be required to assist their own localities? And moreover, whether Federal fiscal assistance should be continued; and, if so, what form it should take.

I hope that the testimony today will help to clarify the fiscal needs of our municipalities, as well as the meaning and extent of the budget surplus.

I believe that these joint hearings can be of great benefit to future considerations of the Congress.

Thank you, Mr. Chairman.

Representative REUSS. Thank you, Congressman Moorhead.

We are privileged to have with us a distinguished member of the Joint Economic Committee from the other body, Senator Jacob K. Javits. Would you like to make an opening statement, Senator?

Senator JAVITS. Yes, I would, Mr. Chairman. Thank you for the privilege.

OPENING STATEMENT OF SENATOR JAVITS

First, Mr. Chairman, I thoroughly approve of the joint hearings, and I compliment the Chair, the chairman of the Joint Economic Committee, and Representative Moorhead, your cochairman, for arranging this hearing.

It seems to me that you are serving a very critical purpose here. That is—and perhaps I am coining a word—to “demythify” Proposition 13. I don’t think the voters of the United States have lost their marbles. They gave us a message, but they didn’t intend to dismantle the country.

And I think that it is critically important that this be put into focus: that we share our problems with the people.

My own city of New York, for example, we’ll literally collapse from lack of maintenance if you try to apply any standard of what the citizen wants to pay in taxes relative to what it takes to pay for his desired level of maintenance of city facilities, when those costs are compared with what it costs to pay for his home and an environment which he and his family can live a reasonable life.

So I think you are performing a great service, within the limits of our other problems, and in the Senate I will do my utmost to participate.

I thank you very much.

Representative REUSS. Thank you, Senator.

Are there other members who at this time would like to make an initial statement? If not, let’s straightaway get to work.

All the witnesses have turned in compendious and very helpful prepared statements, and under the rule and without objection they will be printed in full in the record.

That will enable the witnesses to proceed in their own way, either elaborating, magnifying, or whatever suits them best.

We will hear first from Mr. Neil H. Jacoby, of the University of California Graduate School of Management.

Mr. Jacoby.

STATEMENT OF NEIL H. JACOBY, DEAN, GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITY OF CALIFORNIA, LOS ANGELES

Mr. JACOBY. Thank you, Mr. Chairman.

You have invited me to speak about the meaning of California’s Proposition 13, and the legal limits on government spending in general.

I should like to take the brief time allotted, if I may, to elaborate briefly on five points.

First, that there is a systemic bias toward, or structural flaw in our democratic political system that leads to overspending by government, in the strict sense that the total of government spending is more than the citizens would approve if they had a chance to vote on the total.

Second, that the two major causes of this bias are: Pressure-group politics and unbalanced collective bargaining, with the increasingly powerful public employees’ unions. And these are, I think, causes of increasing strength and power.

My third point is that effective legal limits on spending can help to correct the bias by giving people a chance to vote on aggregate spending, by making collective bargaining with public employee unions less unbalanced, by simulating market pressures on government for efficiency, that is to say, we have lacked, in the field of government, pressures for efficiency which the market brings to bear on business. Spending limits can function as a substitute. I believe these points are all borne out by the experience of California, so far, with Proposition 13.

My fourth point is that the long-run effects of Proposition 13 spending limits in California will prove to be favorable. They are and will produce, in California, economic expansion, with less inflation. What is even more important, they have, I think, revived the faith of the people in the democratic process; giving them a feeling that they can effectively participate in and control their government. There has been no special sacrifice visited on the poor. In fact, their private job opportunities are being, and will be enhanced.

Which leads me to my fifth point: That we need, now, limits on Federal spending to stimulate investment and to restore world confidence in the dollar, which is, as we see in the morning press, continuing to hemorrhage in value. We need to strike a decisive blow against inflation.

Let me now just comment briefly on each of these points.

It is clear that our political processes contain a strong systemic bias toward overspending by government. The basic causes of this, I believe, are numerous, but two factors stand out: The first is pressure-group politics. Our political representatives naturally respond to the strong demands of small groups for spending programs that benefit them greatly, because those demands are only weakly opposed by the majority who benefit little, or not at all.

Every spending proposal has a small group of organized supporters, and a large and inarticulate group of unorganized opponents. The payoff to the politician of meeting the demands of the strong minority outweighs the political cost of flouting the will of the weak majority.

Add to this the familiar phenomenon of "log rolling" for reciprocal political benefits, and it is easy to understand why spending mounts ever higher, even though the majority of voters, including members of favored pressure groups, would oppose a higher total if given a chance.

Without a legal limit on aggregate government spending, the public is never able to vote directly on the total size of the budget.

The second favor is unbalanced collective bargaining by powerful unions of public employees. The case of New York City is illustrative.

To operate in the public interest, collective bargaining requires approximately equal bargaining power on both sides of the table. In business, the union's power to strike is opposed by management's imperative to hold down costs and stay competitive in the market. This makes for tough bargaining. The manager who fails loses his job.

In government, history shows that politicians normally accede to the demands of employee unions because a docile electorate shoulders the higher cost of government, and there is no competitive market to penalize the manager of a high-cost government. Hence, unbalanced

bargaining power has become a central cause of overspending by government.

Now, effective legal limits on spending can, I believe, help to cure this serious fault in the political process. It does give the people a chance to decide how large their government should be in relation to the private sector; it increases the bargaining power of the public official; and it simulates market pressures for efficiency that operate in the business field.

In the private sector, as I have noted, market competition forces the business firm to stay reasonably efficient if it is to survive. In the public sector, there is no counterpart to the market to compel public officials to engage in housecleaning. And for some 40 years, public spending at all levels has grown almost continuously, and there has never been an occasion to houseclean.

Meanwhile, budgets have become laden with unnecessary positions, spending programs continue after they are obsolete, there is no pressure to modernize methods and equipment, civil service rules protect the inefficient while foreclosing rewards to the efficient, and the evidence shows that productivity, motivation, and morale in the public sector are low.

I think California's experience under Proposition 13 shows that a legal limit on government spending can be a substitute for the market in forcing efficiency.

What has happened in California was that tough priority-setting decisions that had been avoided for many years by public officials, while revenues were rising, began to be made. Unfilled and unnecessary jobs were struck out of budgets; marginal and obsolete programs were eliminated; moratoria were put on hiring and on increases in pay and benefits; and to date, less than 9,000 government employees have been laid off, although it had been predicted that 45,000 would lose their jobs.

California governments will cut their spending about 10 percent under budgeted levels during this fiscal year. Now this leaves about an equal amount of economizing for future years, assuming no new taxes, which Governor Brown has said he will not approve.

Because public budgets in California have been expanding 10 percent or more a year, adjustment to Proposition 13 merely means stopping government's growth for about 2 years. It has not meant massive layoffs as were earlier predicted.

The long-run effects of Proposition 13 will be salutary. And I may point to the fact that the Congressional Budget Office has confirmed my own forecast: That Proposition 13 will have a positive effect upon California employment and income in 1980 and beyond, and will reduce inflation by cutting housing costs, which is a material factor in the Consumer Price Index.

Now let me come to the lesson for the Federal Government. I think the California experience, to date, indicates that legal limits on government spending would be beneficial in all American States, but most of all they are needed in Federal Government.

The persistence of a \$50 billion Federal deficit in an economy now close to full employment is a root cause of inflation and dollar depreciation. Ending inflation is our primary national problem, and it calls for bold action, now, on the fiscal front as well as on the energy front.

The imperative need, I believe, is to end the Federal deficit by cutting spending. That will release savings now used to finance government for productive investment in the private sector, and by restoring confidence in the dollar it will induce an inflow of foreign investment.

I commend the anti-inflationary proposals of Federal Reserve Chairman G. William Miller, who proposed to cut the deficit from an estimated \$50 billion in the present fiscal year to \$30 billion in fiscal 1980, to \$17 billion in fiscal 1981, to zero in fiscal 1982; and over the same period, he would cut Federal spending from 22 to 20 percent of the gross national product.

These spending limits that I suggest—which Chairman Miller suggested—are liberal. California governments are cutting spending by 10 percent in 1 year; whereas, we are proposing here a 10-percent cut over 3 years. Nor does 10 percent, by any means, measure the amount of fat on the body politic. We have estimates that there is 20-percent fat in California government.

I propose, gentlemen, that these limits be written into law by a joint resolution of the Congress; and that that resolution would mandate a proportional cutback of all Federal programs whenever the total exceeded the prescribed limits.

I believe that Proposition 13-type effects would soon follow. The opportunities for billion dollar savings, without sacrifice of national security or essential services, are legion.

Examples are food stamps, farm subsidies, pork barrel water projects, redundant military bases, and nonproductive Health, Education, and Welfare programs.

HEW itself recently acknowledged \$7 billion of discovered annual waste through fraud, and I suggest there must be twice as much through maladministration.

The expansionary effects of a congressional action of this kind I believe would be dramatic. Private investment would boom. Confidence in the dollar would surge upward around the world. I fear most foreigners think we've lost control of our fiscal affairs. Interest rates would stay at moderate levels, encouraging housing and other private investment. The inflation that is undermining American society and weakening our economy would be brought under control. And what is more important is the shaken confidence of Americans in their Government would be restored.

Mr. Chairman, the times call for decisive action.

Thank you very much.

Representative REUSS. Thank you, Mr. Jacoby.

[[The prepared statement of Mr. Jacoby follows:]]

PREPARED STATEMENT OF NEIL H. JACOBY

California Proposition 13 and Legal Limits on Government Spending

You have invited my comments on the causes and probable effects of Proposition 13, which was overwhelmingly approved by the voters of California last June 6th. It immediately cut property taxes by 60 percent and total state-and-local revenues by 21 percent, and it rigorously limits the future growth of property tax revenues. Governor Brown and the California Legislature subsequently agreed that the \$6.5 billion state surplus should be allocated to the local governments to ease the burdens of adjustment, that there should not be any new state taxes, and that the State government should share with the local governments the tasks of fiscal austerity. Proposition 13 is now reducing State-and-local spend-

ing in California. It is functioning as an effective legal limit on government expenditures. Such an explicit limit is likely to be adopted by the voters of California next November.

THE SYSTEMIC BIAS TOWARD GOVERNMENTAL OVERSPENDING

Events of recent years have demonstrated that legal limits on government spending are needed to correct the bias toward overspending in our political system. Government spending has boomed. It is shocking that, after three years of economic expansion, the federal government continues to run an estimated \$50 to \$60 billion annual deficit. Powerful public employees unions have exacted pay levels that much exceed those in the private sector for equivalent jobs. They have gained retirement benefits that threaten the solvency of our governments. Government spending at all levels is excessive; in the federal government it seems to be out of control.

It is now clear that our political processes contain a strong, systemic bias toward overspending by government. They do not produce an optimum allocation of income as between governmental and private expenditures. Californians voted for Proposition 13 because they believe they are getting smaller benefits from the marginal dollars collected from them and spent by government than they would derive from the opportunity to spend those dollars themselves. They are convinced that government is trying to do too much; and what it is doing is done inefficiently.

What are the basic causes of systemic overspending by governments? Although the reasons are numerous, two factors stand out: pressure group politics and unbalanced collective bargaining in the public sector.

PRESSURE GROUP POLITICS

Democratic governments generally suffer from a disease that can be fatal if not checked. Total government spending expands irrationally as a result of "pressure group" politics. Our political representatives naturally respond to the strong demands of small groups for spending programs that benefit them greatly, because those demands are only weakly opposed by the majority who benefit little, or not at all. Every spending proposal has a small group of organized supporters and a large and inarticulate group of unorganized opponents. The payoff to the politician of meeting the demands of the strong minority outweighs the political costs of flouting the will of the weak majority. Add to this the familiar phenomenon of "log rolling" for reciprocal political benefit, and it is easy to understand why spending mounts ever higher, even though the majority of voters—including members of favored pressure groups—would oppose a higher total if given a chance. Without a legal limit on aggregate government spending, the public is never able to vote directly on the total size of the public budget.

UNBALANCED COLLECTIVE BARGAINING

The second important factor in explaining the systemic bias toward governmental overspending is unbalanced collective bargaining by powerful unions of public employees. As the case of New York City illustrates, excessive pay and benefits for public employees has emerged as a dominant cause of municipal fiscal distress. The problem of unfunded pension obligations looms menacingly over our heads. Public employees unions have wrested excessive compensation from public officials through the collective bargaining process, on threats of slow-downs, "sick-outs" and strikes.

One must question the validity of transferring to the public sector—where employees already enjoy the job security of civil service—the institutions used in the private sector to determine wages, hours and fringe benefits. To operate in the public interest, collective bargaining requires approximately equal bargaining power on both sides of the table. In business, the union's power to strike is opposed by management's imperative to hold down costs and to stay competitive in the market. This makes for tough bargaining. The manager who fails loses his job. In government, history shows that politicians normally accede to the demands of employee unions, because a docile electorate shoulders the higher costs and there is no competitive market to penalize the manager of a high-cost government. Pay and benefits for employees make up the bulk of government expenditures. Hence, unbalanced bargaining power has become a central cause of government over-spending.

EFFECTIVE LEGAL LIMITS CAN REDUCE THE OVER-SPENDING BIAS

Effective legal limits on government spending can help to cure defects in the political process. Such limits give the people a chance to decide how large their government should be in relation to the private sector. The people can determine what proportion of their income should purchase public goods and services, and what part should remain for private allocation. As a result, incomes are allocated more effectively. The benefits derived by the public from a given level of income increase.

Effective legal limits on government spending also increase the bargaining power of public officials. As has been observed, "There is no way in which the politicians could be persuaded to stand up to (public employees') unions without something like Proposition 13 to provide the necessary backbone."¹ It put their political futures on the line.

Legal limits on government spending must be effective if they are to correct the overspending bias. They must actually reduce the budgeted growth of government spending. Merely nominal formulae for limiting expenditures, that do not compel public officials to take economizing actions, are worse than nothing. California voters decisively rejected Proposition 8 at the last election. It would have limited the annual percentage increase in State government spending to the inflation rate plus 1.2 times the percentage increase in California income—a formula that would have permitted the State to grow as fast as it had been growing. Although the politicians and bureaucrats feel comfortable with this limit the people did not. Two-to-one, they endorsed Proposition 13 instead.

The reason why the legal limitation on government spending in California took the form that it did was that California has been over-zealous in taxing and spending. Furthermore, it has been collecting 50 percent more property tax revenue than the nationwide average percentage. It has used this revenue to finance welfare medical and school costs, as well as the costs of property-related services. Over-reliance on property taxation, combined with booming assessed valuations of property as a result of inflation, was threatening the ability of many citizens—both owners or renters—to keep their homes. Any democratic government that threatens the tenure of people in their homes is courting disaster. Proposition 13 therefore killed two birds with one stone: It stabilized property taxes at a reasonable and predictable level, and it forced state and local governments to economize. States that now tax property moderately do not need Proposition 13. But all states share with California the problem of streamlining governments that have grown fat and flabby during years of rising revenues. They do need legal limits on government spending.

EFFECTIVE SPENDING LIMITS SIMULATE MARKET PRESSURES FOR EFFICIENCY

History teaches that all human organizations need to "clean house" periodically—to streamline their organizations and processes—in order to stay vital and efficient. Over time, organizations tend to accumulate deadwood personnel, obsolete programs, out-moded methods and unproductive expenditures. In the private sector, market competition forces the business firm to stay reasonably efficient if it is to survive. A firm with slack management loses market share and profitability, and new management comes in to eliminate unproductive products, plants and personnel, and to restore efficiency. Remedial action is usually swift and certain, because the alternative is bankruptcy.

In the public sector, there is no counterpart to the competitive market to compel public officials to engage in house cleaning. For more than forty years—since Franklin Roosevelt's New Deal—government spending has risen almost continuously. Public officials have grown accustomed to an ever richer diet of revenue to finance more public spending. They have never had to clean house. Meanwhile, governmental manpower has become redundant. Budgets are laden with unnecessary positions. Spending programs continue long after they have become obsolete. There is no pressure to modernize methods and equipment. The bureaucracy opposes labor-saving changes. Civil service rules protect the inefficient while foreclosing rewards to the efficient. The evidence shows that productivity, motivation and morale in the public sector are abysmally low.

Effective legal limits on government spending can be a substitute in the public sector for the market competition that enforces efficiency in the private sector.

¹ Irving Kristol in the Wall Street Journal, June 28, 1978.

California's experience under Proposition 13 offers convincing proof of this proposition. Faced for the first time in their political careers with the prospect of less money to finance public services, California's public officials at first reacted with a dismay that approached panic. They predicted "chaos," announced "doomsday" budgets, proposed massive layoffs of government employees, and threatened drastic cuts in essential public services. Initially, none proposed that spending should be trimmed by higher productivity and tighter management. Years of disuse had attenuated their capacities for economizing.

Soon, however, hard necessity worked to rejuvenate these capacities. The tough, priority-setting decisions that had been avoided in the years of "easy come" began to be made. Unfilled and unnecessary jobs were struck out of budgets. Marginal and obsolete programs were eliminated. Moratoria were put on hiring and on increases in pay and benefits. More efficient methods were introduced. Hitherto unknown surpluses and reserve funds were discovered. To date, less than 9,000 government employees have been laid off, although it had been predicted that 450,000 would lose their jobs. No essential public service has been eliminated. More than one public official has told me privately: "Proposition 13 is the best thing that has happened in this state in years. We can now get rid of waste that was politically impossible to eliminate before. We can say "no" to the pressure groups."

California's adjustment to the sharp revenue cuts of Proposition 13 is not over. The house-cleaning process will continue for several years. Overall, California governments will cut spending 10 percent under budgeted levels during this fiscal year. This leaves an equal amount of economizing for future years, assuming no new taxes. Because their budgets have been expanding 10 percent a year, adjusting to Proposition 13 merely means stopping government's growth for two years. Meanwhile, Governor Brown has appointed a Commission on Government Reform composed of 11 prominent citizens from various walks of life to recommend efficiency-promoting reforms in the organization and in the revenue and expenditure structures of the state. He has expressed the wish to make California government "a model for the nation."

LONG-RUN EFFECTS OF PROPOSITION 13

How will Proposition 13 affect California in the long run? Let us first dispose of adverse criticisms that have been made of the measure—social, political and economic.

Throughout the nation the measure has been attacked by the Liberal Left. To this group it is an article of faith that America's social salvation lies in an ever-expanding government. They interpreted the overwhelming public support of Proposition 13 as a signal that the public would no longer tolerate rising government spending. Predictably, their reaction to this unexpected change in public sentiment bordered on the hysterical.

Senator George McGovern insulted two-thirds of California voters by describing their action as "degrading hedonism" which was "motivated by racism" and which would impose heavy burdens on the poor.² Professor J. K. Galbraith described Proposition 13 as a "disguised attack on the poor."³ Henry Fairlie, a British journalist, branded it "an irresponsible use of the initiative," which he wrote has been "peculiarly the brainchild of the Western states with their primitive fascination with the forms of democracy."⁴ Adverse economic consequences have also been predicted. Business Week stated that "Californians have threatened the strength and stability of the boom, and have raised serious doubts about the state's ability to accommodate future growth."⁵

Not one of these criticisms is valid. The effort to distort Californians' legitimate complaints about governmental inefficiency and inequitable property taxation into racism and class warfare is reprehensible. It comes with poor grace from the Senator of a state which spends only \$20 per \$1,000 of personal income on public welfare, versus an average of \$25 by the nation and \$33 by "hedonistic" Californians! Proposition 13 has not caused any essential public service to be curtailed, nor any legitimate welfare payment to be cut.

² See Los Angeles Times, July 2, 1978.

³ See Los Angeles Times, July 9, 1978.

⁴ See Los Angeles Times, July 2, 1978.

⁵ Business Week, July 17, 1978, p. 54.

Mr. Fairlie should be reminded that it was not their "primitive fascination" with the referendum that led Californians to support Proposition 13. It was the failure of the California legislature for three years to resolve the problem of property taxation which was threatening peoples' ability to keep their homes while mountainous surpluses were piling up in the State treasury. The referendum bridged a breakdown in representative government.

The doleful economic predictions of Business Week have been contradicted by the Congressional Budget Office and by Chase Econometric Associates. Both agencies confirmed my own forecast that Proposition 13 will have a positive effect upon the California and national economies in 1980 and beyond, and will reduce inflation.⁶ It will prolong and expand the present level of construction in California, with all of the multiplier effects this industry has upon income and employment. No investor in residential real estate, no businessman seeking to build a factory, warehouse, office building, hotel or shopping center, will ignore the inducement of California's stabilized low-rate property tax. It has raised the prospective rate of return to investment. Both economic theory and history demonstrate the powerful influence of higher prospective rates of return upon the volume of investment.

If tax reduction by a state really produced economic recession and unemployment, then the road to prosperity must be ever-higher taxes! Economic reasoning that leads to such an absurd result must be rejected. The stimulative economic effects of a tax reduction are well established.

The political and social effects of Proposition 13 may prove to be even more beneficial than its economic consequences. Californians feel that they have recovered control of their government. They have a revived faith in democracy. They feel more secure in their homes. Proposition 13 has put in motion changes that are making California a better state. It is bringing more efficient government, more equitable taxation, less social tension, and an improved climate for business.

PROPOSED FEDERAL SPENDING LIMITS

The California experience indicates that legal limits on government spending would be beneficial in all American states. Most of all, however, spending limits are needed in the federal government. The persistence of huge federal budget deficits, in an economy now close to full employment, is a root cause of inflation and dollar depreciation. Ending inflation calls for bold actions on many fronts. But the imperative need is to end the federal deficit by cutting spending. This will release savings now used to finance government for productive investment in the private sector. By restoring confidence in the dollar, it will induce an inflow of foreign investment. At this time the U.S. economy would benefit far more from spending reduction and budget balance than from tax reduction.

The anti-inflationary proposals of Federal Reserve Chairman G. William Miller merit strong endorsement. He proposed to cut the deficit from \$50 billion in fiscal 1979, to \$30 billion in fiscal 1980, to \$17 billion in fiscal 1981 to zero in fiscal 1982. Over the same period, he would cut federal spending from 22 percent to 20 percent of the GNP.⁷

These spending limits are liberal. California governments are cutting spending by 10 percent in one year, whereas we propose a 10 percent cut in federal spending over three years. Nor does 10 percent by any means measure the amount of fat on the body politic. Nathan Shapell, Chairman of California's "Little Hoover" Commission on Government Economy and Efficiency, has evidence that California government spending can be cut at least 20 percent without impairing any essential service. Who will contend that the margin of fat in federal government is less?

Why not write these limits into law by a joint resolution of the Congress? The resolution would mandate a proportional cutback of all federal programs wherever the total exceeded the legal limits. Proposition 13-type effects would soon follow. Opportunities for billion-dollar savings without sacrifice of national security or essential services are legion. Examples are food stamps, farm subsidies, pork-barrel water projects, redundant military bases, and unproductive HEW programs. HEW itself recently acknowledged \$7 billions of annual waste.

The expansionary effects of such an action would be dramatic. Private investment would boom. Confidence in the dollar would surge upward around the world.

⁶ Los Angeles Times, July 7, 1978. Wall Street Journal, July 12, 1978.

⁷ Reported by Time, July 17, 1978, p. 62.

Interest rates would stay at moderate levels, encouraging housing and other private investment. The inflation that is undermining American society and weakening our economy would be brought under control. The shaken confidence of Americans in their government would be restored. The times call for decisive action. Political cynics may say this proposal is visionary. I would remind them of the words in the Scriptures—"Where there is no vision, the people perish."

Representative REUSS. We are fortunate in having with us in the hearing room Representative Robert Blackford Duncan of the Third Congressional District of the State of Oregon.

Congressman, we would be honored to have you introduce your colleague, State Senator Jason Boe.

STATEMENT OF HON. ROBERT BLACKFORD DUNCAN, A U.S. REPRESENTATIVE IN CONGRESS FROM THE THIRD CONGRESSIONAL DISTRICT OF THE STATE OF OREGON

Representative DUNCAN. MESSRS. Chairmen, Senator, and members of the committees, I know that those on the House side at least are aware of the total and complete modesty with which those of us from the State of Oregon view the accomplishments of our State and of our favorite sons.

Accordingly, it is an honor for me today to be able to introduce one of our Oregonians who has been honored and whose abilities have been recognized by his election to president of the National Conference on State Legislatures.

Senator Boe and I have known each other for many years. We have campaigned up and down the Umpqua River, Mapleton, Reedsport. We have been up at the Florence. I have known him since before he got in the State legislature where he quickly distinguished himself, moved into a leadership position in the House of Representatives; moved over to the Senate; was elected president of the Senate after one term; and has since been successively reelected three times.

That is an unprecedented event in the State of Oregon. Jason and his supporters attribute it to be a recognition of brains and diligence and hard work and ability; some of his detractors attribute it to the irrationality which some of us in the House of Representatives—with apologies, Senator Javits—sometimes attribute to the actions of the Senate whether at the State or the Federal level.

I count myself as one of Mr. Boe's friends. I'm not sure what he is going to tell you today. Perhaps he will tell you to cut Federal spending, but increase aid to the States. If he says that, I know that he will say much more and I commend to you what he says.

I'm honored to be able to introduce him as he participates in this panel. I'm a former member of the legislature; I was a former member of the Counsel on Intergovernmental Relations; I'm one who believes strongly in the federal system.

I commend the committees for inviting this testimony and the testimony of the panel to the committee.

Thank you.

Representative REUSS. Thank you, Congressman Duncan.

Senator Boe, with a Golden Fleece Award like that you may proceed. We are grateful to have you here.

STATEMENT OF HON. JASON BOE, PRESIDENT OF THE OREGON STATE SENATE AND PRESIDENT OF THE NATIONAL CONFERENCE OF STATE LEGISLATURES (NCSL)

Senator BOE. Mr. Chairman, I have lied about Congressman Duncan for years, and it is only fair he return the honor today. [Laughter.]

Mr. Chairman and Cochairman, Senator Javits, members of the House Subcommittee on the City, and Joint Economic Committee, it is a pleasure to appear before you to discuss the impact of proposition 13 and the structure of fiscal federalism in our country today.

I serve as the president of the Oregon Senate. I am also president of the National Conference of State Legislatures, the NCSL, which is the official representative of the country's 7,600 State legislators and their staffs, now representing all 50 of the States.

NCSL works to help lawmakers meet the challenges of our complex federal system through a variety of State and State-Federal services provided by our headquarters office in Denver and our State-Federal relations office in Washington, D.C.

The NCSL, for those of you who are not familiar with it, is a non-partisan organization funded by the States and governed by a 43-member executive committee. We have three basic objectives:

One: To improve the quality and effectiveness of State legislatures.
Two: To assure States a strong, cohesive voice in the Federal decisionmaking process.

Three: To foster interstate communication and cooperation.

I have been asked to speak today about the effects of the taxpayer revolt on State and local governments. I believe the causes of the taxpayer revolt extend far beyond State boundaries. I believe those of you at this table—and the rest of your colleagues in Congress—must assume at least a large part of the responsibility for the passage of proposition 13 in California.

To further qualify my statement, just recently an identical copy of the Jarvis-Gann proposition, only with a 1-percent limitation, it contains a 1½-percent limitation, but other than that, is a Xerox copy of Jarvis-Gann, was recently placed on the November ballot through the initiative process requiring only 63,000 signatures, but it went on the ballot with well over 200,000 signatures of Oregonians.

So while we are looking at California, I want you to remember that we in Oregon are facing some of the same problems, and perhaps some of the same opportunities that are presented by proposition 13.

I believe that the taxpayer revolt is a loaded gun, and that loaded gun is pointed directly at Congress. The first bullet has hit local governments, and the second bullet may hit State government. But the Federal Government is the ultimate target, and I believe that the third bullet is already on its way toward Washington, D.C.

Unless you act, and act quickly, the voters will not only take the matter out of our hands, but out of your hands. And I must tell you it is my considered opinion, Mr. Chairman—and this is a complete reversal of an opinion I have held for many years—that I firmly believe that within the next 5 years, we will see a constitutional convention called

in this United States. I firmly believe that. I did not, but I do now, because the mood of the people out there is to grab hold and grab hold wherever they can. As they see the initiative referendum process working in the 23 States that have that today, there is going to be increased pressure on those rest of the States that do not have the initiative referendum to move in that direction.

And that is happening right now. There will be over 6,000 State legislators up for election or reelection this year. Every one of those legislators are going to have the finger pointed at them saying "Where do you stand on Jarvis-Gann?" And I suspect you and your colleagues who are up for reelection this year, and those in the Senate who are up this year, are going to be asked that same question, and you are going to be having to respond to those same types of questions.

We in the State legislatures are at the battlefront of the war on high taxes, and we have been so for many years.

Let me go now into the effect on State governments. In the California situation and possibly the Oregon situation, the passage of proposition 13 has attracted widespread popular attention. It reminds us once again that most people believe in the American tradition of limited government and that when government becomes too expensive or too luxurious for public taste, voters can find ways to send a message to their elected officials about scaling back government outlays and programs.

The California legislature was able to temper the effects of proposition 13 through quick, decisive action. But most of the rest of the States don't have the large budget surpluses that were available in California.

I'll let Mr. Farber, representing the Governors Association, go into the fallacy of some of your statisticians in the Federal Government who have been claiming that there is a \$36 billion surplus out there, and we'll commend to you an article from the Wall Street Journal this morning pointing out the fallacies of some of your statisticians' basic assumptions.

But most of the States don't have the large surpluses that were available in the State of California. The passage of a measure like proposition 13 would result in immediate and widespread financial hardships in almost all other States.

The 1-year emergency relief plan devised by the California legislature makes effective use of that State's \$5 billion surplus, since over \$4.4 billion of that surplus is returned to provide relief to that State's counties, cities and school districts.

But I would hasten to add that there are many States like Oregon who have used whatever resources they have to develop homeowner and renter property tax relief programs. And, by the way, one of the great faults with Jarvis-Gann among other things, is the fact that the renter is absolutely left out. In California today they are in the throes of coming to grips with that by some voluntary rental controls or roll-back of rentals which in my opinion are not going to be terribly successful, and will be for a limited time only.

The 1-year emergency relief plan devised by the California Legislature does make good use of their money. Among the special provisions in the relief plan in California are State assumption of the county public assistance costs and the like. Other significant aspects of the California legislation include the provision that most cities and counties

will operate at 80 percent of the previous budget levels, and the provision that most school units will have about 85 to 91 percent of last year's expenditures, which may mean that regular programs will not suffer if certain extracurricular and summer programs are reduced in school budgets.

Delegation of greater authority to California counties to allocate over \$125 million annually, and assurance that cities and counties maintain such essential services as police and fire protection at levels existing prior to Proposition 13 were included.

All State legislatures are going to be watching California closely over the next few years, and also in Oregon, if it passes, as it appears that it might—to see the long-term impacts of Proposition 13. It is apparent the California legislature has been largely successful in meeting many of the measures' immediate challenges. But the real effects of the Jarvis-Gann meat-ax approach to tax reform might not be known for several years.

I don't think anybody, no matter how distinguished they are as economists, can ultimately see what the ultimate effect of Proposition 13 may be when the surpluses have dried up and are no longer available. I believe that the California legislature was right in not looking to Congress for a Federal "bailout". I don't believe that many States, if any, will look for Federal assistance should measures like Proposition 13 make it on the ballot.

They are not looking to fill the sock up from outside sources. They are looking for ways to cut, cut severely, and cut all types of waste. I want to give just a brief history on State limits on spending.

Proposition 13 is the latest in a rather long and extensive history of State limitations on local government budgets beginning in the 1930's when citizens were seeking relief from depression troubles, and again in the late 1960's and early 1970's when they felt the strain from rising property taxes and continuing in 1978 because of the increases in all forms of taxes.

I'll skip through a good deal of this because I know your time as well as ours is somewhat limited.

Let me point out that despite the tremendous publicity given to Proposition 13, most States have had considerable experience with limitations on State and local spending, that the States are acutely aware of the fiscal problems of the property value inflation and are moving almost universally to develop property tax assessment and relief programs to reduce the burdens of rising taxes.

It is clear to me that Proposition 13 is ushering in an era of fiscal restraint for State and local governments throughout the country. This is a new era of fiscal prudence that I think will produce several major events in State financial policies in the years ahead.

States will continue to experiment with several imposed limits on State and local spending rather than have such limits approved through popular initiative.

Tennessee's recent enactment of the constitutional limit on increases in State spending, and the various types of fiscal limits that other States have imposed on local school districts in the course of school finance reform are ample indication that legislatures often need little prodding to curtail State and local spending, especially during these times of double-digit inflation.

As I said earlier, Congress must assume certain responsibilities as a result of the taxpayers' revolt. I don't make this statement lightly. I sincerely believe that much of the anger behind the taxpayers' revolt is aimed at inflation, and is aimed at Federal spending practices that appear to be fueling this inflation.

Forty-eight of the 50 States operate on a balanced budget, by constitutional mandate. We cannot print additional money or operate on a deficit. This is wise, and the Congress would do well to follow the lead of the States in this matter.

My home State of Oregon is just one of the many States that have passed a resolution calling for a constitutional convention to require the Federal Government to live within a Federal budget except in times of war or true national fiscal emergencies.

The voters view your current \$51 billion deficit as one of the main reasons for today's skyrocketing costs and they appear to be right.

Mr. Chairman, I am going to have the rest of my testimony entered in the record, but in conclusion, let me state, Proposition 13 has provided both State and Federal governments with what I think is a rare opportunity. With all the bad things that can be said about it, it has provided State and Federal governments with a rare opportunity to reassess the structure of fiscal federalism in this country.

Both the Federal and State governments will have to better balance their revenue and expenditure structures. The State and Federal governments most certainly will have to address the impact of continued Federal deficits, and their impact on inflation. They will have to apply the same scrutiny to the economic impact of their regulations, and other preemptive measures that unduly raise the cost of government.

We in the States are terribly concerned with the increasing intrusion of the Federal bureaucracy in literally, by bureaucratic edict, ripping pages from the State lawbooks of every single State in this Nation, not by an act of Congress duly signed by the President of the United States and enacted into law, but by bureaucratic edict from the Federal Trade Commission, from the Federal Communications Commission, and others who are without the benefit of passage by Congress, writing, rewriting, and ripping up State laws in all 50 States today as we sit here.

This is a dangerous thing, and I must communicate to you the concerns of the States with regard to what is happening on this level. The Federal Trade Commission, gentlemen, and ladies, is your responsibility. They are an arm of the Congress, and you must watch them carefully. As both the Federal and State governments begin to revise their fiscal policies, in light of Proposition 13, we must have a more constructive and fruitful dialog between the State legislatures and the Congress on such matters as the Federal tax reform, welfare revisions, general revenue sharing, and regulation reform.

As president of the Oregon Senate and president of the National Conferences of State Legislatures, I will assure you that State legislatures will help in steering a course of fiscal prudence for this Nation's intergovernmental fiscal system.

I urge the members of this committee, and your colleagues, to do likewise in order to assure the American public that their Government is one that can responsibly live up to the challenges and to the opportunities that are presented to us today by Proposition 13.

Thank you very much.
 Representative REUSS. Thank you very much, Senator Boe.
 [The prepared statement of Mr. Boe follows:]

PREPARED STATEMENT OF HON. JASON BOE
Proposition 13 and the Future of Fiscal Federalism

INTRODUCTION

Chairman Reuss and Chairman Moorhead and distinguished members of the House Subcommittee on the City and the Joint Economic Committee, it is a pleasure to appear before you today to discuss the impact of Proposition 13 on the structure of Fiscal Federalism in our country today.

My name is Jason Boe, and I serve as the President of the Oregon Senate. I am also the President of the National Conference of State Legislatures (NCSL) which is the official representative of the country's 7,600 state legislators and their staffs. NCSL works to help lawmakers meet the challenges of our complex federal system through a variety of state and state-Federal services provided by our headquarters office in Denver and our state-federal relations office in Washington, D.C.

The NCSL is a non-partisan organization funded by the States and governed by a 43 member executive committee. NCSL has three basic objectives:

To improve the quality and effectiveness of State legislatures.

To assure States a strong, cohesive voice in the Federal decision-making process.

To foster interstate communication and cooperation.

I have been asked to speak today about the effects of the taxpayer revolt on State and local governments. But I believe the causes of the taxpayer revolt extend far beyond State boundaries. I believe those of you at the table—and the rest of your colleagues in Congress—must assume a large part of the responsibility for the passage of Proposition 13 in California. I believe the taxpayer revolt is a loaded gun pointed directly at Congress. The first bullet has hit local governments and the second bullet may hit State government. But the Federal Government is the ultimate target, and the third bullet is already on its way to Washington, D.C. unless you act—and act quickly—the voters will take the matter completely out of your hands.

State legislatures are at the battle front of the war on high taxes—and have been for many years.

PROPOSITION 13: ITS EFFECT ON STATE GOVERNMENTS

The California situation.—The passage of Proposition 13 in California has attracted widespread popular attention. It reminds us once again that most people believe in the American tradition of limited government and that when government becomes too expensive or too luxurious for public taste, voters can find ways to send a message to their elected officials about scaling back government outlays and programs.

The California legislature was able to temper the effects of Proposition 13 through quick, decisive action. But most of the rest of the States don't have the large budget surpluses that were available in California. The passage of a measure like Proposition 13 would result in immediate and widespread financial hardships in almost all other States.

The one year emergency relief plans devised by the California legislature makes effective use of the State's \$5 billion surplus since over \$4.4 billion of that surplus is returned to provide relief to that State's counties, cities and school districts.

Among the special provisions in the relief plan are: State assumption of the county public assistance, the subordination of previously independent special districts to their respective counties, and a freeze on State employee salaries and benefits for public welfare recipients.

Other significant aspects of the California legislation include:

Provision that most cities and counties will operate at 80 percent of previous budget levels.

Provision that most school units will have about 85-91 percent of last year expenditures which may mean that regular programs will not suffer if certain extracurricular and summer programs are reduced in school budgets.

Delegation of greater authority to California counties to allocate over \$125 million annually for the operation of special districts within their jurisdiction. Assurance that cities and counties maintain such essential services as police and fire protection at levels existing prior to Proposition 13.

All State legislatures will be watching California closely over the next few years to see the long-term impacts of Proposition 13. It is apparent the California legislature has been largely successful in meeting many of the measures' immediate challenges. But the real effects of the Jarvis-Gann meat ax approach to tax reform might not be known for several years.

The California legislature was right in not looking to Congress for a Federal "Bail-out". I don't believe that many states—if any—will look for Federal assistance should measures like Proposition 13 make it on the ballot. You in Congress have your own responsibilities in this situation, and I will get to them shortly.

State limits on spending: A brief history.—Proposition 13 is the latest development in a rather long and extensive history of state limitation of local government budgets, beginning in the 1930's, when citizens were seeking relief from depression troubles, and again the late 1960's and early 1970's when they felt the strain from rising property taxes, and continuing in 1978 because of the increases in all forms of taxes.

Over the last decade the impetus for states to play a more extensive role in local fiscal affairs has been derived from the following factors:

- (1) A greater public demand for property tax relief.
- (2) Court-mandated upgrading of assessment practices to encourage equalization.
- (3) The assumption of an increasing share of state/local expenditures responsibilities by the state.
- (4) An effort by the state to control and equalize school district expenditures.

The use of property tax and expenditure limitations originated in the late 19th century. Nine states had such limitations before 1940. Since 1970, fourteen states and the District of Columbia have enacted some form of tax and/or expenditures limitations.

Currently state tax and expenditure controls on local governments are directed primarily at limiting the use of property taxes in an effort to bring relief to the taxpayers in the state.

The two most common tax relief methods used by states to effect a decrease in citizen property tax burdens are homestead exemptions and circuit-breaker programs. A homestead exemption reduces the assessed value of a property by a specific dollar amount. A circuit-breaker program extends a rebate or credit to families whose property tax exceeds a state determined percentage of the family's income. Circuit-breaker programs are usually administered through the state income tax system but can be administered separately.

Both programs have generally been targeted to elderly or disabled homeowners and renters; however, within the last two years several states have revised eligibility requirements so that a larger number and a broader range of their taxpayers are eligible to receive some relief. Indeed, state appropriations for circuit-breaker reached close to \$1 billion in FY 1977. This is not an indication of the growing concern among the states about ever increasing property taxes and the citizen responses to these increases.

Finally, since 1976 five states have passed tax or expenditure limitation legislation to check the growth in state spending. Eight states deliberated on such measures in their 1978 sessions. At least six states are attempting to get such legislation on the ballot in their states this fall. Many other states are actively involved in drafting legislation on these matters for consideration in the near future. As more citizens in each state continue to express their concern about the rising costs of services and ever increasing property taxes, legislatures will continue to respond promptly, but responsibly.

School finance pressures.—Part of this strain from rising property taxes has been reflected in the widening gaps in local spending for public education. Several state courts in the 1970's mandated that education outlays could not depend directly on real estate values unless states equalized the yield from local property tax effort. Laws prohibiting uncontrolled local spending have, therefore, been put on the books over the last decade.

State limits on local school operating budgets are common to every region of the country, with exception of the northeast. No New England state except Maine imposes limitations on local education budget authority (see table 1).

Elsewhere in the northeast, the only statewide controls on school budgets are confined to Pennsylvania, with New York and New Jersey applying limits only to large cities.

Limits are generally imposed in three ways: On property tax rates, property tax levies, and expenditures. Rate limits are used in 26 states; levy limits in 6; and expenditure controls in 4. Rate limits set the maximum percentage of the local property tax base that may be used annually for school revenues; although the real meaning of the rate limits depends in part, however, upon whether state property assessment practices are standardized. While rate limits are the most popular form of budget control, levy and expenditure controls have been increasingly accepted. School districts are permitted to raise local tax revenues equal only to a lump sum pupil or percentage amount. In states with expenditure limits, school districts are permitted to increase their expenditures annually by a legislatively determined percentage; expenditure limits can also function on a lump-sum basis that permits each school district to increase its outlays only by a certain dollar amount for each pupil.

Although only very sparse information on actual fiscal results have been documented, the evidence indicates that State controls on local budgetary authority have minimally affected education. States which limit local school district expenditures spend an amount comparable to schools in States without limits. Likewise, States with limits raise approximately the same share of educational revenues from local sources as do States without limits. Moreover, there is insufficient evidence conclusively to support the finding that expenditure limitations depress educational quality.

But, limits have had these effects: States rely less on the local property tax as a source of educational revenue, and especially so when limits are part of major reform in school finance legislation. Limits often assist low-wealth, low-expenditure districts which can justify budget increases that would otherwise be suppressed in the name of holding down rising educational costs.

Federal aid policies and spending limits.—Increased Federal funds, together with increased latitude in the use of these funds, can undermine State legislative control of expenditures. Federal funds now make up an average of 21 percent of States' budgets, for a fiscal year 1978 total of \$80 million on its official civilian payroll. These persons include the swelling numbers of workers who receive indirect Federal monies through Government contracts, research grants and Federal matching payments for local government officials. Indeed, State executive agencies often use Federal grants to support programs and functions which the legislature has expressly denied budgetary authority. Thus, the State's responsibility for sound fiscal planning and management is critically at stake.

Scant consideration has been given to the fit between Federal and State programs. For example, some States which have enacted school finance reform laws, consider Federal impact and payments as part of the basic State aid contribution to local school finance budgets. Yet, for the most part, Federal and State-local monies operate independently. Often the Federal Government provides marginal monies for educational programs the later become major State-local fiscal burdens. In the absence of general aid support, this burden strains the ability of a State to adequately fund its own equalizing general aid formula.

Additional problems will be generated when States which may pass spending limits find difficulty in meeting Federal requirements prohibiting supplanting of State monies. Whether California will be able to meet this requirement after current State surpluses dry up, remains to be seen. Because States passing limits may not be able to maintain outlays in the long run, many programs, particularly disadvantaged and bilingual education and manpower programs may be severely jeopardized.

At this point, it is fair to point out that despite the tremendous publicity given Proposition 13:

Most States have had considerable experience with limitations on State and local spending.

States are acutely aware of the fiscal problems of property value inflation and are moving almost universally to develop property assessment and relief programs that will reduce the burden of rising taxes.

Considerable unrest with rising State and local taxes must in part be laid at the door of the Federal Government which has contributed to the expansion of the State-local sector through the increases in Federal aid, particularly categorical aid which promotes higher State-local spending.

FUTURE STATE RESPONSES TO PROPOSITION 13

It is clear to me that Proposition 13 is ushering in an era of fiscal restraint for State and local governments throughout the country. This new era of fiscal prudence, I think, will produce several major developments in State finance policy in the years ahead.

First, States will continue to experiment with self-imposed limits on State and local spending rather than have such limits imposed through popular initiative. Tennessee's recent enactment of a constitutional limit on increases in State spending and the various sorts of fiscal limits that States have imposed on local school districts in the course of school finance reform are ample indication that the legislature often needs little prodding to curtail State and local spending, especially during these times of double digit inflation.

In a related vein, States are also examining their revenue structures quite closely to determine ways in which they can be made more equitable during these troubled times. Colorado, for example, has recently indexed its income tax to prevent undue fiscal surpluses during times of inflation. Several States cut various taxes during this current year (see table 2). The Arizona legislature recently enacted a constitutional amendment which will be submitted to the voters which will limit tax revenue to 7 percent of income. Similar proposals on limiting revenues have recently been enacted in New Jersey and will be considered in upcoming legislative sessions in such diverse States as Maine, Florida, Minnesota, and Pennsylvania. Tax limitation legislation will be a major item in upcoming legislative sessions.

In that context, let me remind this committee that State governments moved vigorously in this past session of the legislature to make many important changes in a variety of State-local fiscal policies. For example:

Seventeen States adopted or expanded their property tax circuit-breaker or homestead exemptions.

Ten States either made major cuts in their State taxes or enacted major exemptions in their broad-gauged taxes (see table 2).

A large number of States are conducting comprehensive interim studies of their overall State-local tax structure to develop new policies aimed at reducing State-local tax burdens or making them more equitable for businesses and individuals.

Finally, States are increasingly active in scrutinizing Federal aid in their own budgets. More and more States are following Pennsylvania's lead in reappropriating Federal aid in their own budget. Thirty-seven States have developed regulation review capabilities that may ultimately be applied to analysis of Federal regulations that increase State and local governmental costs. In these two areas and many others, it is clear that State governments are going to examine the terms and conditions of the Federal aid dollar more closely than ever before to prevent against distortions of State taxing and spending policies. It most certainly means that State legislatures throughout the country will be promoting the concept of having the Federal Government deliver more of their intergovernmental aid through general revenue-sharing and block grants that give broad State discretion in allocating Federal aid.

PROPOSITION 13; THE FEDERAL ROLE

As I said earlier, Congress must assume certain responsibilities as a result of the taxpayer revolt. I do not make this statement lightly. I sincerely believe that much of the anger behind the taxpayer revolt is aimed at inflation and the Federal spending practices that are fueling inflation.

Most States operate on a balanced budget. We cannot print additional money or operate on a deficit. This is wise, and Congress would do well to follow the lead of the States in this matter.

My home State of Oregon is just one of many States that have passed a resolution calling for a constitutional convention to require the Federal Government to live with a balanced budget, except in times of war or true national fiscal emergencies. The voters view your current 51 billion dollar deficit as one of the main reasons for today's skyrocketing costs—and they are right.

But the quick, across the board budget cuts now being considered by Congress are not appropriate. The House recently voted to cut 6.4 billion dollars from various appropriations bills. This move tremendously increased the power of the executive branch by giving the President the final responsibility to determine which programs get trimmed. It is Congress' responsibility to prioritize spend-

ing and determine where cuts are to be made—and to do otherwise is just plain “chicken.”

Congress would do well to take a long, hard look at all existing Federal programs. Whether this is accomplished through a formal “sunset” review or a less formal Ways and Means Committee review is up to you. But Congress had better find some effective way to cut waste and eliminate outdated programs before the voters find a way to do it themselves—as they did in California.

I believe the issue of Federal preemption is central to understanding the origins of the taxpayer revolt. Congress must take a closer look at the mounting economic costs of Federal Government regulation.

One of the President's inflation counselors, Dr. Barry Bosworth, has indicated to the NCSL that increasing Federal regulations in the environmental and occupational health area may be costing this country as much as \$100 billion per year—an amount that may be considerably in excess of the benefits of such regulations. Moreover, these regulations may be adding nearly a full percent to the current inflation rate.

In the same context, the Federal Government must consider the cost of the various mandates and preemptive Federal regulations that are increasingly being issued from Washington. The Vocational Rehabilitation Act of 1973, for example, may cost State and local governments as much as \$9 billion to implement. Not one cent of Federal money is yet forthcoming to help meet this mandate. Mandating programs without the promise of some fiscal support to implement a program is an outmoded notion. More and more States, such as my own State of Oregon, are developing policies that will provide local governments with adequate support for any State mandated program. The Federal Government should follow the lead of progressive States in this field.

Congress should also take a close look at the manner in which it sends funds to the States. Legislatures are going to need budget flexibility to meet the wishes of the voters. General revenue sharing dollars are a must, and I would urge that the administration and Congress even now reaffirm its commitment to early passage of general revenue sharing in the 1980 session of Congress.

Unconditional general revenue sharing represents one of the most fundamental changes in the operation of our Federal fiscal system. With a minimum of strings and with due regard for the budget responsibilities of State and local government, the program has provided welcome assistance for State and local governments in the past several years. This program should be continued and expanded in 1980: Any cutbacks or conditions placed on the program will undoubtedly be opposed by State and local governments and their national organizations such as NCSL. Therefore, to preserve comity among all levels of Government, we will appreciate your early support in revenue-sharing renewal.

CONCLUSION

In conclusion, let me state that Proposition 13 has provided both State and Federal Governments with a rare opportunity to reassess the structure of Fiscal federalism in this country.

Both State and Federal governments will have to better balance their revenue and expenditure structures. The Federal government most certainly will have to address the impact of continued Federal deficits and their impact on inflation; they will have to apply the same scrutiny to the economic impact of their regulations and other preemptive measures that unduly raise the cost of government.

States will be revising their revenue structures to create more fiscal equity for the business and individual taxpayer. They will also be continually analyzing their many local aid programs to prevent undue disruption in essential local public services and to prevent overreliance on the local property tax.

As both levels of government begin to revise their fiscal policies in light of Proposition 13, we must have a more constructive and fruitful dialogue between state legislatures and the congress on such matters as Federal Tax Reform, welfare revisions, general revenue sharing, and regulation reform. As president of the Oregon Senate and the president of the National Conference of State Legislatures (NCSL) you may be assured that state legislatures will help in steering a course of fiscal prudence for this nation's intergovernmental fiscal system. I urge members of this committee and your other colleagues to do likewise in order to assure the American public that their government is one that can responsibly live up to the many challenges brought about by Proposition 13.

Thank you.

TABLE 1.—STATE LIMITS ON SCHOOL DISTRICT OPERATING BUDGETS, 1976

State	Limit in force	Limit imposed on—		Limit coverage			Referendum override possible
		Millage	Expend/levy	Universal	Classified	Partial	
New England:							
Connecticut							
Maine	X	X		X			
Massachusetts							
New Hampshire							
Rhode Island							
Vermont							
Mideast:							
Delaware							
Maryland							
New Jersey	X	X				X	X
New York	X	X				X	X
Pennsylvania	X	X			X		
Southeast:							
Alabama	X	X			X		X
Arkansas							
Florida	X	X		X			
Georgia	X				X		X
Kentucky			X	X			
Louisiana		X		X			
Mississippi	X	X			X		
North Carolina							
South Carolina							
Tennessee							
Virginia							
West Virginia	X	X		X			
Great Lakes:							
Illinois	X	X			X		
Indiana	X		X	X			
Michigan	X	X		X			
Ohio	X	X		X			X
Wisconsin	X		X	X			
Plains:							
Iowa	X		X		X		X
Kansas	X		X		X		
Minnesota	X		X		X		X
Missouri	X	X		X			
Nebraska	X	X			X	X	X
North Dakota	X	X			X		X
South Dakota	X	X			X		X
Southwest:							
Arizona	X		X	X			
New Mexico	X	X		X			
Oklahoma	X	X		X			
Texas	X	X			X		
Rocky Mountains:							
Colorado	X		X	X		X	X
Idaho	X	X		X			X
Montana	X			X			X
Utah	X	X			X		X
Wyoming	X	X			X		
Far West:							
Alaska	X	X				X	
California	X		X		X		X
Hawaii							
Nevada	X	X		X			
Oregon	X		X	X			X
Washington	X	X		X			X

Source: See appendix A.

TABLE 2.—SELECTED STATE TAX ACTIONS, 1978

State	State tax cuts/revisions	State tax exemptions	State spending limits	Circuit-breaker/ homestead exemptions
California			Proposition 13	X
Colorado	Indexation of state income tax.			X
Connecticut	Elderly recipients of SSI can receive direct grant in refund of utility and rent bills paid.			X
Idaho				X
Illinois				X
Indiana		Increased income limits on property tax exemptions for elderly.		X
Iowa				X
Kansas				X
Maine	Reduced personal income tax rates.			X
Maryland				X
Massachusetts		Extended income limits on income tax exemptions.		X
Michigan				X
Minnesota	Reduced State income tax rates.			X
Mississippi	Doubled standard deduction allowable.			X
Nebraska				X
New Jersey				X
New Mexico	Reduced State sales tax rate.			X
New York	Reduced State income tax rates, increased investment tax credit, increased amount standard deduction allowable.			X
Rhode Island				X
South Dakota	Increased property and sales tax refunds for elderly and disabled.			X
Tennessee			Limited state spending to the rate of economic growth in state.	X
Vermont	Repealed State income surtax.			X

Representative REUSS. Our next witness is Mr. Stephen B. Farber.

STATEMENT OF STEPHEN B. FARBER, DIRECTOR, NATIONAL GOVERNOR'S ASSOCIATION

Mr. FARBER. Chairman Reuss and Mr. Cochairman Moorhead, members of the House Subcommittee on the City, and the Joint Economic Committee, it is a great pleasure for me to appear before you today

on behalf of the National Governors' Association, the policy instrument of the Nation's Governors.

Your hearings today are timely and important. The issues which you are examining require less heat and more light. These hearings can help achieve this result.

My prepared statement, which you have seen, addresses several questions that are of fundamental importance to the debate over tax and expenditure limitations. One key question is the extent to which State assistance to local governments has increased to enable those governments to restrict growth of their local property taxes.

Our analysis at the National Governors' Association shows that State support of local governments now totals \$73 billion and has virtually doubled in the last 12 years even after the impact of inflation is discounted.

Two-thirds of all State revenues go to support local governments. State discretionary grants to local governments have increased twice as fast as overall State aid. As a result local property taxes have steadily declined both as a percentage of State and local revenues and as a percentage of personal income.

During the past 12 years State assistance to local governments in welfare has grown by 450 percent; in revenue sharing, by 409 percent; in education, by 240 percent; in highways, by 103 percent; and in health and hospitals, by 259 percent.

I would like to emphasize the growth in revenue sharing, 409 percent, because we strongly believe that the Federal Government would also be making more effective use of its funds through continued and expanded use of mechanisms for revenue sharing.

Sometimes in Washington, D.C., Mr. Chairman, the magnitude and the significance of State assistance to local governments are underestimated. But I can assure you that in the capitals of all the 50 States, both State and local officials have a full appreciation of the meaning of the \$73 billion figure that I quoted, a figure that looms even larger in importance when tax and expenditure limitations are discussed or projected.

A second key question deals with actions States have taken, and are taking, to limit taxes and expenditures. On the tax side, almost every State has acted in the past 3 years to limit State and/or local taxpayer liability through increased credits, deductions, or exemptions. State circuitbreaker programs, for example, now operate in 30 States.

In 1977, they returned \$932 million to just over 5 million households for an average rebate of \$184. On the expenditure side, tax expenditure limits of different kinds have been set in Tennessee, New Jersey, Colorado, and Michigan, and they are pending in other States.

In short, Mr. Chairman, the past several years have seen extensive State action to limit taxes and expenditures.

The need now, as States consider new approaches in the wake of the passage of proposition 13, is for programs that are well considered and precisely targeted.

A third key question deals with the impact of tax limitation efforts on the State and national economies, and on the delivery of services. You are familiar with the recently completed CBO analysis of the effects of proposition 13. That report is sobering in its conclusions. Whether or not one fully agrees with the report's conclusions, the

message, it seems to me, is quite clear: We must all insist on knowing the full impact of programs to limit taxes and expenditures on the economy of the States and of the Nation, and on the delivery of services, before and not after they are adopted.

The question to which my statement devotes the most substantial attention, Mr. Chairman, is the actual fiscal condition of the States. There has been widespread, and I believe quite damaging, error and confusion on this question, and these hearings can perform a great service by helping to set the record straight so that sound and well-informed public policy can be made.

The prevailing myth in some quarters is that there is a massive surplus in the States in the range of \$30 billion.

Cochairman Moorhead alluded to these figures in his opening presentation. I'm glad that you did, Mr. Cochairman, because it's time to nail hard, and nail precisely, what the facts are.

The reality, as opposed to the myth, of the State surplus, or more accurately, the States' general fund operating balance, is quite different. The \$30 billion figure often heard is actually a combination of what the Commerce Department calls "social insurance funds," and "other funds" for both State and local governments.

The social insurance or pension funds are not available to State and local governments to pay their operating costs. Yet these funds currently represent nearly two-thirds of the so-called surplus.

The aggregate State government general fund operating balance, as of the first quarter of 1978, was projected at \$6 billion by our best analysis, and that figure reflects sound budgeting practices.

During the first quarter of 1978, local governments, as opposed to State governments, appeared to have an operating balance of approximately the same size as State governments; that is, in the range of \$6 billion. These are data that we have compiled painstakingly with the excellent assistance of the National Association of State Budget Officers.

The aggregate State operating balance represents less than 6 percent of the operating budgets of all States. Sound budgeting experience suggests that such a contingency fund is necessary to offset unexpected emergencies or financial difficulties, and in all of the States which you represent, Mr. Chairman and members of the subcommittee and committees, you know that these emergencies, whether floods or disasters of other kinds, or fiscal difficulties, can and do arise and must be budgeted for.

The bulk of the aggregate State operating balance is found in just a few States, and in those States, such as California, where Governor Brown and the legislature have acted decisively to deal with the impact of proposition 13, the balances have already been largely committed.

The fact is that most States—such as New Jersey, Mrs. Fenwick, which has a \$23 million surplus in a massive State budget—have a modest or marginal balance at the very best.

In short, the reality of the State financial situation is significantly different from the myth. The surplus, as Barron's magazine concluded in its May issue of this year, is "vanishing," and "phantom."

The aggregate operating balance for State governments is about \$6 billion, or one-fifth of the commonly cited \$30 billion figure, and

it is projected to be proportionately smaller, perhaps 30 percent smaller, by the end of fiscal year 1979.

The balances in most States are small, and represent sound financial management, and far from acting as a drain on the economy, these balances will either be returned to citizens to reduce property taxes, or reinvested in economic growth.

This morning's Wall Street Journal, on page 3, has this headline: "U.S. Finds State, Local Budget Surpluses Evaporating, Trims Third, Period Estimate."

I commend this excellent story to your attention. The impact of this information on the tax limitation debate and on fiscal federalism cannot be overstated.

Misinformation on the fiscal condition of the States could well confuse, and even inflame, the tax limitation debate. And as the night follows the day, inaccurate data will lead to unsound public policy.

It is frankly high time to consign the myth of the massive State surplus to the oblivion it deserves. As Gov. William G. Milliken, chairman of the National Governors' Association, has said, "Anyone who claims that there are massive State surpluses is not familiar with the facts."

As the administration and Congress consider the fiscal 1980 Federal budget, and as you examine the longer-term issues, such as continued State participation in general revenue sharing, it is extremely important for options to be considered, and decisions made, on the basis of the reality, not the myth of the States' fiscal condition.

It is time to note with precision the tremendous growth in State assistance to local governments, and the enormous size of that assistance, and time to note as well, with equal precision the fact and not the fiction about the States' fiscal condition.

Finally, Mr. Chairman, it seems to me that on this question, as on the others I have just discussed, the stakes for responsible government, and for fiscal federalism, are extremely high.

The National Governors' Association will continue to address all these questions, just as fully and forthrightly as we can. We look forward to a continued close working relationship with the administration, and with the Congress, in this effort.

Thank you.

Representative REUSS. Thank you very much, Mr. Farber.

[The prepared statement of Mr. Farber, with an attachment, follows:]

PREPARED STATEMENT OF STEPHEN B. FARBER

Chairman Reuss, Cochairman Moorhead, and members of the House Subcommittee on the City and the Joint Economic Committee, I appreciate the opportunity to appear before you today on behalf of the National Governors' Association, the policy instrument of the Nation's Governors.

Your hearings on efforts to limit taxes and expenditures, and their implications for fiscal federalism, are timely and important. Since the passage of Proposition 13 on June 6 by the voters of California, taxpayers and public officials in every State have been grappling hard with the problems and the opportunities created by efforts to limit taxes and expenditures. The issues involved are in great need of less heat and more light. These hearings can help develop the sound and reliable base of information required for a better informed consideration of the issues.

In my statement today I would like to address four fundamental questions:

1. What is the actual fiscal condition of the States?
2. What constructive steps have states taken in the past, and are they now taking, to provide greater financial assistance to their local governments?

3. What constructive steps have states taken in the past, and are they now taking, to limit taxes and expenditures?

4. What effects will tax limitation efforts have on the state and national economies and on the delivery of services?

The first question—what is the actual fiscal condition of the states?—is of crucial importance. I regret to say that there is widespread error and confusion on this point—despite the best efforts of the National Governors' Association, the National Conference of State Legislatures, the National Association of State Budget Officers, and others—and it is high time to set the record straight.

Notwithstanding the data contained in the NGA-NASBO Fiscal Survey of the States, the prevailing myth in some quarters is that there is a massive "surplus" in the states in the range of \$30 billion. This figure has been taken out of context from the President's Economic Report of last January and from the national income and product accounts of the Commerce Department's Survey of Current Business which have preceded and followed it.

The reality, as opposed to the myth, of the state "surplus"—or more accurately, the states' general fund operating balance—is quite different.

First, the general fund operating balance of State and local governments is not 30 billion. The \$30 billion figure is actually a combination of what the Commerce Department calls "social insurance funds" and "other funds." The President's Economic Report notes that "a large part of the aggregate surplus represents accumulations of pension funds for the 13 million employees of State and local governments." The social insurance funds are not available to state and local governments to pay operating costs.

The most recent figures from the Commerce Department—for the first quarter of 1978—show \$19.9 billion in "social insurance funds" and \$11.5 billion in "other funds". These figures are significant for at least two reasons. First, they reflect the increasing efforts by State and local governments during the past three years to put their pension funds in order. Second, they show that of the total State-local "surplus", nearly two-thirds is unrelated to the current State-local fiscal condition as measured by operating balances.

Second, even the "other funds" category is misleading because it includes a significant amount of restricted revenues—for highways, parks, and other purposes—not available for general fund expenditures. The aggregate state government general fund operating balance, as of the first quarter of 1978, was projected at six billion dollars, and reflects sound budgeting practices. Commerce Department figures released in May indicate that the local share of "other funds" has generally been larger than the State share since 1970. In 1976, for example, "other funds" for local governments were \$2.6 billion and for State governments, \$1.2 billion. During the first quarter of 1978 local governments appeared to have an operating balance of approximately the same size as State governments—that is, in the range of \$6 billion.

The aggregate state operating balance represents less than 6 percent of the aggregate operating budgets of all States. Sound budgeting experience suggests that such a contingency is necessary to offset unexpected emergencies or financial difficulties. The 6 percent aggregate figure represents a slimmer margin for emergencies than many States normally seek to budget. Moreover, since nearly every State is required by its constitution or statutes to have a balanced budget, such operating balances are imperative.

Third, the bulk of the aggregate State operating balance is found in just a few states, and in those States—such as California, where Governor Brown and the legislature have acted decisively to deal with the impact of Proposition 13—the balances have already been largely committed. Most States have very modest or marginal balances. The balances reflect strong economies in energy- and food-producing States, the effects of more progressive revenue systems in an improving national economy, and inflation-induced revenue growth.

Fourth, the States' fiscal 1979 budgets will further reduce current balances. A substantial percentage of the balances which are reported by the States in our surveys will be spent in the fiscal year which began in most states on July 1. A preliminary survey of 29 States indicates that by the end of fiscal year 1979, next June 30, operating balances will decline to four to five percent of general fund expenditures. The revenues will be used to support property tax relief programs, recession-delayed projects, inflation-caused cost increases for labor and materials, and hard-pressed local governments. Also requiring increased State financial support will be such needs as underfunded pension liabilities, equalization of school support, services for the handicapped, and maintenance and upgrading of the public infrastructure.

These demands will put existing balances quickly and efficiently back into the State economies. Moreover, far from acting as a "drain" on the economy—as the President's Economic Report suggests—these resources will enable States to supplement Federal efforts to further expand economic growth.

In short, the reality of State finances is significantly different from the myth. The surplus, as Barron's Magazine concluded in its May issue, is "vanishing" and "phantom." The aggregate operating balance for State governments is about \$6 billion, or one-fifth of the commonly cited \$30 billion figure, and is projected to be proportionately smaller—perhaps by 30 percent—by the end of fiscal year 1979. The balances in most States are small and represent sound financial management. And far from acting as a drain on the economy, these balances will be either returned to citizens to reduce property taxes or re-invested in economic growth and development.

It is imperative that the current misunderstanding of State fiscal data be clarified. We have urged Chairman Schultze of the Council of Economic Advisers to work with us to improve reporting and data collection techniques for State government finances and to incorporate these data into the federal budget reports and the annual Economic Report of the President. And because many Federal policy makers have seemed to interpret the State-local "surplus" figure in the national income and product accounts as the definitive measure of the fiscal condition of State and local governments, we have urged Secretary Kreps to include in the Survey of Current Business a short explanation of the "surplus" figure and its limitations as an indicator of fiscal condition. A copy of our letter to Secretary Kreps is attached for the record.

The impact of this information on the tax limitation debate, and on fiscal federalism, cannot be overstated. Misinformation on the fiscal condition of the States could well confuse, and perhaps even inflame, the tax limitation debate. And as the night follows the day, inaccurate data will lead to unsound public policy. It is frankly high time to consign the myth of the massive State surplus to the oblivion it deserves. As Governor William G. Milliken, Chairman of the National Governors' Association, has said, "Any one who claims that there are massive state surpluses is not familiar with the facts."

As the Administration and Congress consider the fiscal year 1980 Federal budget and examine longer-term issues, such as continued state participation in general revenue sharing, it is extremely important for options to be considered and decisions made on the basis of the reality—not the myth—of the States' fiscal condition.

Let me turn briefly to the three other fundamental questions before these hearings.

The first question is what constructive steps have States taken in the past, and are they now taking, to provide greater financial assistance to their local governments? Precise information about this increased State assistance, which has helped to restrict the growth of property taxes, is essential to informed debate over tax limitation strategies.

A report just completed by the NGA Center for Policy Research entitled Allocation of State Funds to Local Jurisdictions indicates that State support of local governments now totals \$73 billion and has virtually doubled in the last 12 years, even after the impact of inflation is discounted. The report also shows that two-thirds of all State revenues go to support local governments and that State discretionary grants to local governments have increased twice as fast as overall State aid. As a result local property taxes have steadily declined both as a percentage of total State-local revenues and as a percentage of personal income.

During the past twelve years, the report shows, state assistance to local governments in welfare has grown by 450 percent; in revenue sharing, by 409 percent; in education, where many States have acted dramatically to overhaul their school finance systems, by 240 percent; in highways, by 103 percent; and in health and hospitals, by 259 percent.

A related and equally important question is what constructive steps have States taken in the past, and are they now taking, to limit taxes and expenditures? On the tax side, almost every State has acted in the past three years to limit state and/or local taxpayer liability through increased credits, deductions, or exemptions. State circuit breaker programs, for example, now operate in 30 States and in 1977 returned \$932 million—an increase of 108 percent over 1974—to just over five million households—an increase of 68 percent over 1974—for an average rebate of \$184. On the expenditure side, tax expenditure limits of different kinds have been set in Tennessee, New Jersey, Colorado, and Michigan and are pending in other States.

In short, the past several years have seen extensive state action to limit taxes and expenditures. The need now, as States consider new approaches in the wake of the passage of Proposition 13, is for proposals that are well considered and precisely targeted. To assist in this effort the NGA Center of Policy Research, in response to a suggestion made by Governor Ella Grasso and at the request of Governor Milliken, will serve as a clearinghouse to advise Governors on different approaches to tax and expenditure limitation and their impact on services.

A final question of basic importance is what effects will tax limitation efforts have on the State and national economies and on the delivery of services. The Congressional Budget Office has just completed a report on the impact of Proposition 13 on the national economy, Federal revenues, and Federal expenditures. That report is sobering and instructive. It argues that Proposition 13 will cause an employment loss of about 60,000 jobs by the end of 1978; a reduction in the national Consumer Price Index of 0.2 percent by the end of 1978 and 0.4 percent by mid-1980; an increase in Federal revenues of \$600 million in fiscal year 1979 and \$900 million in fiscal year 1980; and a potential reduction in California's participation in Federal grant programs that have matching requirements, particularly in welfare, employment and training, education, and transit. The report further argues that "if such actions spread to a significant number of States, the impact on the Nation's economy and the Federal budget could become significant. Unless the reductions in taxes are at least twice as large as the accompanying slowdown or cut in expenditures, the net effect is likely to be a slowdown in economic activity and employment growth."

Whether or not one fully agrees with the report's data and conclusions, the message here is clear. We must insist on knowing the full impact of proposals to limit taxes and expenditures on the economy of the States and the Nation, and on the delivery of services, before, not after, they are adopted.

On this question, as on the others I have discussed, the stakes—for responsible government and for fiscal federalism—are extremely high. The National Governors' Association will continue to address these questions as fully and forthrightly as we can. We look forward to a continued close working relationship with the Administration and Congress in this effort.

Attachment.

NATIONAL GOVERNORS' ASSOCIATION,
Washington, D.C., July 24, 1978.

Hon. JUANITA M. KREPS,
Secretary of Commerce,
Washington, D.C.

DEAR MADAM SECRETARY: As you may know, the National Governors' Association and National Conference of State Legislatures have expressed concern on several occasions about what appears to be a widespread misunderstanding of the meaning of the state-local "surplus" figure reflected in the national income and product accounts prepared by the Commerce Department's Bureau of Economic Analysis. Enclosed are some of the materials in which we have conveyed our concerns to members of the Administration, Congress, and the press.

Regrettably, the misunderstanding has persisted despite our efforts, and it appears to have the potential to influence public policy. This letter is to ask your assistance in a small matter that could go a long way toward clearing up this misunderstanding.

The heart of the problem is that many federal decision-makers have interpreted the state-local "surplus" figure in the national income and product accounts as the definitive measure of the fiscal condition of state and local governments. We are sure that your economists would agree that the national income and product accounts were not intended to measure the absolute fiscal condition of state and local governments and that they should not be used for this purpose.

We believe that it would be helpful if the Commerce Department would publish in the Survey of Current Business a short explanation of the precise meaning of the surplus figure and of its limitations as an indicator of fiscal condition. By way of example, the following language addresses the main points with regard to the figure's limitations:

The size of state and local government surpluses, as reflected in the national income and product accounts, has attracted significant public attention in recent months. The following technical points should be kept in mind in interpreting this statistic:

1. The national income and product accounts are not a definitive measure of the fiscal condition of state and local governments. The accounts measure flows

among sectors of the economy that generate income or product. The accounts thus provide income and expense information but do not show state and local government balance sheets, which would be necessary to make informed judgments about fiscal condition. The accounts do not show, for example, the debt position of state and local governments nor do they reflect the condition of assets with regard to maintenance and replacement.

2. The accounts cover more than 80,000 governments, and aggregate trends can mask contrary conditions for even a majority of these governments.

3. The accounts show the net flow of social insurance funds as part of the state-local surplus although these funds are not available to state and local governments to pay operating costs.

4. The vast majority of state and local governments are required by constitutional provision or statute to operate on a balanced budget and are prohibited from borrowing to meet operating costs. In these governments, the ability to deal with contingencies may dictate the deliberate budgeting of a surplus.

5. A significant portion of state and local revenues is restricted by constitutional provision or statute to specific and narrow uses and is therefore not relevant to the fiscal condition of state and local government general operating funds.

6. The size of the state-local surplus as reflected in the national income and product accounts may be influenced by changes in the rate at which state and local governments spend for capital construction. These changes may be caused by external factors not significantly related to the fiscal condition of the governments.

An explanation along these lines in the highly respected Survey of Current Business would help ensure that the state-local surplus figure is not misunderstood and would therefore contribute to better-informed public policy.

Sincerely,

WILLIAM G. MILLIKEN,

Governor of Michigan;

Chairman, National Governors' Association.

JASON BOE,

President, Oregon Senate;

President, National Conference of State Legislatures.

Representative REUSS. We will now hear from Mr. Fred F. Cooper.

STATEMENT OF FRED F. COOPER, COUNTY SUPERVISOR, ALAMEDA COUNTY, CALIF.

Mr. COOPER. Thank you, Mr. Chairman. I would like to, of course, refer to my prepared statement as well, as I have submitted a resolution adopted by the National Association of Counties at their annual convention in Atlanta 2 weeks ago today.

Representative REUSS. Without objection, those will be included in the record at the end of your oral statement.

Mr. COOPER. In my prepared statement, I attempted to look at what I see as some of the reasons for passage of Proposition 13 in California. I am a county supervisor in Alameda County, which has a population of 1.1 million people. It is across the bay, east of San Francisco, has 13 cities running from the core urban cities of Berkeley and Oakland in the north to suburban cities of Fremont, Livermore, and Pleasanton in the south.

So we have both the urban and the suburban problems, and are, of course, at the core of the problem of Proposition 13, the problems and the solution.

I think one of the key factors that I think has been overlooked in passage of Proposition 13 and the reason why voters—many voters—seem to be angry with Government is that for 30 years, in the forties, fifties, and sixties, we had inflation, but we still had people's purchasing power increase. In the past 5 years, the purchasing power has been eroded, and we are continuing to have inflation, but people's purchasing power does not keep up.

I think Congress needs to look at the impact of the actions of the Arab oil countries and the impact of the environmental and consumer movements on purchasing power in this country.

Those three things have all substantially increased the cost of goods and services in the country without adding anything to the value of the goods and services, and I think have resulted in the purchasing power of many people being eroded.

Inflation, of course, is a contributing factor, but as I have indicated, we have had inflation for a number of years without purchasing power being diminished. And when people see their purchasing power eroding, they look for somebody to blame. They tend to blame the unions, business, and now these days, following Watergate, it is big government, and I think it is important to focus on the reasons for the erosion of purchasing power and get people to understand better what is happening.

Obviously, when they get angry, they look for something to do something about; the property tax with Proposition 13 gave them that opportunity to express their dissatisfaction and cut at least one major cost item that they could have an impact on. Another major factor is mandates to local government passed without providing the funds. Those mandates come from the Congress, they come from the State legislature, they come from the courts.

I have outlined in my prepared statement some of the mandates from the courts, some of the mandates from the Congress, and some of the mandates from the State legislators that our county has to live with that increase in our costs, that require us to increase our property tax much faster than just the cost of living, and it seems to me that Congress needs to look at the effect of those mandates, and some of them come from laws you pass and are implemented by regulation.

As I pointed out in my prepared statement, the same newspapers and television stations and voters complain about Alameda County increasing the property tax 1½ years ago, and they were also reporting disabled people sitting in Senator Cranston's office in San Francisco, and coming back to Washington and asking that Secretary Califano adopt regulations, and those regulations resulted in costs of \$10 to \$20 million. They are based on the law you passed, based on the law Secretary Califano signed.

Everybody was in favor of them 1½ years ago, and nobody looked at the cost, and now we in local government are being blamed for the fact that to implement those regulations takes money. And we are being blamed for the fact that you have imposed those regulations on us without giving us a dime to fund the cost. And, I think you need to look at some way of requiring economic impact statements when you adopt regulations, and when you adopt legislation that has an impact on local government.

Finally in my prepared statement, I point out that California has rejected three similar propositions to Proposition 13 over the past 15 years, and this one was passed even though three prior ones had been rejected.

I think two key factors that resulted in the passage of the fourth one, when three had been rejected were: One, the substantial increase in the market value of single-family homes, partly due to inflation, and partly due to the environmental and no-growth movements that have resulted in the assessed valuation of the average home in California

doubling over the past 5 years, and has resulted in a substantial shift of the property tax burden from commercial and industrial property to homeowner.

The second factor that did not exist when California rejected similar programs three times previously was the substantial State budget surplus—which has passed \$5 billion—and, of course, a substantial amount of that budget surplus was accumulated by the State passing on costs to local government through regulations and through State legislation without providing the dollars.

So, at the same time the State legislature and the Governor have increased the property tax through mandates, they have been accumulating a substantial surplus, and their inability to keep their commitments which they have been making for 2 years to use the surplus to fund some property tax relief for the homeowners also added to people's anger, and by the time they adopted the program under the threat of Proposition 13, the voters had lost confidence in their sincerity.

So those two factors did exist this year in California. They do not necessarily exist throughout the rest of the country, but they do explain to at least a great extent the reason why Proposition 13 passed when three prior measures failed.

I think Congress could assist the States by studying the impact of the environmental movement on increased cost of housing, by looking at what is happening to the purchasing power in this country, and helping people understand what is happening before you adopt the mandates, and you might leave it open to the possibility of requiring that whenever you insist on expenditures through your laws or regulations that we do something new, or we expand the program, that to send the money on to fund them.

Local government in California, through the passage of Proposition 13, has become almost totally dependent upon the State and Federal Governments for the funds with which to operate. This erosion of local control over local government is a dangerous thing because it will result in the inability of local officials to adjust local programs to meet local needs, it will mean that only programs approved in Sacramento and Washington will be funded, and it means that the most vital decisions for local government will be made by State and Federal employees adopting and modifying regulations in Sacramento and Washington, rather than by people responsible to their local voters.

That is the real danger of Proposition 13, and if that is true throughout the country, local government throughout the country will become less and less responsive to the local voters.

Thank you.

Representative REUSS. Thank you, Mr. Cooper.

[The prepared statement of Mr. Cooper, together with a resolution adopted by the National Association of Counties, follows:]

PREPARED STATEMENT OF FRED F. COOPER

Members of the subcommittee: I appreciate this opportunity to appear and testify before you on what I see as some of the causes for the passage of Proposition 13 in California and several of the problems that led to its passage.

Perhaps the biggest single factor is the fact that the cost of local government, and county government in particular, is going up faster than the cost of living at the same time that individual taxpayers see their purchasing power

eroded away through actions of the Arab oil countries, the consumer movement and the environmental movement. While we have had thirty years of inflation, throughout most of that period people's purchasing power has increased more rapidly than their expenses, but in the last five years that has not been the case. People see their purchasing power each year being reduced, they look for someone to blame, and the tendency is to blame labor unions and business for raising prices, and to complain about property tax going up rapidly since it is one thing where they have some control. I do not think adequate attention has been paid to the fact that a major portion of the erosion in purchasing power is due to actions of the Arab oil countries, the environmental movement, and the consumer movement since all three result in our having to pay higher prices for products without the products being improved or being made more valuable in any way. Perhaps your committee can focus on the erosion of purchasing power in this country and the basic causes, since inflation is often blamed, but inflation in the 1950's and 1960's did not result in lower purchasing power.

A more direct cause of voter dissatisfaction with the property tax is the fact that it goes up substantially faster than the cost of living. Partly this is due to the fact the cost of some things that counties purchase go up faster than the cost of living, particularly utilities and gasoline due to the oil crisis. But of course higher oil prices are built into the cost of every item of goods and services purchased by counties just as substantially higher medical costs are built into the price of every item of goods and services. Every time you go to a grocery store and buy a bag of potatoes you are contributing to the medical care of the grocer and his staff, the people who process and deliver the items, etc. Higher medical care costs should be added to my previous discussion of increased costs from Arab oil countries, and the consumer and environmental movements.

A major factor causing the county property tax to increase much faster than the cost of living is governmental mandates. These include the United States Congress, the California legislature, and both state and federal courts as follows:

1. The average length of a felony trial in Alameda County has tripled in the past fifteen years, from just over two days to over eight days. Mostly the increased length is due to decisions of the United States Supreme Court, and a substantial amount is due to decisions of the California Supreme Court, which require the courts to provide attorneys, provide time for hearings on a great many different things such as search and seizure, past records of police officers, discovery of evidence, etc. The increased length of trials requires more judges, more district attorneys, more public defenders, more clerks, more courtrooms, etc.

2. Mandates by the federal government increase local costs. Passage by Congress of unemployment insurance is increasing our costs, and even though the Fair Labor Standards Act application to local government was suspended by the Supreme Court, many jurisdictions including my own are continuing through labor negotiations to apply portions of that act to county operations at higher costs. The adoption by HEW of regulations for the disabled and handicapped a year and a half ago will eventually result in increased cost to local government, probably more than one-half in the schools, of \$10 billion to \$20 billion. In this area it is significant that the same taxpayers and newspapers that are criticizing local government in California for the high property tax were, a year and a half ago, quite sympathetic to the demonstrations by handicapped people in Senator Cranston's office in California and in Washington, when they were asking Secretary Califano to sign the regulations. The same people who urged that the regulations be signed are now complaining about having to pay the cost. It might be useful to require an "economic impact report" before Congress passes legislation affecting local government, and before federal agencies adopt regulations that require changes in the operations of local governments.

3. A large portion of the increased property tax for Alameda County has been due to mandates by the legislature of the State of California. We have been required to fund increasing amounts each year for Medi-Cal, AFDC, and adult welfare. State law and state regulations frequently require improvements and expansions in county programs, without supplying any funds. At the same time, when the State provides partial funding for local programs the State frequently provides no cost of living increase in their share of the program. For example, the state has been paying the same \$95 per month for the care of juveniles in juvenile camps since 1953, leaving the county to pick up all increases in costs over the past 25 years.

I believe the above listed factors of reduced purchasing power and increased mandates by the courts and the state and federal governments apply fairly uniformly throughout the country, although I suspect that the state mandates are less of a problem in states with low overall tax rates than they are in California.

I would urge the Congress to look at the erosion of purchasing power over the past several years associated with the oil crisis, and the consumer and environmental movements, and to consider some sort of economic impact report on local government whenever Congress, or state legislatures, or the courts, mandate new programs or mandate improvements in existing programs.

If we look specifically at California and Proposition 13 we need to recall that over the past fifteen years the voters in California have rejected three similar measures to proposition 13—two proposed by the former Assessor of Los Angeles County and one proposed by former Governor Ronald Reagan.

It is my feeling that three factors existed in 1978 that were not present when the voters rejected the three similar measures previously as follows:

1. The erosion of purchasing power on the part of most people has gotten most severe in the past two or three years, and results in frustration since inadequate attention has been paid to the problem and inadequate explanations given. People get frustrated when their purchasing power goes down, but the frustration is compounded by the fact that they are not sure who to blame, and is compounded further when they see their taxes increasing rapidly to provide additional services and benefits to people whom they feel are not carrying their full weight. So far, that frustration has not extended to dramatic increases in the Social Security tax to fund dramatically increased benefits to senior citizens, but unless there is better public understanding of what is happening I think we can anticipate in the next few years the same frustration directed at senior citizens as is presently directed at recipients of welfare.

2. The cost of housing, and particularly single family housing, has doubled in California in the past five years. This seems to be partly due to general inflation, and partly due to the environmental movement, which has kept the supply of housing down at the same time the demand has increased, thereby causing market values to sky-rocket. Since property tax assessments are based on market value, the assessment of the average home has doubled over five years and therefore even with the same tax rate the amount of tax being paid has doubled. Because single family homes increase in market value much faster than commercial and industrial property, this has resulted in a shift of part of the property taxes from commercial and industrial properties to homeowners. It should be noted that the opinion polls in California show equal numbers of people against Proposition 13 as those in favor of it up through March of this year. When the increased assessments came out in April, public opinion shifted dramatically in favor of the proposition.

3. The other major factor present this year in California that was not present previously was the fact that the State was sitting on a budget surplus of \$3 to \$4 billion at the same time that the State legislature and Governor were unable to provide the property tax relief that they had been promising for more than a year. Voter frustration increased as the taxes went up, as dramatically higher assessment notices were sent out in April, and yet the legislature and Governor were unable to keep their promises to distribute the surplus to solve the problem, at least until some time after Proposition 13 qualified. The fact that the legislature finally passed an alternative measure some months after Proposition 13 qualified for the ballot made many voters feel that the legislature would not have done anything except under the threat of Proposition 13. It is, of course, significant that substantial portions of the State surplus were developed as a result of state mandates by both the legislature and administrative mandates from the Governor that increased the property tax. If, instead of accumulating a large surplus, the State had used the money to fund the many mandates to local government which increased property tax and to provide adequate funding for the State's share of partnership programs, the property tax would not have increased so dramatically and Proposition 13 might not have passed.

Congress could assist the states by studying state surpluses, by studying the impacts of the environmental movement on increased cost of housing, by attempting to help control inflation in housing costs, and by encouraging the use of state surpluses to fund state mandates, thereby reducing the need to increase local property taxes.

Local government in California, through the passage of Proposition 13, has become almost totally dependent upon the state and federal governments for the funds with which to operate. This erosion of local control over local government is a dangerous thing because it will result in the inability of local officials to adjust local programs to meet local needs, it will mean that only programs approved in Sacramento and Washington will be funded, and it means that the most vital decisions for local government will be made by state and federal employees adopting and modifying regulations in Sacramento and Washington, rather than by people responsible to their local voters.

[Resolution adopted by the membership of NACo, the National Association of Counties, July 11, 1978, in Washington, D.C.]

TAX REFORM AND RESPONSIBLE GOVERNMENT

Be it Resolved, upon the initiative of President William O. Beach, that NACo adopts the following statement on tax reform and responsible government, to have the effect of a resolution :

The adoption of Proposition 13 in the state of California constitutes a confirmation from the voters of that state of what has been a NACo position of longstanding—that the property tax levels at the local level are often intolerable, and the property tax itself has been asked to carry far too many of our governmental burdens. In addition to the traditional property-related services, it also now often must pay for our expensive modern educational systems, health and social services, and many other programs. Too often this over-loading of the property tax is not the result of votes by local elected officials, but rather than mandates of Federal and state government. NACo has long held that the major burden of property taxes frequently arises from Federal and State policies mandating the conduct and financing of Federal and State programs from local resources principally, and in many cases exclusively, from the property tax.

NACo is acutely aware of the public concern and reaction to the crushing burdens of property taxes placed upon property owners not only in California, but elsewhere in the nation. We support the roll-back of property taxes if they reach confiscatory levels, and the adoption of property tax levels which accurately reflect the costs to local governments to provide essential local governmental services.

While the implementation of such roll-backs may, in many cases, cause initial severe economic and programmatic dislocations, a direct result of such implementation can be put into clear public perspective the impact of Federal and state mandate programs and policies upon the local governments' principal source of revenue—the property tax.

NACo calls upon the President, the Congress and each state's executive and legislative leaderships to recognize the clear and compelling principle of the need for equitable reallocation of cost burden sharing now placed upon the property tax used by many of our nation's counties and other local governments.

NACo further calls upon Federal and state governmental leadership to review, with sensitivity to the unacceptable tax burdens of all kinds upon the people of this nation, all aspects of governmental spending to reduce waste, duplication and unnecessary governmental spending—an objective which NACo and its individual members have long advocated, and to which we re-commit ourselves.

In order to more clearly re-state where NACo and its member counties stand, we hereby rededicate ourselves to the following long-held principles and objectives :

Delivery to the best of our abilities a wide variety of important and essential public services to our citizens, including vital human services to the poor, aged, disabled, mentally and physically ill and those otherwise disadvantaged who are least able to care for themselves ;

Operation of the delivery of those services within the confines of a balanced budget that the taxpayers can afford ;

Maintenance of a vigilant watch in order to maintain only essential positions in county government and otherwise to eliminate all unnecessary expenditures from our public budgets ;

Continuing efforts to increase efficiency and productivity of both management and the rank and file of county employees ; and

Fair and equitable administration of the property tax, together with all other local taxes.

We also, individually and as a national organization, pledge our best efforts, in cooperation with our state associations of counties and our fellow state, city and Federal officials, to encourage and work at all levels of government :

To resist all state and Federal mandates to local government unless there is a provision for funding by the state of Federal government ; and

To control inflation, by vigorously urging the President and Congress to balance the Federal budget at the earliest possible date and we pledge to assume our share of that responsibility.

Finally, we pledge ourselves to the following specific actions and commitments :

Establish priorities

In the interests of economy, we ask each of our twelve steering committees to establish priorities among their various functional areas. We ask the Board of Directors to establish priorities among those submitted by the committees. Fi-

nally, we as the policymaking membership pledge ourselves to the difficult but necessary task of developing each year an American County Platform which combines a balance of necessary programs and fiscal responsibility.

In establishing priorities, we ask each of our steering committees to give full consideration to actions in their respective subject areas which are calculated to increase economy and efficiency by such devices as caps on medical expenses, removing much of health and welfare costs from the property tax base, and bring Federal, State and local regulations to a minimum.

Maintain NACo's tax revolt action center

Provide factual information to public officials, media and the citizens in general, on the various methods and devices for tax reform and expenditure control. In particular, we will endeavor to better educate voters on the real problems concerning the property tax, the roll of mandated programs in driving the property taxes to often near confiscatory levels, and the need for basic tax spending reforms at the state and Federal levels.

Strengthen NACo's new county center

Top association priority should be given to the New County Center, which provides information to the public officials and citizens in general on ways and means of improving county administration, finance management, planning, organization, staffing, budgeting and public reporting. Special emphasis should be placed upon the following: consolidations of elimination of special authorities and districts; functional consolidations; joint governmental contracting; voluntary regional cooperation; increased management and labor productivity; and improved general public administration.

Provide Federal budget input

At the earliest date, the leadership of NACo should meet with the director of the Office of Management and Budget and the Congressional Budget Committees to determine a responsible county role in aiding the President and the Congress in determining Federal budget priorities and limits.

Improve financial management

NACo will continue to help county governments improve their financial management practices. Our Tax and Finance Conference in Los Angeles, September 18-20, 1978, will focus on tax reform activities and fiscal management.

Urge tax and welfare reform

Funding of welfare and certain health costs from the property tax is a major concern to citizens and is strongly opposed by NACo. All efforts should be made to secure Federal action to remove these costly items from the property tax.

Representative REUSS. In order to conserve time, cochairman Moorhead and I have suggested that the next three witnesses, consisting of Mr. Edward Gramlich, of the University of Michigan, Public Finance Director George Peterson of the Urban Institute, and Herrington Bryce of the Academy for Contemporary Problems, take their seats at the table so that after their testimony, we may examine the first eight witnesses, and withhold the final three witnesses until later.

So, if you three gentlemen will just remain at ease where you are; we will hear these three witnesses I have just named.

Representative KELLY. Mr. Chairman, I have a brief statement that I would like to make at this time, if the committee has no objection.

Representative REUSS. Of course, Congressman.

**STATEMENT OF HON. RICHARD KELLY, A U.S. REPRESENTATIVE
IN CONGRESS FROM THE FIFTH CONGRESSIONAL DISTRICT OF
THE STATE OF FLORIDA**

Representative KELLY. Mr. Chairman, and Mr. Cochairman, Proposition 13 represents government by volunteers, where the people en masse have turned away from their duly elected officials—the constitu-

tional government—and have looked to volunteers to lead them and to establish government that is satisfactory to the public.

Recently, a poll in my district showed that the Congress of the United States has a minus-51 job rating, which means that the rest of the people, 49 percent, either didn't have an opinion, or thought Congress was doing all right. But I think that accommodation of these two considerations indicates a very serious significance regarding Proposition 13.

Mr. Chairman, the threat that is being made by the elected officialdom is that if the people try any shenanigans like Proposition 13, that there is going to be reprisals, massive layoffs among the public employees; that a lot of people are going to get fired, and public services are going to be reduced. But nowhere does there seem to be any suggestion that government, as a matter of economy, might cut salaries as a way of retaining employment of everybody and also maintaining the level of public service.

The other suggestion seems to be that, well, we will just shift the burden of spending from local governments to the Federal Government, and in that way some miracle will be wrought. Of course, that is just going to shift the burden on the taxpayers from one pocket to another, and really will not accomplish anything.

So I see merit in two major areas: the idea of cutting salaries and trying to cause government officials who are elected, according to our constitutional processes, to start functioning in the way that Proposition 13 suggests that they should, rather than run the risk of chaos in our Nation and destruction of our constitutional form of government by forcing the people to turn to volunteers rather than the established government.

Representative REUSS. Thank you Congressman Kelly.

Congressman Moorehead will introduce our next panel.

Representative MOOREHEAD. Thank you, Mr. Chairman.

The leadoff witness, for panel No. 2 before the Joint Economic Committee and the Subcommittee on the City, is Mr. Edward M. Gramlich.

STATEMENT OF EDWARD M. GRAMLICH, PROFESSOR OF ECONOMICS, UNIVERSITY OF MICHIGAN

Mr. GRAMLICH. Thank you, Mr. Chairman and committee members. I have a statement of about five or six pages here, which I will submit for the record. What I would like to do is just make five points that I make in the statement much more briefly than I do there.

As Congressman Moorhead said, we are addressing in this panel the question of the high current-day national income account data and the State and local budget surplus, and what it means.

The first point is a factual point. Is the surplus really all that it is cracked up to be: there are a couple of reasons why it is not. The first is that, as Mr. Farber in particular mentioned earlier, one really must deal separately with the pension fund surplus. In the latest full-year numbers that I have available, the overall surplus of \$29 billion. \$15.5 was pension funds, so that the appropriate general government surplus is more like \$13 billion.

There are a lot of reasons why the pension fund surplus doesn't mean anything about even the financial health of pension funds. Cer-

tainly it is true that the money is not available for general government purposes and must be left out of these kinds of discussions.

Now, even the general government surplus of \$14 billion has increased \$20 billion in the past 2 years. There has been a sharp turn-around even in that number. So a second question that I deal with in my testimony is what has caused that. Basically, there are three causes:

The first is that there has been a very sharp drop in State and local construction that accounts for about one-third in the change in surplus. There are a number of fairly, at this point, mysterious, reasons for that. I have some thoughts about that, but I didn't go into them in my testimony.

In any case, the construction budget is again not part of the operating budget of most State and local governments. So probably a better number to focus on is more like the \$13 billion change in the operating surplus over the past 2 years.

Now, what has caused that? I think that you can attribute that mainly to two sources. The first is that the aggregate economy has recovered sharply from the recession of 1975, and in the recession of 1975 State and local budgets were in a precarious budgetary situation. They have recovered now because the economy has recovered.

That is a welcome improvement. We shouldn't regret it, and we probably shouldn't change our views about aiding State and local governments because that has happened.

The second thing is that there has been an increase in some Federal grants in the past 2 years, mostly in CETA grants. Many people feel that there is a lot of so-called displacement with CETA, and if that is so, that could also explain at least some of the rise in the operating budget surplus in the past 2 years.

Now, the next point refers to the composition of the surplus. Is it held by State governments, or is it held by local governments? One thing that I should say this morning is that anybody who talks about this is talking in a little bit of a factual vacuum, because as a matter of fact we don't have very good figures in the most recent period which governments have the surplus.

The Department of Commerce has just published a breakdown of the State and local accounts between the State governments and local governments through 1976. These figures don't cover 1977, which is the year when a lot of the change in the surplus has taken place.

So it is very hard to tell at this point where the surplus actually is, by State governments or local governments. But if you look at the 1976 numbers, what you find is that, indeed, the State governments have received a little bit more of the year-to-year change, but that the State government budgets are always more cyclical than local government budgets. If you compare the budget position now with the 1960's, that in fact local governments are doing slightly better now than they were in the 1960's, and State governments are doing the same or a little bit worse.

So, while it is true that State governments have received a little more of the latest rise in the surplus than local governments, local govern-

ments have received some and local governments are still better off relative to the 1960's.

It is very hard to go beyond that and talk about individual governments.

Now, the next point is the relevance that these surpluses for overall macropolicy. These surpluses are saving in the overall national accounts: They are revenues that are not met by expenditures. This does mean that other things being equal it is going to be harder for the Federal Government to cut its own budget deficit without causing an increase in unemployment.

And it may be that, as some of the speakers have said this morning, it is a top priority for the Federal budget to come more into balance. But what is liable to happen is either the State surpluses, State and local surpluses, will disappear more rapidly than they otherwise would have, or we will observe a worsening in unemployment. I think those risk in the Federal budget policy should be confronted directly.

The final point regards the relevance of these surpluses for longer term, questions about Federal grant policy, aiding urban governments, or aiding various functions at the State and local levels. And there I think the answer is that the relevance is not much; that is, that one can look at Commerce numbers and observe these numbers bouncing about always, and there are good reasons for the rise in the surplus in recent times.

The surplus probably has a very high transitory component—and it certainly always has—and if you are considering more permanent things such as, let's say, aid to urban governments or supporting various social goods such as antipollution expenditures, or roadbuilding, or whatever, those decisions ought to be made on more permanent, longer run grounds. You should not be observing a State and local surplus which bounces up and down according to short-term changes in income and, also, in the Federal grant policy.

Thank you.

Representative MOORHEAD. Thank you, Mr. Gramlich.

[The prepared statement of Mr. Gramlich follows:]

PREPARED STATEMENT OF EDWARD M. GRAMLICH

State and Local Budget Surpluses and Federal Grant Policies

Thank you for inviting me to testify this morning. In my remarks I'd like to focus on an astounding fact that is lately affecting fiscal and grant policy decisions: the \$29 billion budget surplus run by state and local governments in 1977. How can this number be true when we keep reading of urban fiscal crises? What will happen to it? What does it mean for federal fiscal policy and federal grant policy? Why should there be yet more aid from the biggest debtor government, the federal government, to those large creditor state and local governments?

Before getting into the substance, a brief look at the facts. The aggregate state and local surplus, the number that is causing all the commotion, is given in the left column of table 1. There it can be seen that this surplus never exceeded \$4 billion before 1972, took a brief rise in 1972-73, fell back down in 1974-75, and lately has soared back to \$29.2 billion by 1977. What is going on?

TABLE 1.—STATE AND LOCAL BUDGET SURPLUS, NATIONAL INCOME ACCOUNTS BASIS

(In billions of current dollars)

Calendar year	Overall surplus	Less: Pension fund surplus	Equals: General government surplus	Plus: Net capital items	Equals: Operating budget surplus
1960	0.1	2.3	-2.2	6.2	4.0
1961	-4	2.4	-2.8	6.9	4.1
1962	.5	2.6	-2.1	7.0	4.9
1963	.5	2.8	-2.4	7.4	5.0
1964	1.0	3.2	-2.2	7.7	5.5
1965	-----	3.4	-3.4	9.2	5.8
1966	.5	4.0	-3.5	10.5	7.0
1967	-1.1	4.8	-5.9	12.7	6.8
1968	.3	5.3	-5.0	14.0	9.0
1969	2.1	5.9	-3.7	14.1	10.4
1970	2.8	6.8	-4.0	12.3	8.3
1971	3.7	7.5	-3.8	13.3	9.5
1972	13.7	8.1	5.6	13.3	18.9
1973	13.0	8.9	4.1	13.7	17.8
1974	7.6	10.5	-2.9	16.5	13.6
1975	5.9	12.1	-6.2	15.1	8.9
1976	18.4	14.5	3.9	10.4	14.3
1977	29.2	15.5	13.7	8.9	22.6

Source: Survey of Current Business, various July issues.

A first thing that is going on is that this overall number, recorded in the national income accounts statistics of the Department of Commerce, includes the surpluses of employee's retirement funds. For macroeconomic purposes this saving is relevant, and does imply that the federal government must dissave more to maintain a high level of overall spending demand. But in trying to examine the financial health of state and local governments, it should be recognized that pension funds must run a surplus to pay for larger pensions for greater numbers of employees in future years. Whether the surplus is large enough to maintain the actuarial standing of the funds is still questionable—many observers think not. But whether it is or is not, at least this component of the surplus is not available for normal governmental operations, must be deducted and leaves the smaller general government surplus in the third column. To be sure, it has still risen almost \$20 billion in two years time, but \$13.7 billion is less dramatic than \$29.2 billion.

A second thing that is going on is that even the general government surplus does not measure the true operating budget for most states and localities because it includes capital expenditures. The fourth column in the Table gives the adjustments necessary to go from total budgets to current operating budgets—construction expenditures are not considered expenditures and are added back, debt retirement (a better proxy for how much capital is "used up") is deducted, and grants for construction deducted. Since normally net capital expenditures as so defined are positive, the operating surplus in the fifth column is always more positive than the general government number. Perhaps more relevantly, however, we should focus on the change in this value, and there we see that the change is less dramatic than before because of a recent mysterious drop in construction that has caused at least part of the recent rise in the NIA surplus.

A last factual question is to inquire into the breakdown of this surplus or its change into that received by states and localities. Because certain necessary data are not yet published, we cannot do this for 1977, but we can for 1976, and there we find that states have received slightly more of the recent rise than localities. But not much more: localities have shared in the recent improvement too. Moreover, state budgets are recently more cyclical than localities, and their recent gains in surpluses merely restores losses in the recession of 1975. If we were to compare the average fiscal position in the seventies with that in the sixties, localities are the governments that are doing better.

The result of all these adjustments is then to take much of the pizzazz out of the recent changes in the state and local surplus. Not only is a realistic indication of the fiscal health of state and local governments not as high as the gross NIA number, but its recent change is also less dramatic—only \$13.7 from the low point in 1975 to the high point in 1977. This is a change, and perhaps a welcome indication that things are better for state and local governments, but certainly not as much to get excited about.

Since even the adjusted surplus shows a recent rise, we might inquire further about what it means. Basically the surplus records changes in the stock of buffer assets possessed by state and local governments, and as say income rises, in the short run governments are likely to put much of this change into their stocks and run a temporary surplus. As time goes on, this behavior makes less and less sense, because once stocks get built to a sufficient level, there is no point in further saving. So over the cycle the surplus will rise temporarily in an upswing, fall temporarily in a downswing, and average out to some normal level over time. A brief look at the numbers in either column three or column five indicates strong traces of this behavior over the seventies. The surplus was up in good years 1972, 1973, 1976, 1977 and down in bad years 1974, 1975. An ironic side effect of this is that if the recently passed Jarvis Amendment can be interpreted as forcing the State of California to get rid of its surplus, that is exactly what past relationships say the state would have done anyways (even as far as saying it would mainly result in tax reductions).

Economic fluctuations are only one of the causes of possible changes in the surplus, however: the other might be federal aid. Just as in the short run a rise in income might pad surpluses before there are inclinations or plans to spend the money, so might also be the case for federal aid. In some statistical work I have done on state and local budgets I have indeed found this to be the case. With general revenue sharing, I find that only one-third of the money is used for expenditure increases or tax reduction after one year and about sixty percent after two years—broadly in agreement with some studies commissioned by the Treasury. If there is displacement of public service employment grants, the same will be true—much of this money will not result in higher expenditures or lower taxes, but will simply be saved by local governments. Hence an additional reason for changes in the surplus is changes in federal aid policy, with big rises in the early years of general revenue sharing (1972-73) and CETA (1975-76).

It seems to me that the lessons that can be drawn from all this are as follows:

(a) At least part of the level and change in the state and local surpluses are illusory, caused by pension fund surpluses and by a mysterious drop in construction.

(b) In any case the surplus always moves about in an erratic manner in the short run, rising when income rises and aid is increased, and falling in the reverse situations. We should expect some abnormal surpluses right now, and we can also expect they will disappear in a year or so, even without Jarvis Amendments.

(c) The high surpluses are relevant for macro policy. State and local governments are saving, and the federal government must dissave accordingly to maintain spending demands. This is one reason why it is now difficult to cut the federal deficit without generating unemployment.

(d) The high surpluses may or may not be relevant for grant policy. If the aim of grant policy is to stimulate the overall economy in a recession, the surplus changes impede this aim because they imply that the grant money will not get spent. But if the aim of grant policy is a more permanent one of counteracting the economic decline of certain areas, transitory changes in the budget surplus are not very relevant and certainly not sufficient reason to limit the aid.

Representative MOORHEAD. The two committees would now like to hear from Mr. George E. Peterson, director of public finance, the Urban Institute, Washington, D.C.

Mr. Peterson.

STATEMENT OF GEORGE E. PETERSON, DIRECTOR, PUBLIC FINANCE PROGRAM, THE URBAN INSTITUTE, WASHINGTON, D.C.

Mr. PETERSON. Thank you very much, Mr. Cochairman. I have been asked to concentrate on the current fiscal condition of the large cities, especially those that are fiscally distressed. In my prepared statement, I follow recent developments in seven of those cities, Boston, Buffalo, Cleveland, Detroit, Newark, Philadelphia, and Pittsburgh, which 2 or 3 years ago appeared to be in nearly as precarious a financial position as New York City.

The financial recovery of these cities has been impressive. Although their long-term tax base prospects have not improved greatly, most have recovered from immediate financial strain; this fact changes the character of the choices to be made about Federal aid policy.

I would like to emphasize five themes in my paper which I think relate closely to the comments of the other panelists.

First, there is now underway a fundamental reversal of city spending, employment, and wage trends. Until 1975, city government spending had increased steadily year in and year out relative to the gross national product as illustrated by the charts on the right hand side of the room. This trend has now come to a halt. Congressman Kelly mentioned public sector wages. Wages in the majority of large cities in fact have declined in real terms during the last 3 years, in some cities quite substantially.

In this sense, Proposition 13 is a confirmation rather than a harbinger of the movement to restrain public spending. Viewing this period a decade from now, the last 3 years may well stand out for halting the postwar trend of persistent growth in the share of national output spent by State and local government.

This reversal has been most visible in the older cities. During the decade preceding 1975 the Nation's older cities, those that were losing population, jobs, and tax base, not only spent more per capita than other cities, had more public employees per thousand residents, and paid higher wages to those employees, but all of these costs of public sector operations were growing more rapidly than elsewhere and had been growing more rapidly for the past decade.

Table 1 of my prepared statement shows how greatly things have changed since 1974. Since 1974, public sector wages in those cities losing population have grown at about one-half the rate of wages in other cities. Public employment actually has declined in these cities at a faster rate than population has been lost, with a consequent decline in the number of workers per thousand residents, especially if you exclude Federal employment trainees.

These trends are in sharp contrast to those visible in the newer, more prosperous cities.

In short, we are in the midst of a strong reversal of fiscal course. Budget difficulties have forced the large cities to cut back on their historic spending growth.

Second, I would like to call your attention to the nature of the cities' budget adjustments and the role of tax limitations in shaping those adjustments.

Table 2 of my prepared statement shows how different have been the reactions of different cities to local fiscal pressure. In Boston, Philadelphia, and Pittsburgh, the adjustments were made almost entirely through tax increases. Some of those have been very large indeed. Philadelphia increased its property tax rate by 66 percent, and its wage and income tax rate by 30 percent.

Boston increased its property tax rate by 28 percent and Pittsburgh had to reinstitute its wage and income tax.

In Newark, there was a very large municipal tax rate increase which, fortunately for the city was offset by the State taking over a large share of school costs, making possible school tax reductions.

Detroit—the city with perhaps the greatest exposure to cyclical downturn—responded more quickly to the cyclical rebound in the local economy, which was translated through the cyclically sensitive income tax base into a strong recovery in local revenues.

I might add that Detroit was very greatly assisted by State counter-cyclical aid programs as well as Federal aid programs.

There are two other cities, Buffalo and Cleveland, which tried to balance their budgets almost solely through expenditure reductions, with virtually no tax increases and little outside aid except for the standard Federal aid programs. I think it is interesting to look at the reasons for these differences of response.

Buffalo is subject to a strict limit on its rate of property taxation. It has been at or near the maximum of that tax ceiling for some time, and thus unable to increase local taxes. In fact the State courts recently ruled unconstitutional State legislation allowing property tax rates imposed for pension payments to be excepted from the statewide 2-percent tax rate limitation established by the New York State constitution. As a result the city has had to cut back severely on its rate of property taxation.

Cleveland has one of the most severe voting requirements for authorization of tax rate increases in the country. Cleveland has been unable to secure voter approval for property tax increases either for general city government or for its schools.

One point comes through clearly from these adjustments, and that is just how difficult it is for cities to balance their budgets solely by restraining expenditures.

Cleveland and Pittsburgh have made as great an effort at spending cutbacks as can reasonably be expected. Cleveland's public employment is down by 16 percent in the course of 3 years. Real wages also have declined. But these spending reductions have not been sufficient to balance local budgets.

One of the reasons for this I have illustrated in table 3 of my prepared statement, which compares the costs of current service delivery with the fixed costs of a labor force that are unresponsive to reductions in current services.

You can see that over the 5 years covered in the table, which were 5 years of very heavy inflation, Pittsburgh trimmed its labor force by 20 percent, more than 2,000 employees, and was able to hold its total current service costs to an increase of 11 percent. Yet, its contributions to pension costs increased by over 120 percent. The city's cost of other fringe benefits increased by a total of 170 percent.

The point simply is that in these cities where population and tax base are declining rapidly, it is extraordinarily difficult to make commensurate reductions in public sector budgets because of the fixed nature of many of the costs of city government. Moreover, even reductions of 20 and 25 percent in the labor force may not suffice to balance the local budget.

Local tax rate increases have been a central ingredient of the fiscal adjustment of financially distressed cities where these adjustments have been successful. A prohibition against tax rate increases through imposition of new tax limitations, I think, would be very traumatic to these cities, as it would remove the most disciplined option for restoring budget balance.

I might add that, in fact where these limitations have been in effect, such as in Buffalo and Cleveland, one response has been to go deeper into debt as the cities have borrowed to cover their fixed costs.

Third, let me comment on the surplus situation. These cities, too, have had substantial surpluses in fiscal 1977, and 1978. But I think it is important to see how current annual surpluses take on a quite different meaning in the context of recent budgetary history.

You can see from tables 4 and 5 in my prepared statement that each of these cities went very deeply into the red in 1975 and 1976: Philadelphia to the tune of \$78 million in 1 year; Detroit \$35 million; and Boston \$60 million. In fact each of these cities went so far into deficit during the 1975 and 1976 fiscal years that they entirely depleted their balances on accumulated account, creating cumulative deficits as well, which had to be covered by the issuance of short-term debt.

State constitutions require that the cities generate surpluses in subsequent years to restore their cumulative budget position. Concentrating solely on the surpluses generated in 1977 and 1978 without comparing these with the deficit positions which the cities have inherited and which they are now liquidating is, I believe, to misread the message of the surpluses. It is one thing to compile a surplus on top of a sound fiscal position; it is something quite different to generate a current account surplus that permits repayment of the debt issued to cover previous operating deficits.

The restoration of cash liquidity was just as important to the cities in normalizing their budgetary circumstances as the restoration of liquidity was to the private corporate sector, which was also recovering from the recession and where the first priority for almost all corporations was to liquidate the massive debt increases incurred during the recession in order to restore a sound financial basis.

Let me also mention two uncertainties that lie ahead and that complicate further the surplus interpretation. It was noted that many of these surpluses are being held in pension funds. Despite that fact, almost all large city pension funds are seriously underfunded at this time, relative to the obligations that the future carries.

Two of these cities in this sample are on a virtual pay-as-you-go basis of pension funding. It has been estimated by auditors that Pittsburgh and Boston would have to approximately triple their current pension fund contributions to fully fund their outstanding pension obligations over a 40-year period. As the cities move toward fuller

funding of their pensions, we can count on incurring larger surpluses on cash account in pension funds. It will become a matter of severe public policy how those funds should be invested, and how the cash surpluses should be interpreted.

The final point I wanted to mention is related to the downturn in capital construction. One thing that has been happening in addition to the change in cash surplus is under-investment in the existing capital stock of several of these older cities, which has had the effect of depreciating the assets the cities have accumulated in the past. The drop in maintenance and repair expenditures in several of the older cities has been on the order of 30 and 40 percent. In fact, what appears to be a cash surplus may be an indirect conversion of physical capital to cash, by letting that capital run down in order to save on maintenance, repair, and replacement costs.

Thank you.

Representative MOORHEAD. Thank you very much, Mr. Peterson.
[The prepared statement of Mr. Peterson follows:]

PREPARED STATEMENT OF GEORGE E. PETERSON

Fiscally Distressed Cities: What is Happening to Them?

The fiscal condition of cities has been a major source of Federal policy concern for the last three years. New York City's financial distress reawakened public officials to the risks involved in managing cities during national recession and local economic decline. Much of recent federal domestic legislation, adopted or proposed, has aimed at strengthening the fiscal capacity of cities or at lessening their fiscal exposure to weak local economic conditions.

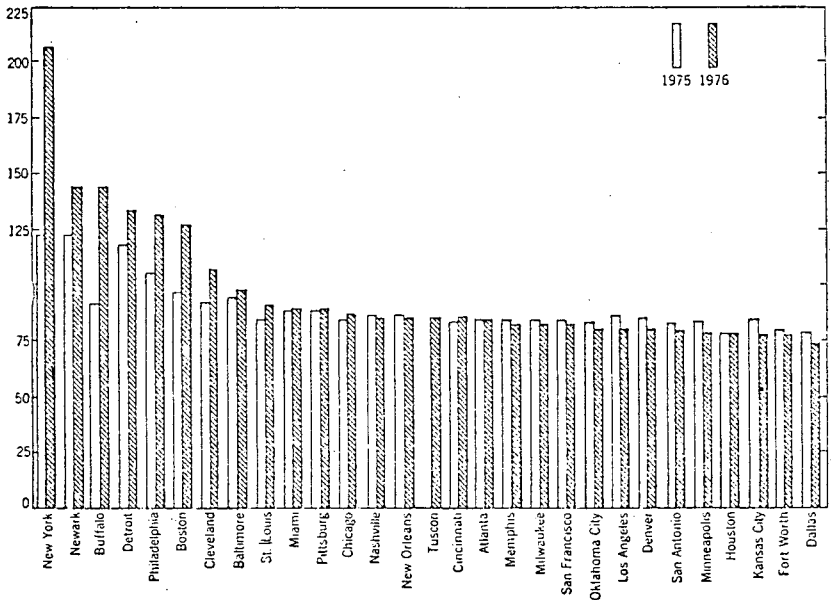
This paper tracks recent fiscal events in seven of the nation's most fiscally distressed cities: Boston, Buffalo, Cleveland, Detroit, Newark, Philadelphia, and Pittsburgh. The fiscal strain on these cities is reflected in Figure 1, which shows the interest costs paid for municipal borrowing relative to Moody's AAA bond index. With New York, these cities possessed the highest perceived risk and interest rate premiums during the capital market disruptions of 1975-76.

The rank ordering of presently perceived fiscal distress has changed substantially from that shown in Figure 1. Detroit, which in 1975 was regarded by the bond market as financially troubled in the same degree as New York City, has largely recovered its equilibrium. Cleveland, which appeared in relatively sound fiscal condition in 1975, now faces the greatest financial disarray. The events that produced these divergent paths reveal a good deal about the signs of fiscal health in urban governments.

In general, American cities have experienced a strong fiscal recovery since 1975, assisted by recovery of their local tax bases, federal aid programs, and local expenditure restraint. Many cities continue to face long term prospects of tax base stagnation, but immediate financial difficulties are limited to a handful of cities, such as Cleveland, which have failed to take vigorous measures to close their budgetary gaps.

Figure 1

YIELD ON 1984 GENERAL OBLIGATION BONDS OF DIFFERENT CITIES
RELATIVE TO THE MOODY'S Aaa MUNICIPAL BOND INDEX, 1975 AND 1976



Source: L. Browne and R. Syron, "Big City Bonds after New York," *New England Economic Review* (1976), Chart 2, p. 8.

EXPENDITURE CUTBACKS AND TAX RATE INCREASES

In a long term perspective, the cities' fiscal problems emerged largely because the cities were slow to cut back expenditure commitments in line with population losses and local tax base declines. Budgetary difficulties have given a powerful impetus to spend restraint. For the quarter century ending in 1975, local public spending rose year in and year out relative to national product, but during the present economic recovery city expenditures have grown at a much slower rate than national output. Cities suffering economic and population decline have taken the lead in restraining expenditures. In this sense Proposition 13 seems a confirmation rather than a harbinger of a new attitude in the state-local sector. Viewed a decade from now, the last three years may well stand out for halting the post-war trend of persistent growth in the share of national output spent by state and local governments.

Table 1 shows the convergence that is now occurring within city government finances. In 1973-74, the per capita public expenditures of the nation's older cities—those losing population and jobs—were far higher than other cities', as were the number of city government employees per resident and public sector wages. The expenditure gaps between "declining" and "growing" cities had been widening steadily for the past decade. Since 1974 this trend has reversed. Comparable Census data are available only through fiscal year 1976, but local financial reports show that the trends toward convergence of spending, employment and wages have persisted, even strengthened, in the last two years. As might be expected, the budgetary pressure on older cities has proved to be an effective spending limitation.

TABLE 1.—SPENDING, EMPLOYMENT AND WAGE TRENDS, LARGE CITIES (1974-76)

[In percent]			
Item	Large cities gaining population ¹	Large cities growing in population in 1960-70, now declining ²	Large cities losing population ³
Growth in per capita spending ⁴	+37	+31	+24
Growth in noneducational city employment, per 1,000 residents ..	+8	+3	-1
Growth in average monthly wage, noneducational employees.....	+30	+20	+15

¹ Honolulu, Houston, Jacksonville, Memphis, Phoenix, San Antonio, and San Diego.

² Columbus, Dallas, Denver, Indianapolis, Kansas City, and Los Angeles.

³ Baltimore, Boston, Buffalo, Chicago, Cincinnati, Cleveland, Detroit, Milwaukee, New Orleans, New York, Philadelphia, Pittsburgh, St. Louis, San Francisco, and Seattle.

⁴ Excludes education and welfare, functions not provided by many of the cities.

Source: Bureau of the Census, City Finances and City Employment, selected years.

Local tax rate increases also have played an important role in restoring financial solvency to the fiscally troubled cities. Table 2 shows the tax rate and revenue adjustments made by the seven cities reviewed in this paper. As is clear from the table, different cities have relied to different degree on local revenue increases to restore budgetary balance. Philadelphia, Boston, and Pittsburgh have depended heavily on tax hikes. Newark, New Jersey, also has financed its municipal revenue needs through steep tax increases, though it was able to substitute municipal millage rates for school millage rates as the result of the school tax relief enacted under New Jersey's new school finance arrangements. Detroit was greatly aided during the recession by the adoption of new state aid programs. Since 1976, Detroit's economic base has rebounded vigorously. Indeed, Detroit's fiscal troubles, more clearly than those of any other city, were largely cyclical in nature. The exposure of the city's automotive industry to recession was compounded by Detroit's heavy use of the cyclically sensitive municipal income tax. In fiscal 1975, income tax revenues fell some \$14 million, or 13 percent, short of projected levels. Fortunately for the city, the income tax base responded with equal alacrity to the economic upturn. In fiscal 1977 and 1978, the city underestimated income tax receipts by a total of almost \$22 million. The counter-cyclical assistance programs of both the federal government and the State of Michigan were able to smoothe out these violent fluctuations.

Cleveland and Buffalo present a different picture. Both have attempted to react to budgetary pressure almost solely through expenditure reductions, in part because of limitations on their ability to raise taxes.

TABLE 2.—CHANGES IN LOCAL TAX RATES AND LOCAL REVENUE COLLECTIONS (FISCAL 1975 TO FISCAL 1977)

[In percent]			
City government	Property tax rate	Wage and income tax rate	Total locally collected revenues
Boston	+28	(1)	+19
Buffalo	² +5	(1)	+5
Cleveland	0	0	+5
Detroit	+23	0	+6
Newark	³ +101	0	⁴ +51
Philadelphia	+66	+30	+41
Pittsburgh	0	(1)	+26

¹ No tax.

² Property tax rate decreased by 12 percent in fiscal 1978.

³ Largely offset by reductions in school tax financed by State of New Jersey.

⁴ Newly installed.

Source: Local financial reports.

ARE FURTHER TAX OR EXPENDITURE LIMITATIONS ON DISTRESSED CITIES DESIRABLE?

Further tax or expenditure limitations are desirable only if it is thought the adjustments of distressed cities to their long run budget constraints are occurring too slowly. To impose a new set of tax or spending ceilings would, in many cases, require more rapid reversals of policy than the cities can handle. Without accumulated balances to cushion their adjustments, cities would have to translate such limitations into immediate layoffs or (what is more likely) new borrowing to cover their revenue losses.

An examination of the record of tax and spending restraints in cities laboring under fiscal strain shows some of the undesirable effects these can have. The New York State courts recently ruled unconstitutional state legislation allowing property tax rates imposed for pension payments to be excepted from the state-wide 2 percent tax rate limitation on true property values. As a result, Buffalo was forced to cut its property tax millage from 87.03 in FY 1977-78 to 75.60 in FY 1978-79. In order to balance its budget on a cash basis, the city borrowed \$11.5 million from the state. However, the city is hoping the state eventually will treat this sum as an advance aid payment. Should the loan terms be enforced, Buffalo will find itself in severe financial trouble as it is forced to make back payments plus finance continuing pension obligations from a severely limited taxing authority. Buffalo faces this financial predicament despite the fact that twice in the last three years the New York State retirement systems, to which Buffalo belongs, have sharply reduced pension benefits for new public employees. Constitutional restrictions prevent the city or state from reducing benefits for existing employees. Hence, the possibilities for effecting economies are sharply circumscribed.

Cleveland is another city which finds itself in financial difficulty, in part because the city is prevented from balancing its budget through tax rate increases without voter approval. Between 1973 and 1976 Cleveland cut its city labor force by 16 percent, the largest reduction of any big city in the country. It has reduced real wages for public sector workers. And it has substituted federally supported CETA workers for locally paid workers, at one time using almost all of its CETA slots for police and sanitation personnel. Nonetheless, the city's expenditure reductions have not been sufficient to balance its budget. Without the ability to raise taxes, Cleveland has gone deeper and deeper into debt. It now faces probably the most difficult fiscal circumstances of any American city. The city is under court order to pay some \$16 million for past acquisition of electricity for resale through its municipal utility, but cannot secure voter approval for a new tax levy or court authorization to raise the funds through a bond issue. The city has added to its short term debt to finance its other cash requirements, much as New York City did prior to its financial crisis, but now the bonds and other public bondholders have refused to purchase further debt. The city has temporarily staved off financial crisis by arranging for its water system to buy the city's short term debt issues. Cleveland's school system also has been accumulating short term debt, finally forcing the state to take over operation of Cleveland's schools after voters refused to authorize the tax hikes necessary for repayment.

In short, tax rate increases have been an essential ingredient of the fiscal adjustments of recently distressed cities, where these have been undertaken successfully. The fiscal problems of these cities have been so great that it is impracticable to expect them to restore sound financial condition through expenditure reductions alone.

FIXED COSTS

The difficulties that cities face in reducing budgetary outlays are illustrated by the experience of Pittsburgh. Pittsburgh was perhaps the first city to attempt to cut back its public sector operations in full proportion to its population loss. Between 1960 and 1975 Pittsburgh lost nearly one-third its population, declining from 677,000 population to 459,000.

The city since 1970 has reduced public employment at a much faster rate than population loss. Between 1969 and 1975 full time equivalent employment was reduced from 7,595 to 5,557. Real public sector wage levels over the same period dropped by 14 percent, one of the sharpest declines for any big city. These economies enabled the city to hold the line on taxes and even to eliminate the local wage and earnings tax for a period.

The fixed costs in municipal operations, however, make it difficult to achieve budgetary savings commensurate with employment reductions. Table 3 illustrates some of the obstacles to budget cutting. Although Pittsburgh was able to restrain current labor service costs far below the rate of inflation over the period 1970-75, it could not control other personnel costs, including the costs of severance pay, pensions, and other benefits to employees who were laid off. New York City's recent spending illustrates the same difficulty: though the city's work force has been greatly reduced, the inflexible costs of debt servicing and pension contributions have scarcely altered their upward course. The nature of these costs sets severe limits to the spending reduction it is feasible to ask large cities to make.

TABLE 3.—EXPENDITURE GROWTH FOR WAGES AND BENEFITS, PITTSBURGH, 1970-75

[In thousands]

Item	Year		Growth
	1970	1975	(percent)
Current service costs:			
Public safety	\$32,641.6	\$34,044.8	-----
Public works	16,607.9	16,537.7	-----
Parks and recreation	5,947.7	6,156.9	-----
Library	1,976.5	2,443.5	-----
Land and buildings	2,315.8	2,404.3	-----
Supplies	271.8	4,490.0	-----
Total	59,781.4	66,472.2	+11.2
Benefits:			
City contribution to pension funds	3,151.0	7,144.0	+126.7
Other fringe benefits (workman's compensation, hospitalization, group insurance and severance pay)	2,074.8	7,305.5	-----
Total	5,225.8	14,449.5	+176.5

Source: Annual financial statements for Pittsburgh, Pa., 1970, 1975.

SURPLUSES

An operating surplus also presents a different appearance in cities under severe fiscal pressure than it does elsewhere. Surpluses in fiscal in accord with legal requirements. Indeed, the necessity of counterbalancing past operating deficits with current year surpluses is a large measure of the fiscal discipline imposed by the budgetary process. Tables 4-6 show the annual and accumulated balance positions of the several cities. Tables 4 and 6 present local operating results as reported by the cities themselves; Table 5 converts local accounts to a uniform pro forma basis, which recognizes only recurring revenues and restates revenues and expenditures on a consistent basis. Each of the cities can be seen to have gone into the red at some point during the recession, and most faced negative accumulated balances at the end of 1975 or 1976, which were subsequently offset by operating surpluses. Restated on a pro forma basis, Cleveland's accounts show it to be the only city with a steadily worsening financial position throughout this period. The city's operating deficits were hidden from public view by extraordinary revenues realized from asset sales and by transfers from the cash balances of enterprise accounts.

With the single exception of Pittsburgh, the cities also entered fiscal 1977 with unrestricted cash deficits. The value of short term debt outstanding exceeded local cash reserves held in other than restricted pension fund or bond fund accounts. These cash deficits reached as high as 50 percent of annual general expenditures in Cleveland. Their presence made it imperative for cities to roll over their short term debt, yet made access to the bond market difficult. The restoration of liquidity therefore was as immediate a financial priority to these cities, and as important to their future fiscal prospects, as was the restoration of liquidity to the private corporate sector during the recovery from the recession. All of the cities except Buffalo (and Cleveland on a pro forma basis) have now eliminated their accumulated deficit balances. The only city which failed to make progress on its accumulated balances through current account surpluses—Cleveland—now finds itself in a perilous financial predicament.

TABLE 4.—GENERAL FUND OPERATING SURPLUSES (DEFICITS) AS REPORTED BY 6 CITIES

[In millions of dollars]

City	Fiscal years ending—			
	Dec. 30, 1974 to June 30, 1975	Dec. 30, 1975 to June 30, 1976	Dec. 30, 1976 to June 30, 1977	Dec. 30, 1977 to June 30, 1978
Detroit	(35.6)	(22.7)	51.5	13.5
Newark	9.7	(5.6)	6.2	¹ (.1)
Philadelphia	(27.6)	(77.8)	64.3	NA
Boston .....	.7	(12.6)	24.8	NA
Buffalo	(5.8)	.6	-----	NA
Cleveland .....	.2	.1	.3	² 0

¹ Estimated.² Budgeted.

Source: Local financial reports and bond prospectuses.

TABLE 5.—PRO FORMA GENERAL FUND OPERATING RESULTS

[In millions of dollars]

City	Fiscal years ending—			
	Dec. 30, 1974 to June 30, 1975	Dec. 30, 1975 to June 30, 1976	Dec. 30, 1976 to June 30, 1977	Dec. 30, 1977 to June 30, 1978
Detroit	(35.6)	(22.7)	51.5	3.5
Newark	(4.7)	(6.6)	8.2	¹ 1.1
Philadelphia	(27.6)	(77.8)	(64.4)	NA
Boston	(9.1)	(60.2)	24.8	NA
Buffalo	(12.6)	1.4	-----	-----
Cleveland .....	.02	(3.4)	(8.8)	² (16.8)

¹ Estimated.² Budgeted.

TABLE 6.—ACCUMULATED GENERAL FUND BALANCES (DEFICITS) END OF FISCAL 1975 OR 1976, AS REPORTED

City	Fund Balance	Year
Detroit	(36.9)	1976
Newark	(19.3)	1975
Philadelphia	(87.8)	1976
Boston	NA	-----
Buffalo	(20.5)	1976
Cleveland .....	.1	1976

Capital investment

Capital spending, particularly spending on repair and maintenance of existing capital facilities, has borne the brunt of fiscal adjustment in a number of financially hard pressed cities. Several of the older cities operating under fiscal pressure have had spectacular reductions in their capital spending—Buffalo trimmed its capital budget by one-third in 1976 and more in 1977. New York reduced total city capital spending by more than half, some \$800 million; while Pittsburgh cut back capital outlays by almost 20 percent. Hardest hit in each case were general improvements to the city infrastructure systems. In several instances, cities were shut out of the municipal capital market for an extended period of time, causing their bond fund reserves to dwindle and impairing their ability to finance capital improvements.

Because of the difficulties they have encountered in raising local revenues or issuing general obligation bonds, many of the older cities have become deeply dependent upon federal aid programs to pay for their capital budgets, especially that portion devoted to general improvements. No less than 80 percent of Newark's capital budget in 1978 will be financed by federal emergency local public works funds, as well as 65 percent of the capital budget of Pittsburgh, 30 percent of the public construction contracts issued by New York City and 43 percent of St. Louis' total capital spending.

It is difficult to get a firm grasp on the postponed maintenance, repair and capital spending of cities. The last several months also have brought sharp recovery

to capital expenditures. But the danger persists that in bringing their budgets into balance cities will try to squeeze savings from their capital stock.

IMPLICATIONS FOR FEDERAL AID PROGRAMS

In many respects the greatest risk attending city finances at present is the fate of the temporary federal aid programs that have helped cities resist fiscal pressure. The enabling legislation for both CETA and antirecession fiscal assistance expires on September 30, 1978. The local public works program already has terminated, though a sizable proportion of the funds remain to be spent by local recipients. All three programs have successor legislation currently pending before Congress.

Our review suggests the following conclusions for future federal assistance toward large, "distressed" cities:

(a) From the standpoint of financial condition, relatively few cities need extra help at this juncture. City finances have strengthened considerably in the last 24 months; those cities that remain in weak financial shape find themselves in that predicament largely because of local management decisions. It would be undesirable to remove the pressure on city budgets altogether through external assistance, since this pressure has been primarily responsible for promoting the spending restraint that seems in the cities' own best long term interests.

(b) The simultaneous elimination of CETA, countercyclical revenue sharing, and Local Public Works aid undoubtedly would disrupt city budgets. The first two programs in 1977 accounted for approximately 16 percent of the general operating budgets of the cities in our sample. Although CETA funds now are used largely to support district employment programs, rather than to pay for ordinary municipal services personnel, loss of these funds would require large scale adjustments in local service delivery and tax rates. Elimination of local public works assistance would, with some delay, depress city capital spending.

(c) In choosing the right mix of urban aid for the future, the federal government would do well to look beyond financial difficulties to the long run tax base deterioration of the cities. The most important studies in tax base equalization have been taken by state governments, through school aid formulas and urban aid packages which compensate cities for their special costs of service provisions. The cities' recovery from the financial pressure of 1974-76 is now nearly complete. Some of the temporary federal aid programs adopted to cope with this pressure can begin to be eliminated. In devising long term fiscal assistance for the cities, Congress should look to a fresh partnership with the states, so that federal aid is used to encourage permanent state initiatives at sustaining the tax capacity of urban areas.

Representative MOORHEAD. The committees would now like to hear from Mr. Herrington J. Bryce, vice president, the Academy for Contemporary Problems.

STATEMENT OF HERRINGTON J. BRYCE, VICE PRESIDENT, THE ACADEMY FOR CONTEMPORARY PROBLEMS, COLUMBUS, OHIO

Mr. BRYCE. Thank you very much. Mr. Cochairman, and members of the committees. I have a prepared statement which deals with the fiscal problems of smaller cities as requested by the committees. That prepared statement also attempts to distinguish between some of the fiscal trends in the declining small cities and in metropolitan and non-metropolitan small cities.

I would prefer, however, not to read the testimony but to give just a brief oral statement which highlights these two points made in my written version.

I think, first of all, it is rather important that we appreciate the fact that small cities account for a very significant part of the general expenditures of all cities and also for the capital spending of all cities. Small cities, depending upon how they are defined, account for anywhere from one-third to 40 percent of the general expenditures of all cities.

Consequently, they have important impact on the resource allocation of cities in general, and the truth is that they have a very significant impact on our ability to deal with cyclical crises and resource allocation.

In addition to their relative importance in the spending of cities in general, I think that the most important feature of these expenditures is the significant rise in dependency of small cities on the Federal Government.

I have looked at particularly a very short period, 1969 through 1976 which, of course, embraces two recessions, and during that period of time the small cities which I have looked at increased their dependency on the Federal Government by over 800 percent. This was almost twice as much as cities in general.

Now, John Shannon, from whom I think you will hear later, has looked at some annual rates of increases in small cities during the period of 1965 through 1972 and I think his figures show that among small cities, that rate of increase in dependency was even higher than it was for the most of our cities with the exception of the six or so cities over 1 million in population. But I wish to underline my particular finding that looks at it in the short period, which shows an increase of over 800 percent.

Now, there are any number of ways in which one might look at that figure. First of all, I think it does imply some serious kinds of problems concerning local initiatives. I think, however, that if the current trends continue with respect to how citizens embrace the possibilities of putting a cap on local expenditures or local government revenues, we can expect that that dependency will rise and probably rise rather sharply in the near future. That rise will occur as well if we accept, which I do, the position of our previous speakers which indicated that the State surplus is one which is probably, one, overestimated; and, two, transitory.

The dependency, however, is not all that bad. First of all, I wish to call your attention to the fact that in a sense, part of the dependency reflects a tendency on the part of the Federal Government to finance some of its mandated costs which arise when the Federal Government requires local action by way of regulations such as through EPA; part of the dependency is reflected in the transfer funds from the Federal Government to local governments which permits the local government, small cities in this particular case, to meet those requirements.

The second part of the dependency reflects on the part of the Federal Government its willingness to deal with cyclical crises. Clearly that is the case with some programs; clearly that is the case with CETA, and other such programs.

Now, that is not bad because what it does is it reduces the fiscal strain that smaller cities would experience had there not been those transfers available.

A third part of the dependency must be viewed as a voluntary act on the part of the local government. There are many programs, for example, community development block grants, in which a local government has the option of participating. My own figures have shown that among the small cities I have looked at over 84 percent of them

applied to participate in the community development block grant program.

The point is that dependency reflects in this sense an expression on the part of many local governments to participate in these programs even though the price the Federal Government might impose is not to them a very comfortable one.

It is widely acknowledged that many of our small cities find it very difficult to deal with some of the specific regulations and specific requirements of Federal programs. The point is, however, that should the Federal Government transfers to these cities decrease, given the current trends to put a cap on local on government revenues, we can expect a significant fiscal crisis; I believe, in many small cities.

I wish to stop here, Mr. Cochairman, and refer the committee back to my prepared statement.

Representative MOORHEAD. Thank you.

Without objection the prepared statements of all the members of panel 2 will be made a part of the record.

[The prepared statement of Mr. Bryce follows:]

PREPARED STATEMENT OF HERRINGTON J. BRYCE¹

CURRENT TRENDS IN FINANCING SMALLER CITIES

This testimony looks at the recent fiscal trends in small cities—generally those ranging in size from 25,000 to 50,000 although in particular circumstances it also considers cities 50,000 to 100,000. It looks at various types of expenditures and revenue sources and compares the experiences of growing and declining cities and of metropolitan and nonmetropolitan cities, as was requested by this Committee.

The period of comparison is relatively short, 1969-70 through 1975-76, a period which embraces two recessions and during which the Consumer Price Index and Producers Prices rose by approximately 55.6 percent. A problem of looking at any jurisdictional group over time by size class is that over very long periods of time some cities enter and others leave the group so that the composition of the group is not constant. The period being used in this testimony is sufficiently short such that we do not have major changes in the composition of what we refer to as small cities.

General expenditures

By 1975-76, general expenditures in cities 25,000 to 50,000 (small cities as defined in this testimony) exceeded \$13.4 billion or 25 percent of the total general expenditures of all cities combined. Thus, while small, these cities have a significant impact on the demand for goods and services among jurisdictions.

The three major expenditure categories among small cities are in police, sewerage and sanitation and highways. Each takes roughly 14 percent of their general expenditures. The lower proportion of the municipal budget going to education in smaller cities as compared to all cities combined is not to be misconstrued. The latter figure contains the effects of those few large cities which conduct their own educational systems. Education in other cities is frequently the responsibility of independent school districts.

Table 1 also shows that a much larger proportion of the budgets in small cities goes to highways. This, too, is not to be misconstrued. The total mileage which falls within the local government system in rural areas alone, for example, is nearly three and a half times as great as the mileage in cities.²

¹ This testimony is drawn from a study on small cities which this author is conducting for the Joint Center for Political Studies. The study is funded in part by National Science Foundation grant ERS74-21286 and assistance from the Charles F. Kettering Foundation (National Urban Policy Roundtable which is coordinated by the Academy for Contemporary Problems). I am grateful for the assistance of Barbara Buhl, Avra Raption and Shirley Lee. The views expressed in this paper are strictly those of the author and do not necessarily reflect the views of any of the organizations mentioned or their sponsors.

² U.S. Department of Transportation, "Highway Statistics: Summary to 1975" (Washington, D.C., U.S. Government Printing Office, 1976) p. 211.

Over the period, two of the functions in which expenditures have risen fastest among small cities are police and park and recreation. In both cases, the rise is greater than explainable simply in terms of inflation.

The crime rate among cities 25,000 to 50,000 grew six times as fast between 1975 and 1976 as it did in all cities taken as a whole and much faster than all big cities except the six cities which have over a million people. In fact, many of the middle-sized cities (those 250,000 to 1 million in population) had a decline in crime during this period. The crime rates rose especially fast among the nonsuburban cities (25,000 to 50,000 in population). It was two and half times as fast among those cities as it was among suburban cities.³

The rapid rise in spending on park and recreational services is to be viewed more than as a measure to provide amenities for present residents. Among many small cities the major attraction to visitors as well as prospective newcomers is in the area of park and recreational facilities.

Capital expenditures

Capital expenditures increased among small cities by a greater amount than among cities as a whole. In 1975-76, capital expenditures among these small jurisdictions amounted to \$3 billion—roughly a third of the capital outlays of all cities. This is a significant portion of the capital programs of municipal governments.

Just under 50 percent of the capital outlays in small cities go to two functions—highways (23.1 percent) and sewerage and sanitation (24.2 percent). These two areas are also the two most emphasized in the capital improvement programs in cities in general. It should be noted, however, that while among cities as a whole there has been a dramatic shift in capital formation in housing and urban renewal to sewerage, such has not been the case in small cities. Housing and urban renewal remain small proportions of the latter's budget and the proportion going to sewerage has remained reasonably stable between 1970-76.

Table 2 shows that although hospital and public buildings together account for less than 10 percent of the total capital spending by small cities, they are the two fastest growing areas of such spending.

The expenditure on sewerage is particularly important in pointing to a theme (fiscal dependency) which will be discussed in this testimony in a later section. The relative importance of sewerage is related to the fact that this is one of the most common functions discharged directly by small city governments.⁴ Waste disposal is also an important tool for controlling and managing growth. But a significant part of the allocation of resources to this function relates to the imposition of federal requirements as well as the availability of federal dollars obtained through HUD's Community Development Block Grant, the Farmers Home Administration, the Environmental Protection Agency, and to some extent, the Department of Commerce.

Borrowing

Among small cities, the financing of a capital project might occur through a variety of means such as the use of reserves, special assessments, grants, loans and borrowing.

Given the rapid rate of growth of population in small cities, capital expenditures are important in providing new or improved infrastructure. Thus, we find in Table 3 that growing small cities (those 50,000 to 100,000 in population) spend a larger percentage of their budgets on capital items than do declining cities. Forty-one percent of the growing compared to 23 percent of the declining small cities allocate at least a fourth of their annual expenditures to capital programs. Further, as Table 4 shows, growing cities are more likely to have a larger debt outstanding than declining cities. Nearly one half (48 percent) of the growing compared to only 30 percent of the declining cities have a gross outstanding debt of at least \$25 million.

It is frequently more common that declining small cities guarantee their debt instruments with the full faith, credit and taxing powers of the jurisdiction.

³ Federal Bureau of Investigation, "Uniformed Crime Report" (Washington, D.C., U.S. Government Printing Office, 1976) pp. 146-149.

⁴ Herrington J. Bryce, "Planning Smaller Cities" (Lexington Books: forthcoming 1978), ch. IV.

Sixty percent of growing cities as compared to only 49 percent of declining cities had 25 percent or more of their outstanding debt not guaranteed. See Table 5. Heavy dependence on guaranteed debt implies greater exposure to voter referenda. It is also troublesome since the tax base which secures the loan is by implication either declining or growing more slowly in declining cities.

Partly reflecting this fact, the Moody rating of the general obligation bonds of declining cities is *slightly* less favorable than it is for growing cities. Ratings are shown in Tables 6 and 7. Some 81 percent of the growing cities had bond ratings of A or better compared to 72 percent of the declining cities. What is most striking, however, is that declining cities are not significantly more likely to be unrated than growing cities. Roughly 18 percent of the declining cities and 13 percent of the growing are unrated. Admittedly, rating is only one factor which affects the marketability of a debt instrument.⁵

Among small cities there is also a difference between the capital programs of metropolitan as contrasted with nonmetropolitan cities. Some 44 percent of nonmetropolitan small cities allocated at least 25 percent of their annual expenditures to capital programs as compared to 30 percent of metropolitan cities. This reflects the fact that nonmetropolitan cities are more likely than their suburban counterparts to be directly responsible for the provision of basic services.⁶ Table 8.

Accordingly, small cities in the metropolitan areas tend to have a smaller debt outstanding than do their nonmetropolitan counterparts. Only 35 percent of metropolitan cities, but 55 percent of nonmetropolitan cities had an outstanding debt of \$10 million or more. But nonmetropolitan cities were *less* likely to back their debt with the full faith and credit of the municipality. Thus, 61 percent of nonmetropolitan cities had at least 25 percent of their outstanding debt nonguaranteed. Tables 9 and 10.

As shown in Table 6, it is *not* clear (at least among cities ranging in size of 25 to 50 thousand) that bond ratings are decisively lower among nonmetropolitan cities.

Revenues and dependency

Looking at the revenue patterns in Tables 11 and 12 reveals the declining importance of the property tax as a source of revenues among small cities. Nevertheless, this tax remains the major source of all general revenues derived by these cities.

On the other hand, intergovernmental transfers have increased. Like all cities, small cities still get proportionately more of their intergovernmental aid from the state government. But the increase in the flow of funds from the federal government to small cities is spectacular. This aid has increased by over 800 percent (twice the rate of increase of all cities taken together) in the short period ranging from 1970 to 1976. Table 13.

Table 14 helps us to look at this dependency as it relates to growing and declining cities and as it relates to those cities in metropolitan as opposed to those in nonmetropolitan areas. It also shows that dependency is greater among nonmetropolitan cities. Just over half of the metropolitan cities (52 percent) obtained 75 percent or more of their general revenues from their own source compared to 31 percent of nonmetropolitan cities. The data do show as well that growing cities rely more heavily on their own source of revenues than declining cities do. Forty-three percent of the growing cities compared to 32 percent of declining cities obtain 75 percent or more of their revenues from their own source.

The heavy reliance on outside sources while making the local government less vulnerable to the displeasure of local taxpayers does reduce local initiatives.⁷

Another consequence of this increase in dependency is the heavy administrative burden which has been placed on these small cities. It is reported by many of them, for example, that the most difficult task they have in discharging the responsibilities of the Community Development Block Grant is in completing the

⁵ For a discussion of the marketability of debt instruments of small cities, See John E. Petersen, "The Borrowing Costs of Small Cities" in Herrington J. Bryce (ed.) "Small Cities in Transition: The Dynamics of Growth and Decline" (Cambridge, Massachusetts, Ballinger, 1977), pp. 365-368.

⁶ Herrington J. Bryce, *op. cit.*

⁷ For an additional view of the dependency phenomenon among small cities, see John Shannon and John Ross, "Cities: Their Increasing Dependence on State and Federal Aid," in Herrington J. Bryce (ed.) "Small Cities," pp. 189-208.

financial and administrative paperwork.⁸ Partly as a consequence of the federal demands on the administrative and financial components of these governments, their expenditures on financial administration more than doubled between 1969 and 1976. Admittedly, part of this increase is financed by the federal government which permits the use of some fraction of program funds for administrative costs.

CONCLUSIONS

We make a serious error in not giving adequate attention to the role of small cities in determining the overall economic behavior of cities in general. Small cities account for a significant part of the expenditures of city governments. Consequently, as a group, they have a significant impact on resource allocation. But size is not an exclusive determinant of the economic behavior of cities; therefore, we have shown in this testimony some significant differences between small cities depending upon their metropolitan or growth status.

Perhaps the most outstanding feature of the recent fiscal trend in small cities is their growing dependence on the federal government. This trend is not all negative. To some extent it represents partial federal financing of expenditures mandated by the federal government. In some respects, as is true of the various countercyclical measures, it represents federal intervention to relieve fiscal and economic pressures on small cities. Hence, my own study has shown that 75 percent of small cities have relied on CETA to offset the employment impact of the recession. It is also true that part of the fiscal dependency reflects a voluntary action on the part of local governments to participate in federal programs which are optional. My own study shows that over 85 percent of small cities applied for participation in the Community Development Block Grant Program.⁹ The implication is that in spite of the "price" that the federal government extracts for participation by small cities in programs and in spite of the negative side effects of this intervention, the overwhelming majority of small cities would be fiscally hurt by the termination of these programs.

TABLE 1.—GENERAL EXPENDITURES OF CITIES, BY CITY SIZE AND TYPE OF EXPENDITURE, PERCENT DISTRIBUTION, 1975-76

[Dollar amounts in millions]

	All cities	Cities with population of 25,000 to 49,999	All cities (percent)	Cities with population of 25,000 to 49,999 (percent)
General expenditure.....	\$54,425	\$13,465	100.0	100.0
Capital outlay.....	9,312	3,040	17.1	22.6
Other general expenditure.....	45,113	10,426	82.9	77.4
General expenditure:				
Education.....	7,610	1,246	14.0	9.3
Highways.....	4,245	1,886	7.8	14.0
Public welfare.....	4,544	69	8.3	5
Hospitals and health.....	3,462	690	6.4	5.1
Police.....	6,015	1,827	11.1	13.6
Fire.....	3,257	953	6.0	7.1
Sewerage and sanitation.....	5,557	2,009	10.2	14.9
Parks and recreation.....	2,558	766	4.7	5.7
Housing and urban renewal.....	1,525	160	2.8	1.2
Libraries.....	684	196	1.3	1.5
Financial administration.....	912	321	1.7	2.4
General control.....	1,611	597	3.0	4.4
General public buildings.....	934	329	1.7	2.4
Interest on debt.....	2,863	573	4.9	4.3
Other.....	8,828	1,842	16.2	13.7

Source: Academy for Contemporary Problems Staff from data in U.S. Department of Commerce, "City Government Finances in 1975-76" (Washington, D.C., U.S. Government Printing Office, 1977) p. 7.

⁸ The Department of Housing and Urban Development, "Community Development Block Grant Programs, Second Annual Report" (Washington, D.C., U.S. Government Printing Office) p. 10. Approximately 10 percent of county program costs in CDBG were federal paperwork, and 5 percent of municipal program costs resulted from federal paperwork requirements. See Timothy D. Mead, "Impact of Federal Paperwork on State And Local Governments: An Assessment." Report to the Commission on Federal Paperwork, July 15, 1977, pp. 48-53, 69-72.

⁹ See Herrington J. Bryce, "Planning Smaller Cities," *op. cit.*, chs. VII and VIII.

TABLE 2.—CAPITAL OUTLAYS FOR SELECTED ITEMS, BY CITY SIZE, PERCENT DISTRIBUTION AND PERCENT CHANGE, 1975-76

Selected items, 1975-76	Dollars (millions)		Percent distribution		Percent change	
	All cities	25,000 to 49,999	All cities	25,000 to 49,999	All cities	25,000 to 49,999
Total capital outlay for general expenditure	9,312	3,040	100.0	100.0	66.6	85.4
Selected items:						
Education	669	134	7.2	4.4	21.9	94.2
Highways	1,801	702	19.3	23.1	61.1	87.7
Hospitals	207	111	2.2	3.7	88.2	270.0
Sewerage	2,296	737	24.7	24.2	160.6	100.8
Housing and urban renewal	633	85	6.8	2.8	-9.2	25.0
Public buildings	374	157	4.0	5.2	129.4	157.4

Source: Academy for Contemporary Problems Staff from data in U.S. Department of Commerce, "City Government Finances in 1975-76," (Washington, D.C., U.S. Government Printing Office, 1977) p. 7.

TABLE 3.—PERCENT OF GENERAL EXPENDITURE ALLOCATED TO CAPITAL OUTLAY FOR CITIES WITH 1970 POPULATION OF 50,000 TO 100,000, FISCAL YEAR 1975-76 (BY DECLINING OR INCREASING POPULATION, 1970-75)

	All cities	Percent for capital outlay			
		Under 25	25 to 49	50 to 74	75 to 100
Total (number)	230	157	65	8	0
Declining	118	91	22	5	0
Stable or increasing	112	66	43	3	0
Total (percent)	100.0	68.3	28.3	3.5	0
Declining	100.0	77.1	18.6	4.2	0
Stable or increasing	100.0	58.9	38.4	2.7	0
Total (percent)	100.0	100.0	100.0	100.0	
Declining	51.3	58.0	33.8	62.5	
Stable or increasing	48.7	42.0	66.2	37.5	

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 4.—BOND RATINGS OF CITIES WITH 1970 POPULATION OF 50,000 TO 100,000 BY DECLINING OR INCREASING POPULATION, 1970-75

	All cities (number)	Bond rating (percent of cities)						
		Aaa	Aa	A1	A	Baa1	Baa	NA
Total	230	3.5	26.1	24.8	22.2	4.3	3.5	15.7
Declining	118	4.2	25.4	22.0	20.3	5.1	5.1	17.8
Stable or increasing	112	2.7	26.8	27.7	24.1	3.6	1.8	13.4

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 5.—PERCENT OF GROSS OUTSTANDING DEBT WHICH IS NONGUARANTEED FOR CITIES WITH 1970 POPULATION OF 50,000 TO 100,000, FISCAL YEAR 1975-76 (BY DECLINING OR INCREASING POPULATION, 1970-75)

	All cities	Percent nonguaranteed				NA
		Under 25	25 to 49	50 to 74	75 to 100	
Total (number)	230	41	54	37	34	64
Declining	118	18	25	18	15	42
Stable or increasing	112	23	29	19	19	22
Total (percent)	100.0	17.8	23.5	16.1	14.8	27.8
Declining	100.0	15.3	21.2	15.3	12.7	35.6
Stable or increasing	100.0	20.5	25.9	17.0	17.0	19.6

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 6.—BOND RATINGS OF CITIES WITH 1970 POPULATION OF 25,000 TO 50,000, BY METROPOLITAN-NONMETROPOLITAN STATUS

	All Cities	Bond ratings							
		Aaa	Aa	A1	A	Baa1	Baa	Ba	NA
Total (number).....	452	5	93	92	114	16	30	1	101
Metropolitan.....	279	1	56	57	70	8	16	1	10
Nonmetropolitan.....	173	4	38	35	44	8	14	0	30
Total (percent).....	100.0	1.1	20.6	20.4	25.2	3.5	6.6	.2	22.3
Metropolitan.....	100.0	.4	20.1	20.4	25.1	2.9	5.7	.4	25.1
Nonmetropolitan.....	100.0	2.3	22.0	20.2	25.4	4.6	8.1	0	17.3

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association 1978), pp. 3-44.

TABLE 7.—GROSS OUTSTANDING DEBT FOR CITIES WITH 1970 POPULATION OF 50,000 TO 100,000, FISCAL YEAR 1975-76 (BY DECLINING OR INCREASING POPULATION, 1970-75)

	All cities	Gross outstanding debt (thousands of dollars)								
		Under 100	100 to 999	1,000 to 9,999	10,000 to 24,999	25,000 to 49,999	50,000 to 99,999	100,000 to 149,999	150,000 to 199,999	200,000 and over
Total (number).....	230	5	5	46	84	60	24	4	1	1
Declining.....	118	5	3	25	49	25	10	1	0	0
Stable or increasing.....	112	0	2	21	35	35	14	3	1	1
Total (percent).....	100.0	2.2	2.2	20.0	36.5	26.1	10.4	1.7	0.4	0.4
Declining.....	100.0	4.2	2.5	21.2	41.5	21.2	8.5	.8	0	0
Stable or increasing.....	100.0	0	1.8	18.8	31.2	31.2	12.5	2.7	.9	.9

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 8.—PERCENT OF GENERAL EXPENDITURES ALLOCATED TO CAPITAL PROJECTS, FOR CITIES WITH 1970 POPULATION OF 25,000 TO 50,000, FISCAL YEAR 1975-76 (BY METROPOLITAN STATUS)

	All cities	Percent for capital projects				NA
		Under 25	25 to 49	50 to 74	75 to 100	
Total (number).....	452	284	121	25	15	7
Metropolitan.....	279	188	57	14	14	6
Nonmetropolitan.....	173	96	64	11	1	1
Total (percent).....	100.0	62.8	26.8	5.5	3.3	1.5
Metropolitan.....	100.0	67.4	20.4	5.0	5.0	2.2
Nonmetropolitan.....	100.0	55.5	37.0	6.4	.6	.6

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 9.—GROSS OUTSTANDING DEBT FOR CITIES WITH 1970 POPULATION OF 25,000 TO 50,000, FISCAL YEAR 1975-76 (BY METROPOLITAN-NONMETROPOLITAN STATUS)

	All cities	Gross outstanding debt (thousands of dollars)									NA
		Under 100	100 to 999	1,000 to 9,999	10,000 to 24,999	25,000 to 49,999	50,000 to 99,999	100,000 to 149,999	150,000 to 199,999	200,000 and over	
Total (number).....	452	4	30	210	148	36	7	2	0	0	15
Metropolitan.....	279	4	29	135	75	16	6	1	0	0	13
Nonmetropolitan.....	173	0	1	76	73	20	1	1	0	0	1
Total (percent).....	100.0	0.9	6.6	46.5	32.7	8.0	1.5	0.4			3.3
Metropolitan.....	100.0	1.4	10.4	48.4	26.9	5.7	2.2	.4			4.7
Nonmetropolitan.....	100.0	0	.6	43.9	42.2	11.6	.6	.6			.6

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book, 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 10.—PERCENT OF GROSS OUTSTANDING DEBT WHICH IS NONGUARANTEED FOR CITIES WITH 1970 POPULATION OF 25,000 TO 50,000, FISCAL YEAR 1975-76 (BY METROPOLITAN AND NONMETROPOLITAN STATUS)

	Percent nonguaranteed					NA
	All cities	Under 25	25 to 49	50 to 74	75 to 100	
Total (number).....	452	95	77	65	94	121
Metropolitan.....	279	61	46	36	48	88
Nonmetropolitan.....	173	34	31	29	46	33
Total (percent).....	100.0	21.0	17.0	14.4	20.8	26.8
Metropolitan.....	100.0	21.9	16.5	12.9	17.2	31.5
Nonmetropolitan.....	100.0	19.7	17.9	16.8	26.6	19.1

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 11.—GENERAL REVENUE OF CITIES, BY CITY SIZE, AND TYPE OF REVENUE AND PERCENT DISTRIBUTION, 1969-70

[Dollar amounts in millions]

	All cities	Cities with population of 25,000 to 49,999	All cities (percent)	Cities with population of 25,000 to 49,999 (percent)
General revenue.....	\$26,621	\$6,270	100.0	100.0
From Government sources.....	7,906	1,356	29.7	21.6
State.....	6,173	1,066	23.2	17.0
Federal.....	1,337	180	5.0	2.9
Local.....	396	109	1.5	1.7
From own sources.....	18,715	4,914	70.3	78.4
Taxes.....	13,647	3,193	51.3	50.9
Property.....	9,127	2,346	34.3	37.4
Sales.....	2,422	494	9.1	7.9
Other.....	2,098	352	7.9	5.6
Current charges.....	3,113	1,010	11.7	16.1
Miscellaneous.....	1,955	712	7.3	11.4

Source: Academy for Contemporary Problems Staff from data in U.S. Department of Commerce, "City Finances in 1969-70" (Washington, D.C., U.S. Government Printing Office, 1977) p. 7.

TABLE 12.—GENERAL REVENUE OF CITIES, BY CITY SIZE, AND TYPE OF REVENUE AND PERCENT DISTRIBUTION, 1975-76

[Dollar amounts in millions]

	All cities	Cities with population of 25,000 to 49,999	All cities (percent)	Cities with population of 25,000 to 49,999 (percent)
General revenue.....	\$55,341	\$13,839	100.0	100.0
From Government sources.....	22,234	4,635	40.2	33.5
State.....	13,772	2,595	24.9	18.8
Federal.....	7,442	1,656	13.4	12.0
Local.....	1,021	383	1.8	2.8
From own sources.....	33,107	9,205	59.8	66.5
Taxes.....	23,336	5,850	42.2	42.3
Property.....	14,165	3,912	25.6	28.3
Sales.....	5,109	1,262	9.2	9.1
Other.....	4,063	677	7.3	4.9
Current charges.....	6,161	2,086	11.1	15.1
Miscellaneous.....	3,611	1,269	6.5	9.2

Source: Academy for Contemporary Problems Staff from data in U.S. Department of Commerce, "City Government, Finances in 1975-76," (Washington, D.C., U.S. Government Printing Office, 1977), p. 7.

TABLE 13.—PERCENTAGE CHANGE IN REVENUES BY TYPE BETWEEN FISCAL 1969-70 and FISCAL 1975-76

	All cities	City population of 25,000 to 49,999
General revenue.....	107.9	110.7
From Government sources.....	181.2	241.8
State.....	123.1	143.4
Federal.....	456.6	820.0
Local.....	157.8	251.4
From own sources.....	76.9	87.3
Taxes.....	71.0	83.2
Property.....	55.2	66.8
Sales.....	110.9	155.5
Other.....	97.3	92.3
Current charges.....	97.9	106.5
Miscellaneous.....	84.7	78.2
Utility revenue:		
Water supply.....	56.9	59.9
Other utility.....	112.6	118.4

Source: Academy for Contemporary Problems Staff from data in U.S. Department of Commerce, "City Government Finances in 1975-76," (Washington, D.C., U.S. Government Printing Office, 1977) p. 7.

TABLE 14.—PERCENT OF GENERAL REVENUE FROM OWN SOURCES FOR CITIES WITH 1970 POPULATION OF 25,000 TO 50,000, FISCAL YEAR 1975-76 (BY METROPOLITAN STATUS)

	All cities	Percent from own sources				NA
		Under 25	25 to 49	50 to 74	75 to 100	
Total (number).....	452	1	38	211	198	4
Metropolitan.....	279	1	15	116	144	3
Nonmetropolitan.....	173	0	23	95	54	1
Total (percent).....	100.0	0.2	8.4	46.7	43.8	0.9
Metropolitan.....	100.0	.4	5.4	41.6	51.6	1.1
Nonmetropolitan.....	100.0	0	13.3	54.9	31.2	.6

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

TABLE 15.—PERCENT OF GENERAL REVENUE FROM OWN SOURCES FOR CITIES WITH 1970 POPULATION OF 50,000 TO 100,000, FISCAL YEAR 1975-76 (BY DECLINING OR INCREASING POPULATION, 1970-75)

	All cities	Percent from own sources			
		Under 25	25 to 49	50 to 74	75 to 100
Total (number).....	230	2	13	129	86
Declining.....	118	1	8	71	38
Stable or increasing.....	112	1	5	58	48
Total (percent).....	100.0	0.9	5.7	56.1	37.4
Declining.....	100.0	8	6.8	60.2	32.2
Stable or increasing.....	100.0	9	4.5	51.8	42.9
Total (percent).....	100.0	100.0	100.0	100.0	100.0
Declining.....	51.3	50.0	61.5	55.0	44.2
Stable or increasing.....	48.7	50.0	38.5	45.0	55.8

Source: Academy for Contemporary Problems Staff from data in Barbara H. Grouby and Mary A. Schellinger, Profiles of Individual Cities, in "The Municipal Year Book 1978" (Washington, D.C., International City Management Association, 1978), pp. 3-44.

Representative MOORHEAD. Mr. Chairman.

Representative REUSS. I think, Cochairman Moorhead, it would be expeditious and fair, if it is all right with every member of the committee if we now withheld the third panel of three sterling witnesses, and that we eight members at the table, under the 5-minute rule, proceeded to examine the eight witnesses that we have had before us.

We then will hear from the second panel in 30 minutes and start in the questioning on the part of members of the committee where we left off. Is there any objection to that procedure?

If not, let me start out. Mr. Jacoby, yours like the others was a fascinating paper. One is struck by the fact that here the Federal Government has been giving \$2 billion or more a year in general revenue sharing to the States. California somehow or other ends up with \$5 billion of do-re-mi which, mythological or not, seems to be of a nature that can be returned now to localities and some of the taxpayers.

Tax assessments and tax rates on homes did go up frightfully in your State, as who knows better than you? How did this all come about? Could not some light be thrown on this by the action of the smallish community of Petaluma, where the city fathers said,

Look, we are tired of taxing existing homeowners to provide free or subsidized streets, highways, sewer extensions, water extensions and utilities, to new subdivisions whose speculator—developers are then able to sell for less than would be the case had they paid the full price, which results in a tax burden being loaded on the poor souls who got there first, for which they get no visible benefit.

I am not suggesting that is the whole story but there is this tremendous population boom you had in California and with your climate and fine country, I can understand why you had it. Couldn't that be part of this ghastly problem which Jarvis-Gann finally made contact with?

Mr. JACOBY. Chairman Reuss, I think the answer is yes, it certainly had a great deal to do with it. I believe that in interpreting the proposition 13 episode in California one must bear in mind that California had been backward in reforming its State and local revenue system to reduce reliance on property taxation.

The State was increasingly relying on property taxes to finance not only so-called property-related services, street maintenance, lighting, sewers, water, and police and fire protection, but also the increasingly expensive people-related services, recreation, welfare, and health and education.

Just to give you a figure, in 1977 the best estimate I have been able to make of the cost of property-related services in California was \$3.9 billion, but the State and local governments were collecting \$11 billion from property owners and this figure was simply skyrocketing as inflation and speculation was driving up the prices of homes and other real estate.

So that the pinch on the local property owner who was unfairly bearing the burden that ought to be shared more generally combined with the buildup of the State surplus to create a political problem that apparently the California Legislature was unable to solve.

For 3 years the surplus built up while the legislature struggled with various formulae for reducing property taxes that everybody agreed were excessive and were threatening the continued tenure of people in their homes. With 3 percent average State property tax rate and homes that had been selling for \$40,000 a few years ago now selling for \$125,000, you can see now the burden was simply unbearable for the elderly, and for the poor.

So that the State was faced with this political problem of utilizing the surplus to cut property taxes and it brought forth a number of

formulae that were unsatisfactory and after 3 years it appeared to the people that the legislative process had broken down and here I would like to comment on the question raised by Mr. Kelly. He asked quite properly whether California's government was not taken over by volunteers. Well, yes, but this is true whenever the initiative and referendum is utilized and I think more than half the States provide for the initiative and referendum in cases where the legislative process has failed to produce a solution.

So the people in this case produced their own solution, some 5 million people who voted for Proposition 13.

I don't see this as a flaw in our democracy. I think it is unfortunate that the legislative process did not produce a solution, but I think it is fortunate that we do have a safety valve in the referendum and initiative where legislative action fails as it did in California.

But that is now part of the past history. Another question raised by Representative Kelly was whether cuts in salaries to government employees, instead of firing them, might not serve to make an adjustment that is desirable.

Well, as I pointed out in my prepared statement, one of the adjustments to Proposition 13 in California was a moratorium on all State and local hiring and on pay increases. No local government could get any State subvention unless it followed the rule of the State. The State was the fiscal disciplinarian for local governments. So we have had a freeze and will have a freeze this year on local government pay increases, benefit increases and hiring which will go a very long way toward reducing the cost of government in California by the 10 percent that I referred to in my paper.

Representative REUSS. Thank you very much, Mr. Jacoby. My time has expired.

Congressman Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

I am well aware that there has been some criticism of the National Income Account figures. Isn't it the situation, however, that the figures are correct and that it is the use of these figures for purposes for which they were not intended that causes the difficulty, Mr. Gramlich?

Mr. GRAMLICH. That is exactly right. The Department of Commerce gets the national accounts budgets by just adding up the accounts of various sectors of the economy in conventional ways and those surpluses really are there, but you are exactly right in saying that the interpretation is what is in question. In my prepared statement I tried to distinguish between the interpretation for macro-economic purposes where it really is saving, from an interpretation on Federal aid policy which should be determined in longer run, on the longer run basis and where the surplus is not particularly relevant.

Representative MOORHEAD. Mr. Peterson, you have painted a rather positive picture of the fiscal recovery of our cities. Isn't there a distinction, however, between what I would call the basic economic recovery, that is, recovery of the tax base through job and population increases and the fiscal recovery?

Mr. PETERSON. Yes, I would like to draw three distinctions in fact. One is the strict financial condition of the cities, whether there is significant jeopardy of a financial crisis. I think the answer to that

question, with the exception of one or two cities, most conspicuously Cleveland, is: No, the finances are in rather sound shape now and have recovered well.

The second question involves the longer term fiscal condition of the cities, which I would measure primarily by their tax bases, their ability to raise funds from their own tax base. On that account you cannot be very sanguine. Most of these cities have staggering tax bases, some of them have had declining tax bases in the face of rapid inflation. Their ability to provide for themselves, through their own taxable resources is slight and deteriorating, which makes a case for some kind of permanent assistance, I think, from other levels of government. This assistance should be designed, however, to equalize tax capacity, to enhance their ability to purchase services themselves, to stimulate additional local spending.

The third level of consideration is the economic base of the cities. This is partially related to their fiscal capacity over the long run, but also an independent concern.

On that score we have greatly varying trends at this point. Some cities have shown signs of more than cyclical recovery. Others have not.

The Federal Government quite properly is directing much of its attention to stimulating investment in those cities that have not been able to recover economically.

Representative MOORHEAD. There is an interesting difference between Mr. Bryce's prepared statement and yours, Mr. Peterson. You state in your prepared statement that capital spending—referring mostly to the large cities—on repair and maintenance has borne the brunt of fiscal adjustment. On the other hand, Mr. Bryce, you report that smaller cities have actually increased their capital expenditures.

Can you gentlemen give me a reason why the smaller cities go one way and the larger cities go the other way?

Mr. BRYCE. Yes. First of all, I would like to point out that many of the smaller cities did begin to experience the effects of the recession much later than some of the larger cities. I think my figures, in one of the reports I have done, show something like 60 percent of the smaller cities have postponed some amount of their capital programs.

I think that there are a couple of things; one is that to some extent Mr. Peterson's figure, I believe, might take into account some of the effects of increases in prices.

My figures do as well to some extent. Some of the differences might just be an adjustment figure. I do not want to give the impression, as I said in the first part of this statement, that smaller cities were not also affected. Around 60 percent of them did reduce capital expenditures. To some extent increases in capital expenditures were also aided by some of the intergovernmental transfers. Take the community development bloc grant, for example, a very large proportion of those small cities which used discretionary funds used those funds for sewer and sanitation.

Again to underline the point, that increases in capital expenditures by many of these cities during this particular period of time was enabled in part by Federal Government transfers.

Mr. PETERSON. I would like to make one comment. In the broad picture, over the last decade, capital spending by State and local govern-

ments, as a whole, has been down quite sharply; it has been down very severely in the past few years. In the last few years the local public works programs have it percolated through the economy.

One particular handicap that these fiscally distressed large cities faced was that they were unable to gain access to the bond market during 1975 to 1976. That inability to borrow had consequences in the succeeding years as they drew down their capital funds and had no cash with which to invest in capital stock. Certainly for individual cities that has been of primary performance.

Representative REUSS. The time of the gentleman has expired.
Congressman Kelly.

Representative KELLY. Thank you, Mr. Chairman.

Mr. Jacoby, I would like to ask you, are the property taxes in New York about the same, more or less than they are in California?

Mr. JACOBY. I really lack the information to answer that. I can say that the overall average property tax in California before the Proposition 13 was 2.8 percent of market value.

Representative KELLY. Does anyone on the panel know? Are the property taxes higher or lower in New York?

Mr. PETERSON. They have been moderately lower.

Representative KELLY. Who?

Mr. PETERSON. Massachusetts and New Jersey lead the country, yes.

Representative FENWICK. What did you say?

Mr. PETERSON. Massachusetts and New Jersey have had the highest rates followed at some distance by California.

Representative KELLY. Then the situation seems to be that we then play a sort of cynical game in this whole business of government as it is presently being operated. New York City pays the highest taxes in the United States of America when everything is considered. California doesn't pay taxes that are as high. Yet they have revolted.

So the game is for the political establishment, the government as it now exists, to milk the public and the economy, in a way that it doesn't sting so that the public's attention will be called to it. And if they can milk the public a great deal and sting them a little, then that is successful government under the present-day criteria. So in New York the politicians are just more successful at this game of milking without stinging because they get more and create less discomfort among the public.

Is that a fair description of what we are about?

Mr. COOPER. No, no, it is not.

Mr. JACOBY. May I comment, sir?

I am not intimately familiar with the New York fiscal situation, but I would like to comment on California's. I think it is important to recognize that California has relied far more heavily on property taxation for its total to finance State and local services than has the average State. It is also important to recognize that we are relatively a high tax State. A recent study shows that the overall tax burden in California ranks only after Alaska and New York and a margin behind New York is not very large.

We also have relied very heavily on property taxes.

Representative KELLY. That is the point I was making, that the mistake there was not how much you milked the cow, but that you were not careful about it. And you just pulled the wrong thing.

Mr. COOPER. Congressman—

Mr. JACOBY. I think we pulled the right plug, sir.

Mr. COOPER. Speaking as someone who has to deal with the voters at the local level, I disagree with your comment about milking the public. The public wants the service, but does not want to pay for it. When we closed our libraries temporarily, the public came in and said "we voted for 13, but we didn't mean for libraries to be closed. We want you to close welfare, because we are not getting welfare benefits."

You know, everybody sees their service as the bone and somebody else's service as the fat.

Representative KELLY. Let me ask you this then. In New York City, in order to accomplish some economy they reduced the number of people that were working by over 25 percent, but yet reduced the cost of maintaining the services by only 1 percent.

Now, I think the public is really getting flimflammed in this whole operation.

Mr. COOPER. The public wants to be flimflammed, generally.

Representative KELLY. It could be that one person came into the library and said that, but the whole public didn't come into the library and say that and probably does not share any such view.

But let me ask you this: Isn't it a truth that there are an awful lot of things that the Government itself is doing that increase the costs of doing business for all local governments like the Davis-Bacon Act? Isn't that just an arbitrary imposition of inefficiency and excessive costs on local government?

Mr. COOPER. Congressman, I continually go to Sacramento and Washington and face the same problem with the legislation, fair labor standards and unemployment insurance, or something else comes up and I say, "Look, we don't need this. We have put unemployment insurance into our labor agreements," for example. Alameda County doesn't need this legislation. But you can point to a thousand counties in this country that are not doing a competent job. So you get horrible examples.

You are going to have the same thing on pensions, we are 80 percent funded and we are going toward 100 percent. But you can dig up a lot of local jurisdictions in this country that are practically zero funded. On the other hand, General Motors is \$10 billion underfunded. It is hardly unique to the public sector to be underfunded in pensions. But there are other solutions to that.

Representative REUSS. The time of the gentleman has expired.

Representative KELLY. Mr. Chairman, I would like to review and extend the remarks that I made in the record earlier.

Representative REUSS. Is there objection? Hearing none, the gentleman will be permitted to extend his remarks.

Mr. COOPER. Can I comment on one thing Mr. Kelly commented on earlier because I am directly involved in this? My county has laid off more public employees since 13 than any other jurisdiction in California because we are concerned if we don't lay off 10 percent this year, we will have to lay off 20 percent next year, which will be impossible. Ten percent is difficult after you spend 7 years trying to be more efficient.

But when you talk about cutting salaries, it is true we have a salary freeze for 1 year, but you do that for 2 years, no pay increases. You are

going to—or if you start cutting salaries, you are going to lose the competent people. They are going to go to private industry where they can get these decent salaries.

The same people that come in to me and say, "Cut those management salaries" are the same ones who bitch about the way I administer the programs. Yet you want to cut salaries, get rid of the competent people, have them go to private industry and have a higher percentage of incompetent people on your staff managing programs under civil service and they are going to have the justification to say "This is impossible, close the whole thing down."

You cannot cut salaries. You know, we are generally 10 to 20 percent below the Federal Government. A fair number of our people can get comparable jobs in the Federal Government. If you want to cut your salaries and say we should also, I would be happy to go along with that. Then at least I have a chance of keeping some of those competent people on my staff.

How do you keep competent people and not pay comparable salaries?

Representative REUSS. The time of the gentleman has expired.

Representative KELLY. Pay less welfare.

Representative REUSS. The Chair will point out that Senator Boe must leave within the next 10 or 15 minutes. Therefore if there are any questions addressable to him, I would serve notice to the committee.

Congressman Pattison.

Representative PATTISON. Mr. Jacoby, you point out the systemic bias toward Government overspending due to both unbalanced collective bargaining and the pressure group politics. I don't think we could disagree with that.

Isn't there also a corresponding bias, a systemic bias when you are actually cutting the budget or keeping budgets from going up at a local level, a bias against maintenance and against capital expenditures, because they are the easiest things to cut. For instance, not fixing your sewer or not fixing your water system, because it is very hard to go out to the public and say:

Look what I have done. I have spent so much money maintaining the water system or maintaining the sewer system. As long as the water keeps coming out and the toilets keep flushing, nobody really cares.

Consequently, you defer maintenance, as with the railroad experience. Because of the pressure group politics, you keep some of the more visible things that people demand and you ultimately get yourself in a position where your bridges fall down, your sewers collapse, your water system fails. Then you have an enormously expensive capital project which you cannot fund and you then come to the next level of government or two levels up, and then end up with that situation.

With a spending limitation such as Proposition 13, don't we simply run that risk of what you might call irresponsible government, or government that doesn't feel the same market disciplines that you might feel in a business?

Mr. JACOBY. I don't feel that it is a very great risk. My observation has been that where the people feel the need of some capital asset or some maintenance expenditure, they will vote for it.

Representative PARRISON. If, in fact, you should spend, say 10 percent of your value of your sewer on maintaining it, so that you do it a little bit every year, people really don't feel the need for that much. I have never had anybody come to me and say "We really have to maintain these bridges." It is when they fall down that people feel this need.

Mr. JACOBY. Well, they usually have to be impressed with the need by some untoward event, I agree. But where there is a felt need by the public, the public will spend the money.

For example, in my own city of Los Angeles, the public has turned down bond issues for new schools for some years. They don't believe they are needed and I think the figures show that many of our schools are only half used. They are not needed.

On the other hand, the people voted for a \$30 million communications network for the police because they believe, they felt the need for better law enforcement.

I think that we can trust the people to make wise decisions as to how to allocate their incomes as between public goods and private goods, but don't overestimate their information. You give them the information. You will get a rational judgment from them.

Representative PARRISON. It seems to me that what you are saying is, that you can trust the people in the area of maintenance and capital, but that you can't trust the people through their representatives, and I assume you are still talking through representative for maintenance and capital. You can't trust them to resist the special interest, local pressure group politics or the collective-bargaining pressures.

Where can I decide to trust the people?

Mr. JACOBY. We are talking about the vulnerability of the representative in a democratic government to the blandishments of special pressure groups. I am not saying he is a bad man, he is just as good as the rest of us, but his interest is in being reelected and he finds that his strategy is more successful if he caters to the interest of the special pressure group rather than to the general public interest group.

Representative PARRISON. I agree with that. I understand those pressures, I feel them all the time.

Each group wants their piece of the pie and they want to take it out of somebody else's piece of the pie. We understand that. What I am trying to find out is the flip side of that—and apparently you don't agree with it—that as to the same lack of pressures. When it comes to doing the difficult things that are invisible, the long-term things, fixing a jail is not something that too many people go out and campaign on.

I haven't heard anybody campaign on that basis or very rarely. So that fixing a jail, fixing sewers, or fixing water systems that seem to be working well is also the flip side of that lack of pressure, and then you make the same kind of irresponsible decision.

Mr. JACOBY. Well, as I say, if the public is informed of the need for maintenance of public facilities, I believe they will vote for it. There is no evidence that our public facilities overall are undermaintained that I am aware of.

Representative REUSS. The time of the gentleman has expired.
Senator McGovern.

Senator McGovern. Mr. Jacoby, I wonder if you could turn to your prepared statement.

There you say, and I quote:

Senator George McGovern insulted two-thirds of California voters by describing their actions as "degrading hedonism" which was "motivated by racism" and which would impose heavy burdens on the poor.

In all due respects, Mr. Jacoby, I never made any such statement.

Now, I notice you have footnoted your remarks to the July 2 issue of the Los Angeles Times; is that correct?

Mr. JACOBY. That is correct.

Senator McGovern. I would like to read just two or three paragraphs from that article in the Los Angeles Times of July 2, which I authorized:

The roots of the California tax revolt expressed in the passage of Proposition 13 began growing long ago in the soil of an inflation fertilized by the escalation of the Vietnam War and irrigated by the continuing arms race with the Soviet Union.

The media have placed too much emphasis on a recent remark I made suggesting that while the tax revolt articulated a profound and legitimate anger, it also had undertones of racism. Certainly, black and other minorities will suffer disproportionately from the cutbacks imposed on California by the passage of Proposition 13. But I do not believe that the majority of voters was expressing racial resentment.

As inflated property valuations and the increasing cost of living on all fronts leaped out of control, property owners finally saw an opportunity to react against taxes, inflation and ineffective government—all at once.

But it seems to me that there are far better ways than Proposition 13 to make taxes lower and fairer for everyone.

The trouble is that Proposition 13 offers relief to the majority by reducing services vital to the minority and by creating new tax advantages for corporate landowners.

Mr. Chairman. I ask unanimous consent that the full text of this article from the July 2 issue of the Los Angeles Times be printed in the record.

Representative REUSS. Without objection.

[The article referred to follows:]

[From the Los Angeles Times, July 2, 1978]

FEDERAL TAX REFORM AND DEFENSE CUTS ARE THE ONLY ANSWERS

(By George McGovern)¹

The roots of the California tax revolt expressed in the passage of Proposition 13 began growing long ago in the soil of an inflation fertilized by the escalation of the Vietnam War and irrigated by the continuing arms race with the Soviet Union.

The media have placed too much emphasis on a recent remark I made suggesting that while the tax revolt articulated a profound and legitimate anger, it also had undertones of racism. Certainly, blacks and other minorities will suffer disproportionately from the cutbacks imposed on California by the passage of Proposition 13. But I do not believe that the majority of voters were expressing racial resentment.

As inflated property valuations and the increasing cost of living on all fronts leaped out of control, property owners finally saw an opportunity to react against taxes, inflation and ineffective government—all at once.

But it seems to me that there are far better ways than Proposition 13 to make taxes lower and fairer for everyone.

¹ George McGovern, a Democrat, is the senior Senator from South Dakota. He was his party's 1972 presidential standard-bearer.

The trouble is that Proposition 13 offers relief to the majority by reducing services vital to the minority and by creating new tax advantages for corporate landowners. Two-thirds of the proposition's tax relief will go to commercial property, much of it owned by out-of-state interests, rather than to California homeowners.

Beyond this, the tax cut is so sweeping that once the temporary state surplus provided by inflation is exhausted, public services of all kinds—police and fire protection, education and recreation, sanitation and medical care, family assistance and mental health—may have to be slashed sharply. The Jarvis formula may turn out to be the fiscal equivalent of the neutron bomb—a device that preserves property while destroying people.

Californians voted for Proposition 13 because they had no better choice that could both reduce unfair taxes and preserve essential services. But in view of the underlying causes that contributed to that action, I suggest the alternative steps of lowering federal spending on defense and eliminating both national and state tax loopholes currently available to corporations. These steps could lighten the tax burden on our citizenry and slow the ravages of inflation—not only in California, but also throughout the nation.

Much of the inflation and rising governmental costs that have driven up property valuations and taxes of all kinds originated with the cost of the Vietnam War. That war accelerated rapidly after 1965 with no tax increases to pay for it and no effective price and wage restraints to limit inflation.

The ultimate cost of the war to the American taxpayer, including veterans' benefits and debt-carrying charges, will approximate \$500 billion. That is a war tax of \$10,000 on each American household over approximately 10 years.

Nor is the Vietnam War the only factor still with us. Since the end of that struggle, the arms race has been speeding up rather than slowing down. Annual U.S. arms outlays have now skyrocketed to a current annual level of \$126 billion.

In recent years we have squandered \$51 billion on a useless, antiballistic missile complex in North Dakota, now abandoned; we spent nearly \$5 billion on the B-1 bomber before abandoning that project as unneeded. We have spent tens of billions of dollars on the MIRV (multiple independently targeted re-entry vehicles) missile system, which the Russians are now matching. This would not be happening if a prohibition against MIRVs had been included in the first SALT treaty, signed in 1972.

Now a summit round of Strategic Arms Limitation Talks is pending with the Soviet Union. Should they fail or be substantially postponed, we will continue to pile another \$75 billion in extra arms spending onto the backs of American taxpayers during the next five years.

Congress is about to force \$2.5 billion nuclear aircraft carrier on an Administration which insists that the carrier is unnecessary for national security. Although the Soviet Union and the United States both have enough nuclear fire power to pulverize each other many times over—no matter which side strikes first—we are pushing ahead on plans for a costly new mobile missile system on railroad tracks, plus a vast array of cruise missiles. The Soviets will doubtless follow suit.

Former Defense Department official Townsend Hoopes and former Deputy CIA Director Herbert Scoville have contended that the United States could save \$30 billion over the next four years in non-nuclear military forces—without reducing our military effectiveness or our power to deter conventional war. Add to that the \$75 billion which a successful SALT II agreement could save over the next five years, and it becomes clear that such savings could not only reduce government expenditures, deficits and taxes, but in doing so, could also dampen the fires of inflation.

Beyond all this, there are ways to make taxes fairer for everyone—ways I first proposed in 1972. At that time I urged that some of the loopholes in our federal tax laws be closed, estimating the consequent savings at \$28 billion. It was my suggestion that these savings be returned to the states and earmarked for property-tax relief—a proposal that would have cut California's property taxes in half.

On March 21, 1972, I told the Senate: "The American people are angry with a tax system which has become increasingly unjust and which places an enormous burden on property owners. It is no exaggeration to say that we face a full fledged tax revolt. While the President and the Congress would have to decide on the use of revenues resulting from tax reform, I believe that we must place a high priority on their allocation for the purpose of reducing the property tax."

Six years later, after Proposition 13, it is even more urgent to eliminate loopholes in the federal tax code and pass the savings on in the form of tax relief and strengthened public services.

Economist Arthur Okun of the Brookings Institution has suggested a further measure which would use federal tax reduction to fight inflation rather than aggravating it. Instead of offering President Carter's suggested broad tax cut of \$20 billion to corporations and individuals, he favors making a major part of this reduction available to those businesses and their employees who agree to hold down prices and wages.

Economist Robert Eisner of Northwestern University has suggested other helpful tax revisions. He advocates a phaseout of the present 10 percent investment tax credit for corporations, which would save the U.S. treasury \$15 billion annually—savings that could help finance either a tax credit or subsidy to employers for 50 percent of the cost of hiring and training Americans now without jobs. Second, Eisner supports ending all payroll taxes for workers under age 20.

If Proposition 13 was indeed a cry for help, then that help must be constructive and swift, as well as targeted directly at those whose pain is greatest. The combination of prudent savings in our swollen arms budget, plus federal tax reform based on common sense and designed to make our williest tax-avoiders bear their share of the load, would serve us well.

Senator McGOVERN. Even on the bases of what I read, Mr. Jacoby, I wonder how you draw the conclusion you did by my analysis of proposition 13?

Those phrases that you used don't appear at all in the July 2 issue of the Los Angeles Times.

Mr. JACOBY. I believe the article you have quoted was a second speech you made, which succeeded your initial speech in which these comments that I quoted were made, sir.

Senator McGOVERN. It is the only one that appeared in the July 2 issue of the Los Angeles Times.

Mr. JACOBY. I will get the other citation.

Senator McGOVERN. Let me read you the other citation, then. It comes from a speech delivered here in Washington on June 17 before the Americans for Democratic Action annual convention in which I addressed at considerable length a much larger problem that proposition 13, which is the whole question of the priorities of the Nation and the fairness of our tax system as a whole.

Now, this is the only place in that eight-page, single-spaces speech where any reference to racism is made. It is all in about three sentences and this is what I said: "And in conscience some final words must be said. While the tax revolt expresses profound and legitimate anger, it also has undertones of racism"; a newsweekly quoted on California voter, and I quote: "It is those social services that annoy me, social services for the colored, the Mexican, and so forth."

"Sixty percent of the employees may be laid off in Los Angeles are members of minority groups."

Now, frankly, Mr. Jacoby, I regret having mentioned, even in passing, that, while it was by no means a causal factor, there were elements of racism involved, especially in the results of proposition 13.

The reason I regret putting it in is that not that it isn't true, but the fact that you and some of the news media had seen fit to lift that out of context and to use it as the interpretation of what I was trying to say about the essential unfairness of much of our total tax structure in this country.

Mr. JACOBY. If I may share a word in reply, Senator McGOVERN.

It was not my purpose to pillory you, but to rather criticize a rather widely expressed view among the so-called liberal establishment of

the country that the excessive burdens of property taxes in California and the very high cost of the inefficient government we are running, which led to proposition 13 should be explained by an effort to place burdens on the poor or on racial minorities. This is not the case.

Representative REUSS. That will also take care, I believe, of Mr. Jacoby's request, because that second McGovern speech is the one that you at least partially referred to. Is that not so?

Mr. JACOBY. I think the first comment was also relevant. I should have cited that as well, and I am sorry I omitted that reference. But I believe it is true that the expressions of "racial overtones" and the expression of "degrading hedonism" were used by you, Senator.

Senator MCGOVERN. Minor trace elements, Mr. Jacoby. They were not the central thrust of my remarks at all. I am not suggesting you are trying to be unfair but I have made a real effort, including the article that I wrote for the July 2d issue of the Los Angeles Times, to clarify what I thought was an unfortunate distortion of my position, and what does puzzle me slightly is that you quoted that clarification but used the language from the initial statement.

I just repeat again that I agree with you, that that is not a fair statement and I never made any such statements.

Mr. Chairman, since my time is up, I ask unanimous consent that the full text of the earlier speech of June 17 also be made a part of the record.

Representative REUSS. Without objection, it will be made a part of the record.

Mr. JACOBY. I appreciate your effort to clear it up and I certainly wish to say there are no hard feelings on my part, sir.

Senator MCGOVERN. Well, I feel the same way.

Representative REUSS. I thank you both very much.

[The text of the speech referred to by Senator McGovern follows:]

A VISION OF POSITIVE GOVERNMENT

(Remarks by Senator George McGovern (D.-S.D.) before the Americans for Democratic Action Annual Convention, Washington, D.C., June 17, 1978)

We meet in a month when liberals are supposed to be in hiding. California has voted overwhelmingly to approve Proposition 13. In New Jersey, a right-wing extremist has taken a Senate nomination by pledging to cut taxes and to gut government. In Ohio, a general rejection of bond issues may close down schools in Columbus and Cleveland. Across the country politicians are chasing and fanning the popular whirlwind. They are seeking a mandate to govern by running against government itself.

So first of all let me affirm that I continue to be a liberal—a believer in dynamic government unafraid to set important goals and to persist in their achievement. I still believe that social justice and peace among nations are the defining endeavors of our democracy. I do not concede that the New Deal and the United Nations are out of date. I do not intend, in the words of Edmund Burke, "to take up or lay down a great political system for the convenience of the hour."

Expedient politicians have reversed Burke's standards of integrity: apparently they are not in office "to support (their) opinion of the public good"; but they "form (their) opinion in order to get into (office), or to continue in it." Candidates who sowed the wind with anti-government slogans are reaping the whirlwind. It should come as no surprise that citizens who hear government denounced as feckless will decide that the futility is not worth their tax dollars. If Franklin Roosevelt had assailed the needy and the old as shiftless and thriftless, could he have passed unemployment compensation, rural electrification and social security?

Today politics is being malpracticed as tactics, not leadership. Timid officials are repeating and reinforcing a despair of democracy. Last January the President himself announced that the state of the union was one of powerlessness—that “government cannot solve our problems . . . define our vision . . . eliminate poverty . . . or reduce inflation. . . .”

In the past, in success and in adversity, the Democratic Party has stood proudly for the possibility of progress. Woodrow Wilson sought a New Freedom at home and peace through law abroad; Franklin Roosevelt brought a New Deal; Harry Truman fought for a Fair Deal; John and Robert Kennedy opened a New Frontier; Lyndon Johnson and Hubert Humphrey dreamed of a Great Society; and even in the crushing defeat of 1972, we tried to call America home to its founding ideals. We have not come this far to settle now for *no* deal. We are not Americans for Democratic *inaction*.

Let us insist that government can, and must, solve problems—that it can, and must, eliminate poverty and reduce inflation—that it can, and must set goals and define a vision for the nation. For it is as true now as it was when Franklin Roosevelt quoted it in his inaugural address that “where there is no vision, the people perish.” The danger is not the immediate death of the system, but a steady decline of its capacity and credibility. And people literally do perish in the process. Bad diets, bad housing, and bad health care *do* take human lives. Abused children and battered wives *do* suffer and die. Dangerous poorly policed neighborhoods *do* kill people. Blacks and other minorities on average *do* die four years sooner than whites; thousands of senior citizens *do* lose the will to live out a neglected old age. And there is a death of hope among Americans of every race and age who must live out lesser lives in a lesser land. Beyond all of this maybe the death of our planet if we do not soon curb the arms madness.

A clear vision of a better country cannot offer mere abstractions and disconnected echoes of the latest opinion polls. It asks not just for efficient government; it asks efficient at what. It depends not just on preaching love, compassion and competence—but on achieving results. For faith without works is empty.

But the conventional cynicism replies that the liberal faith will not work—that we should not try to move forward because the Great Society failed. I am tired of hearing that myth from the politicians and officials who urged the war that diminished the Great Society. They were not skeptical of government then. They believed the American government could work its will—in an Asian jungle. They were wrong. The final price of their error will total \$400 billion for the fighting and its aftermath. It was the greatest single instance of government waste in any nation's history. That is when the taxpayers should have revolted. Three weeks of the Vietnam war at its height cost more than the highest budget of the war on poverty for an entire year.

Because all the firepower finally proved to be powerless, because it could not destroy enough villages in order to “save” Vietnam, does not mean that we are helpless to save our own cities by saving them, or to prevent needless malnutrition and illness, or to correct unemployment through job opportunities, or to reduce poverty through welfare reform, or to harass the sum and convert waste matter to energy. Government can do what is possible domestically—but not if it pursues a wasteful, self-defeating military globalism.

There is a fatal inconsistency in the nihilism of the new right that government is only good for tax write-offs and costly new weapons. Their Senate nominee in New Jersey emphasizes two issues—a 30 percent reduction in federal taxes and an American withdrawal from the SALT talks. He scorns the “free-spending” of government, but he would spend freely for tens of billions of dollars of extra megatons. How would the bill be paid? What programs would be slashed?

It is time to challenge the simplistic hypocrisies of the new right.

If government has the money to bail out Lockheed and Penn Central, why is it powerless to help older people, neglected children and average Americans—including those with black skin?

If government has billions for nuclear power plants, why does it lack the resources to develop solar power instead?

If government can find billions to dig 13-mile underground tracks for intercontinental missiles, why can't it restore railways and city transit instead?

In 1976 we were pledged a decrease of five billion to seven billion dollars in military waste; since then, we have had an increase of twenty billion. And recently we have been invited to the brink of a new cold war. We have heard no convincing rationale that current events in Africa outweigh the fundamental, mutual interest of America and Russia in ending the arms race before it ends all

of us. But we have heard bombastic implications that who backed the Katanga rebels is a more urgent concern than SALT. Rather than proving that our leaders are tough enough, official overreaction to such minor events may convince the public that any SALT agreement that can be negotiated will be a bad one. How senseless it would be to hazard Armageddon for Shaba Province.

The real spendthrifts are the hardline hawks whose "worst case" nightmares are burdening the taxpayer, inflating our economy and jeopardizing the peace. The signing of SALT I in 1972 has saved us \$15 billion in a needless ABM. The loss of SALT II would cost us \$75 billion over the next five years—ten times the total property tax cut in California under Proposition 13. The arms race fuels the fires of inflation and the tax revolt. To be anti-waste is to be anti-war. In 1972, I urged military economies and tax reform to finance property tax relief. We were six years ahead of Howard Jarvis—and we explained how to pay the bill fairly. Today the fault for the heavy burden of unfair taxes rests not on liberal programs, but on needless war, a reckless arms race and an unjust tax system designed and continued by selfish special interests.

Instead voters are offered a degrading hedonism that tells that to ask what they can take from the needy—and conceals the fact that in effect they also will take necessities from themselves. Television commercials reassured Californians that local governments could lose revenues without losing essential services. Voters in surveys believed that enough frills could be eliminated. Now it turns out that the frills include police and firefighters; that entire school systems may be shut down; that even if they open, class sizes will soar as high as 170 pupils; and that 225,000 employees probably will be laid off—which will raise state spending for unemployment compensation and welfare. Tax dollars will be shifted: they will pay employees less to do nothing rather than enough to provide services.

Ironically, two-thirds of the tax relief will enrich corporations and corporate landowners—many of them absentee owners thousands of miles from California. The homeowners knew it; but they believed that to get a fair break for themselves, they had to give that boon to the corporations. Property taxes in California were fifty percent above the national average. State officials had piled up a five billion dollar surplus. They were proud of it: they cited it as evidence that they could cut government down to size. And they fought over it; they delayed even minor property tax reform. So people who literally were being taxed out of their homes were so frustrated that they followed a pied piper—a paid lobbyist for the real estate industry.

Politicians looking to ride or ride out the whirlwind of Proposition 13 cannot see or shape a vision of tax justice. They have become instant economizers and flailing taxcutters in the storm. The panic is nonpartisan. In New York, a Democratic official has suggested an arbitrary ceiling on the number of state employees that would force tens of thousands out of work; he did not say what services would be slashed. In the same state the Republican candidate for Governor proposed a constitutional amendment to limit local taxes; according to an aide, he left it deliberately vague.

Here in Washington, officeholders have been busy compounding the deeper causes and the worst inequities of the tax revolt. The President resurrected his promise of a balanced budget by 1981, while simultaneously calling for a tax cut and an even bigger Pentagon budget. That combination will bring economic trouble if he really means it and disillusion if he does not. A Congress that has spurned even meager reform of federal taxes has rushed to cut the budget at least a little. Intent on not offending the powerful, the House of Representatives attacked the weak. It voted down \$225 million to remove architectural barriers to the handicapped. What a spectacle the majority made of themselves: after raising the Pentagon's billions, they pinched a relative pittance for the halt, the lame, and the blind.

Was this one of those wasteful programs which will not work? Are we short of the materials and designs to build ramps? Nothing could more vividly expose the character of the assault on domestic government. A convenient arrogance of powerlessness comforts the comfortable: they would give less for what others need.

But even the comfortable would be in trouble if the whirlwind reached too far. John Kennedy's warning is still true that if we cannot help the many who are poor we cannot save the few who are rich.

It took Vietnam to teach the hard lesson that the American government in arms is not all-powerful. Will it take the domestic equivalent of that defeat to show the government in fiscal chains and our society in bondage? The new right figures that they can follow the tax revolt all the way into the White House.

And in this illiberal hour, the rest of us are advised to trim our sails, tame our conscience, borrow the passing rhetoric, and gratefully accept a leadership of style over substance.

How can we continue to advocate government as the employer of last resort when the voters are making it the unemployer of immediate resort? We do so because it is right. We do so because we still believe in the decency of the American people. We believe that they prefer a government that is both efficient and compassionate. But if they do not have that alternative, then they, like the citizens of California, may pick a government whose only virtue is that it has been cheapened—not merely in finance, but in principle. The new right can exploit frustration; timid candidates may be swept along in the tide. But liberals can offer a steady vision of taxes that are lower for the majority and fairer for everyone. We can offer the vision of a society committed to a fuller justice for all citizens. We can and we must demand an end to the arms race as the condition of our prosperity and our survival.

First, we can provide tax relief through tax reform and the reduction of military waste. Billions of dollars are lost in unjustified tax loopholes; there are billions of dollars to be saved in completing the SAL/T talks.

Second, we can offer additional tax relief that simultaneously controls inflation. Rather than cutting corporate taxes willy-nilly as now proposed we should, as Arthur Okun recommends, offer tax rebates to businesses and their employees who practice price and wage restraints.

By contrast, present anti-inflation policy saps the economy of \$100 billion of output. The policy raises unemployment and the costs of welfare and unemployment compensation. Economists are now warning of an imminent recession. To invite it in order to control inflation, to make unemployment a secondary concern, in Republican economics that did not work before. It is failing again as inflation soars into double digits.

As Roosevelt once said: "We are poor indeed if this nation cannot afford to lift from every recess of American life the dread fear of the unemployed that they are not needed in this world." Are we so poor now that 6 or 7 percent unemployment has become the moral equivalent of full employment? Fifteen years ago a 4 percent rate was just a temporary goal. Is a level far higher now to become a permanent condition?

Third, we can offer financial relief by enacting programs instead of dismantling government. A common sense program of nutrition education and preventive health care could cut the nation's medical bill by one-fourth and probably more.

Similarly government intervention in energy could prevent excessive price increases. The Administration apparently will welcome any energy program now, including deregulation of natural gas. Government is not working when the average family's gas bill will rise \$2,000 over the next seven years. Government is not working when the moral equivalent of war becomes the functional equivalent of surrender to the oil monopoly. Instead of an energy policy that seeks conservation through higher prices and higher oil taxes, we should be pressing hard for alternative, renewable sources of energy and more economical transportation.

How ironic it is to see the new rightists piously protesting every public endeavor that costs anything, then eagerly advocating natural gas legislation that will transfer \$60 billion from people's pockets to private boardrooms. In truth the tax revolt is an accident that happened to their ideology. They are not against waste: they are anti-government, good or bad, except when it is paying for B-1 bombers or neutron bombs. Their loyalty is not to hard-pressed taxpayers, but to the ideology of McKinley, Harding and Hoover.

I know that it is not politic to oppose that ideology now—that Proposition 13 in California has stirred a panic even more serious than the Cubans in Africa. But the redeeming purpose of politics is to explain, to educate, to take risks for a conviction—in short, to lead. I also know that no matter who leads us, the political journey from the vision to the reality will not be an easy one.

I believe that Jimmy Carter is a dedicated, conscientious man who longs to be a good President. I well know that the problems that now afflict the nation are not the results of a single presidency and no single President will end this time of troubles. Wilson and Roosevelt lost their share of congressional and judicial struggles. But what counted was that they fought another day, and then another, for their conceptions of how government could and should work. And they

held a vision of greatness constantly before the American people. A President reaps disapproval not because he is set back in a cause that is right, but when he is lukewarm in a course that is confused.

We elect leaders to set goals and solve problems, not to plead that they are insoluble. And in the final analysis, their leadership must be a moral one. I do not mean the moralism of insubstantial pieties or dreary self-righteousness. Moral leadership does not tell us how good we are, but how we can do better. It touches conscience as well as self-interest.

And in conscience, some final words must be said. While the tax revolt expresses profound and legitimate anger, it also has undertones of racism. Crime was, and is, a legitimate issue; but in the last decade, law and order became a code word. So it could be with tax relief. A news weekly quoted one California voter: "It's those social services that annoy . . . me—social services for the colored, the Mexican, and so forth." Sixty percent of the employees who may be laid off in Los Angeles are members of minority groups.

It is unfashionable now to worry about the poor and minorities and to defend the idea that they, too, deserve an opportunity. Perhaps property taxpayers ought to remember, if only for a moment, how many of them would never have owned a home without a government loan and a mortgage tax write-off. To give up on government now, to turn our backs on those who have been left behind, to decide that all we can do is keep our own share, is to give up on our own best instincts. It is un-American; it is unacceptable.

At stake is whether America will become a parcel of geography drained of ideals, a collection of selfish, competing economic persons whose highest purpose is the bottom line. We worry about defending our nation as a physical entity; we must also defend it as a source of justice and mercy. National security includes the condition of our national spirit as much as the size of our nuclear arsenal. The gravest threat today is not a foreign adversary, but an enemy within. That enemy is not a conspiracy or a fifth column; it is inside ourselves and among our leaders. It is the sense of futility. It is the dulled conscience. It is the lost vision.

Those of us who have seen the liberal vision have an obligation to nurture it.

We must insist that this latest revolution against taxation need not overthrow the first, best traditions of that earlier revolution for "the unalienable rights" of all people.

We must speak for those who have no voice.

We must stand for those who have no lobby.

We must be strong for those who are weak.

We must demand fairness for those to whom life has been unfair.

We must take the road that leads to peace.

We must not be ashamed to care or afraid to be liberal. For in this month when we are supposed to be hiding, a month that comes 10 years after Robert Kennedy's death, we still refuse to see things as they are and assume that they have to be; we continue to dream things that never were—and to say "why not."

Representative REUSS. Senator Boe has to leave. Congresswoman Fenwick has a question to ask him.

I recognize the gentlelady from New Jersey.

Representative FENWICK. I wonder if you could comment on the feelings of or express an opinion given by Mr. Gramlich about unemployment as a result of this proposition 13.

I would like to say that I don't think that that feeling of impatience or "rage" against government, and what it imposes on people, is found only in California. It is found all over the Nation, and I think it is increasing.

But, could you comment on the unemployment aspect of that?

Senator BOE. Yes, I believe that there is no question in my mind that the ultimate effect of proposition 13 will be decreased employment, particularly in schools. When we are talking about property taxes, we are talking about education.

In the State of Oregon, we are not too far different than most of the rest of your States, 75 cents of every property tax dollar goes to the support of education, K through 12 or K through community college of education.

Representative FENWICK. Right.

Senator BOE. That is what we are talking about, where I think where the stringent unemployment aspects are going to happen.

Representative FENWICK. What do you mean by "unemployment aspects"? Do you mean through teachers that will be unemployed?

Senator BOE. Certainly.

Of you average school budget, 80 percent is salaries. So, if there is going to be cuts in funding, there will be cuts in education and your pupil-teacher ratio will increase from 1 to 25 kids to 1 to 40 kids. It is the only way the budget can be balanced.

Representative FENWICK. But, isn't it also true that some of the education budget is spent for programs like the summer lunch program? According to Congresswoman Holtzman, this produced a handsome profit in 10 weeks of \$1 million in her district?

There are elements which have nothing to do with education and are extremely burdensome and expensive, and maybe those could be eliminated, which would be discontinued, which would not result in unemployment but denial to that enterprising gentlemen of his \$1 million profit?

Senator BOE. This is perhaps correct. Goodness knows, we, in the State legislatures are faced with the same problems on a smaller scale than you are.

You can go through the Federal budget, Mr. Proxmire, our distinguished gentleman in the Senate does it regularly and points out that some of the interesting things that some of the things that the Congress budgets for around it, and throughout the Federal budget.

I do have to leave and I want to leave this with you if I can. I think that to voters, the most dangerous thing about this is the fact that there is going to be a backlash, a voter backlash, somewhere between 4 and 8 years down the track, if this goes on, as the way I see it.

The reason for that is this: Your property taxes, under this, are rolled back to 1975-76 with a 2-percent incremental increase. But if the property sells, then the assessor comes and assesses at the new true cash value.

Statistics tell us nationally that homes sell for three times in 20 years. That means every 6-plus years, homes resell. They will then be reassessed at true cash value.

Senator McGovern mentioned two-thirds of property taxes are paid now by income-producing properties. So we have two-thirds here and one-third for the homes.

As those homes sell—because Southern Pacific does not sell their railroad and utilities don't sell their utilities, and apartment owners don't too often sell their apartments, so the present relationship of two-thirds, one third within 6 to 8 years is going to be this way—homes are going to be picking up two-thirds and income-producing properties are down to about a third.

Now, we, in the States really only have one way to tap income from business, and that is through the property tax. Oregon's corporation excise tax is 7 percent. We cannot get more because the Fed's have

already preempted us with the 49 percent or 48 percent or whatever the rate is now.

Representative FENWICK. Right.

Senator BOE. The States simply have to keep that corporate excise tax down to a reasonable level for competitive reasons as well as others. So the property tax is really the only way that we have a chance of business supporting local public services.

Representative FENWICK. Right.

Senator BOE. When homeowners begin to realize what has happened in this shift, then, I am prepared to predict that there will be a voter reaction that will make Jarvis-Gann look like a picnic and the brunt of it is going to be felt by the business community.

They can wave their checks and say, "Look, we contributed against Jarvis-Gann," like they did in the California Manufacturer's Association meeting, and the public will say, "To heck with that; we are going to get you, now."

I think that is one of the greatest dangers that we have at this time, and so far I have heard no answers to that from my colleagues here.

Representative FENWICK. I will tell you may answer but my time has expired.

We are addicted to spending down here. That is the truth. Never was an effort made to reduce the increase in the budget from 11 to 9 percent and it was turned down by the House of Representatives.

Just that alone explains what has happened to the deficit, to the people's rage. They cannot seem to control it. We are addicted to spending. It is work. We are all here and that is it.

Representative REUSS. I must call the gentlelady's attention to the four excellent display charts which show that our addiction, while considerable, is of a Quaalude nature compared with other levels of government. [Laughter.]

Representative FENWICK. Look at CETA and all, but look at the revenues as a percentage of Government expenditures, the blue; look at the Federal spending over there.

Representative REUSS. Senator Boe, thank you for giving us your time. We are most grateful to you. Now, I think, under the rule, we will start right out in the questioning after the next panel with Congressman Cavanaugh and Congressman McKinney, who have not yet been heard from.

We would like to hear from the final panel. Professor Greytak, would you lead off? Of course, the other witnesses will stay, if you would, for further questions.

STATEMENT OF DAVID GREYTAK, THE CENTER FOR METROPOLITAN PLANNING AND RESEARCH, THE JOHNS HOPKINS UNIVERSITY, AND THE MAXWELL SCHOOL OF PUBLIC AFFAIRS, SYRACUSE UNIVERSITY, SYRACUSE, N.Y.

Mr. GREYTAK. Mr. Chairman and members of the committee.

I have a prepared statement which I would like to submit for the record, but which I would like to partially summarize at this point.

Representative REUSS. As with all statements, it will be received in full into the record.

Mr. GREYTAK. Let me begin by noting that expenditures of State and local governments prior to 1974 increased less than 10 percent before 1974. They have increased at a rate in excess of 14 percent after 1974.

Over the previous decade, the per capita State and local government expenditures increased by fully 250 percent, a sizable increase by any measure.

Three types of explanations are given for this growth.

First there is the demand-side explanation. Here the argument goes that a large population of growing incomes demand more public services and therefore larger levels of public expenditures.

The second is the cost-side explanation. Here the argument is simply that the success of public employee bargaining and inflation have increased the costs of providing any level of public services.

The third argument is an "inefficiency" argument and states that because of mismanagement and/or low productivity the public sector has become increasingly costly.

Actually it's likely that elements of all three of these explanations have been operative. However, an understanding of the relative importance of these three are essential for they hold very different prospects for future growth in expenditures and therefore have different implications for differing types of goals.

If mismanagement is at the root of the problem, then reorganization, new technology, and innovation can hold forth promise for expenditure control.

If the explanation lies in growing demand, then declining school-age population and a decline in the dependent populations, which will accompany economic recovery, hold some promise for future relief.

If cost pressures result principally in public employee unionization and inflation, a continuation of both of these implies that there is little relief in sight.

With regard to the demand-side argument, the data would seem to indicate that growing service needs cannot account for much of the growth in public State and local government expenditures.

In fact, although expenditures have grown at accelerated rates recently, population in general has not.

More to the point, the reins on employment growth at all levels of government—at the State level and all levels of local government as well—have been growing increasingly tight since 1973. This is particularly the case for employment in education, and employment by municipalities.

In fact, municipal employment in 1976 stood at a level below that of 1973. As a result of the wide differences in expenditures and employment growth rates per capita. State and local government expenditures have increased at 5 to 7 times the rate of per capita State and local government employment in recent years.

The reading of the data implies that little of the growth in State and local government can be attributed to increasing demands and growing service levels.

The situation is quite different in the case of the cost cycle. Although State and local governments have been able to put the brakes on employment, though the record is much different in employee compensation, average wage and salary compensation for State and local employees has continually increased, but since 1972 it has increased at rates somewhat greater than in the previous decade.

Fringe benefits and other supplemental expenditures per employee also have increased at rapid rates—12 to 15 percent per year during the last 5 years—and in 1976 the average fringe benefit cost per State and local government employee stood at a level of about \$1,850.

As high as this figure is, it is probably an understatement of the true cost of wages-salary supplement. There are strong reasons to believe that many of the State and local government pension funds are underfunded, and full funding would inflate that figure even more.

Even if the full cost of pension programs were included, the true cost of fringe packages still would be understated, for employees receive substantial benefits in the form of paid vacation, holidays, sick leave and the like.

When the costs of these are included, the ratio of fringe benefits to pay for hours worked jumps quite sharply.

For uniform services of local government, for example, the rate is in the range of 46 to 47 percent. For other local government employees the range is slightly lower but still at about 40 percent.

As high as these costs are, there are reasons to believe that they will continue to increase.

As the full effects of the recent social security legislation and the movement toward fuller funding of State and local government pensions materialize, they will increase.

Inflation is another important factor and one mentioned by many. Although it affects all sectors of the economy, its impact on State and local governments is difficult to determine as none of the generally available price indexes is appropriate for application in the public sector.

Under the sponsorship of the National Science Foundation, the metropolitan studies program of Syracuse University has developed a set of indexes for State and local governments which measure inflation's impact on their expenditures and their tax bases.

These indexes clearly reveal the susceptibility of governments to inflation. They indicate that, if State and local governments had simply absorbed price increases of goods and services they purchased from the private sector, while compensating employees in transfer payments for only the increases in the cost of living, their expenditures would have increased by about 22 percent during the 5-year period 1967 to 1972, a period of moderate price increases.

During the 2-year period of double-digit inflation, 1972-74, inflation pressures on State and local government expenditures exceeded that of the previous 5 years as a whole. That is, inflation may have increased the cost of State and local governments by as much as 25 percent in just 2 years.

The decline in the rate of inflation after 1974 is reflected in the lower rate of cost increases for State and local governments, roughly 12 percent between 1974 and 1976.

An analysis based on these data reported in my prepared statement indicates that fully two-thirds of the growth of local government expenditures between 1972 and 1976 can likely be attributed to inflation alone.

Alternatively, only about 21 percent of local government expenditures can be attributed to the increase in the number of local government employees. Clearly local governments have had little room to increase the amounts of goods and services they purchase from the private sector or increase the real income of their employees.

It is also possible to calculate the impact of inflation on tax bases and, to be fair, this must be done. These calculations indicate that inflation has led to an increase in the nominal values of many tax bases. Indeed, between 1974 and 1976, the purchasing power of the tax bases of many local governments was reestablished at 1972 levels.

Still, there remains the question of whether local governments were able to capture the inflation-induced increases in the nominal values of their tax bases. For some taxes, such as those on retail sales and incomes, changes in tax bases are immediately translated into revenues. For others, particularly the property tax, these changes must be measured before they can be realized. In those jurisdictions where reassessments are prompt and accurate, the effects of inflation on property tax revenues will be captured quite quickly. California is one State where reassessments are regular and accurate.

The implication is that, for 7 years, inflation increased expenditures more than tax revenues. Then, between 1974 and 1976, a reversal occurred. It does not take much of an imagination to envision the plight of local officials. Conditioned by the experience of the previous 7 years, any budgetary slack which occurred after 1974 was a surprise. Uncertainty as to the permanence of newly found sources of revenues no doubt precluded the sharing with taxpayers what might be just a one-time shot of relief from the pressures of inflation on public budgets. Such circumstances lead to tax burden increases unaccompanied by service level expansion, and this obviously is the fuel for tax revolt.

The implication of this analysis, and I will summarize quite quickly, is that increasing cost due primarily to inflation rather than growing demands is largely responsible for the recent increases in State and local government expenditures. This being the case, the inevitable conclusion is that the fight against inflation must be the single most important element in any program to restrain increases in State and local government expenditures and tax burdens.

There are other possibilities for restraining growth in the expenditures and tax burdens of State and local governments.

In particular, care must be taken not to follow the course which simply shifts the burdens of local government operations from local taxpayers to State taxpayers with no reduction in combined State and local government tax burdens. This may be a likely outcome of the imposition of property tax limits, State assumption of the financial

responsibility for what had been local functions and increases in State transfers to local governments.

As has been mentioned by earlier witnesses here, there are also serious local control and equity issues related to the above-mentioned and other policy alternatives. Many of these are discussed in my submitted statement. In the interest of time, I will not pursue them at this point.

Thank you.

Representative REUSS. Thank you, Mr. Greytak.

[The prepared statement of Mr. Greytak follows:]

PREPARED STATEMENT OF DAVID GREYTAK

The Increasing Costs of Local Governments: Underlying Causes and Policy Considerations

INTRODUCTION

The development of serious policies for effective control of local government expenditure growth requires not only a knowledge of the factors underlying the growth in the cost of local government, but equally an understanding of the consequences of the available policy options. These topics have been of increasing concern to public policy analysts and researchers. Still, a consensus has yet to be achieved as to the exact nature of the problem, let alone the appropriate policy response. The purpose here is to examine in a general way a number of the factors related to the growth in the local public sector and to consider some of the problems associated with some of the more popular policy alternatives. It should be emphasized at the outset that the available evidence about the cost and expenditures of local governments is sufficient to support only those conclusions which are of a general nature. More explicit statements would require detailed analysis of local government fiscal documents. Given the limitations of the general available information about the operations and costs of local governments, any conclusions, including those stated herein, must be considered as tentative.

PART I

Growth in expenditures

Expenditures of state and local governments, both in total and those in support of current operations, have grown at a substantial pace during the last decade (Table 1). The rate of growth in these expenditures, however, has been higher in the 1973-76 period than in the previous five years, 1967-1972. The increase in the rates of expenditure growth is quite sharp, as both total expenditures and current operating expenditures have grown at annual rates in excess of fourteen percent since 1974, while prior to that date their growth rate was generally less than ten percent. This rapid growth in expenditures, in combination with fairly slow growth in population, has resulted in an increase in per capita expenditures from \$539 in 1967 to \$1422 in 1976, an increase in excess of 250 percent. As was the case with total expenditures, the annual average rates of increase in per capita expenditures indicate that their growth has accelerated during recent years.

A number of possible explanations of the growth in expenditures exist. On the one hand, it may be argued that expenditure increases are largely due to expansion of service levels; that, as total population, the number of school-aged children, and the number of dependent poor increase, the need for public sector activity also grows. Alternatively, there is the cost side argument. Simply stated, the success of public employee unions, coupled with inflation, has driven up the cost of providing any given level of service. Finally, there is the efficiency argument; that, because of mismanagement and low productivity, the bureaucracy has become increasingly costly.

Most likely, some combination of the elements of all three explanations has been operative. However, some idea of the relative importance of the three is essential, for they hold very different prospects for future growth in expenditures.

TABLE 1.—GROWTH IN STATE AND LOCAL GOVERNMENT EXPENDITURES AND GROWTH IN PER CAPITA STATE AND LOCAL GOVERNMENT EXPENDITURES, SELECTED YEARS, 1967-76

[Dollar amounts in millions]

	General		Current operation, total	Employees per 10,000 population
	Total	Per capita		
State and local government direct expenditures:				
1967.....	\$106,675	\$539.14	\$68,248	378
1972.....	188,825	906.80	125,630	444
1973.....	205,195	977.81	138,974	456
1974.....	226,032	1,069.27	154,810	466
1975.....	266,483	1,250.38	180,976	478
1976.....	305,268	1,422.11	204,976	475
Average annual growth rates (percent):				
1967-72.....	10.0	9.1	10.17	2.7
1972-73.....	8.7	7.8	10.5	2.7
1973-74.....	10.1	9.1	11.6	2.2
1974-75.....	17.9	16.9	16.5	2.5
1975-76.....	14.6	13.7	12.9	-.01

Source: U.S. Bureau of the Census, Governmental Finances, Selected years, 1967-76, U.S. Government Printing Office, Washington, D.C.; and U.S. Bureau of the Census, Public Employment in 1976, series GE 76 No. 1, U.S. Government Printing Office, Washington, D.C., 1977.

If the problem is one of mismanagement, then reorganization and/or the adoption of new technology and innovation procedures would imply the possibility of expenditure control. If growing service explanations are appropriate, then the anticipated decline in school-age population and any decline in the size of the dependent population which accompanies growth in the economy should provide some relief. Alternatively, if cost pressures are the principal cause of growth, the the outlook is for continued expenditure growth.

Demand considerations

An obvious question to be posed when confronted with such rapid growth in expenditures is whether it has been a response to increased service needs. As is well known, the search for the answer to such a question is a maze of pitfalls, arising out of the difficulties and complications associated with the measurement of public output and service levels.¹ However, the extent to which service level increases have accompanied expenditure growth can be evaluated in ways that are rough and crude, but which can be taken as indicative.²

Despite the fact that the pace of growth in state and local government expenditures has stepped up during the last few years, rates of public employment growth have continually declined during this decade (Table 2). Since 1973, the reins appear to have been drawn increasingly tight on educational employment by all levels of government, and on total employment by municipalities. In fact, employment growth has all but ceased since 1973. The case is even more extreme for municipalities. In this case, employment reductions in 1976 offset the growth of the two previous years and, in 1976, the municipal full-time equivalent employment level was below that of 1973.

¹ These problems have been discussed in the context of case study evaluation of local government productivity and performance in David Greytak, Donald Phares, and Elaine Morley, "Municipal Output and Performance in New York City" (Lexington Books, 1975).

² For a detailed case study account of the relation between expenditure, service levels, and productivity, see Jesse Burkhead and John P. Ross, "Productivity in the Local Government Sector" (Lexington: D. C. Heath and Company, 1974).

TABLE 2.—EMPLOYMENT (FULL TIME EQUIVALENT) OF STATE AND LOCAL GOVERNMENT, 1962-76

[In thousands]

	State and local	State	Local	Municipalities	Education
1962.....	5,958	1,478	4,480	1,486	2,730
1972.....	9,237	2,487	6,750	2,029	4,585
1973.....	9,578	2,547	7,031	2,109	4,751
1974.....	9,852	2,653	7,199	2,127	4,901
1975.....	10,098	2,744	7,354	2,142	4,952
1976.....	10,206	2,799	7,407	2,107	5,003
Average annual growth rates (percent):					
1962-72.....	4.5	5.3	4.2	3.2	9.1
1972-73.....	3.7	2.4	4.2	3.9	3.6
1973-74.....	2.9	4.2	2.4	.9	3.2
1974-75.....	2.5	3.4	2.2	.7	.1
1975-76.....	1.1	2.0	.7	-1.7	.1

Source: U.S. Bureau of the Census, Public Employment in 1976, table 2.

It could be argued that the decline in municipal employment reflects just the substantial employment rollback which has occurred in New York City. However, the record for large cities shows that employment reductions have occurred in a number of cities during recent years. In 1976, half of the twenty largest cities reportedly cut back the number of employees on their payrolls.³ The case is similar with state and local government employment. Although state and local government employment has continually increased, the rate of growth in per capita employment has been at a much lower rate, in the neighborhood of two to three percent, than that in expenditures. In fact, per capita employment declined in 1976 despite the increase in expenditures. In addition, expenditures for current operations have increased more slowly than total expenditures since 1974, whereas in previous years the reverse was the case. The implication is that state and local government expenditures for labor and other services directly related to the provision of public services account for a smaller share of total expenditures than had been the case in the recent past. To the extent that service levels are closely related to employment and expenditures for current operations, these differences in rates of increase can be taken as an indication that factors other than expansion of current service levels account for an increasing share of the growth in state and local government expenditures.⁴ Whether this trend can be related to the growing importance of state governments, whose share of total state and local expenditures increased from 37.2 percent in 1967 to 40.8 percent in 1976, is an interesting, but at this point unanswerable, question.

Of course, it could be that, because of increased productivity, public sector employment growth understates the increase in service levels. However, it is doubtful that the technology and efficiency of governmental operations have changed sufficiently to allow a service level increase commensurate with growth in per capita expenditures. Given the contrast between the patterns of growth

³ Roy Bahl et al., "The Outlook for City Fiscal Performance in Declining Regions" (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, April 5, 1978).

⁴ Other than current operation expenditures, total direct expenditures includes capital outlays, interest on debt, insurance benefits and repayments, and assistance and subsidies. Of these, changes in the latter are likely to be closely related to changes in service levels, i.e., welfare payments. However, the share of State and local direct expenditures which assistance and subsidies accounts for has declined since 1971.

in state and local government expenditures and employment, the association between increasing expenditures and employment additions seems weak at best. Moreover, the implication that government expenditures and costs of operation have increased more rapidly than levels of service seems inescapable.⁵ As will be discussed later, state and local government employment additions themselves can be held accountable for a relatively small part of expenditure growth.

Cost considerations

Although state and local governments apparently have been able to put the brake on employment growth, the record is much different when it comes to employee compensation. Indeed, the average wage rates of state and local government employees have increased regularly since 1967 (Table 3). However, since 1972, they have increased at rates which exceed the rate for the previous ten years. This would seem to lend credibility to the many accusations about excessive pay rates for state and local government employees. In fact, state and local government wage rates have been above the average industry level for some time. However, since 1973, the difference has been continually eroded as private sector wage rates increased at a greater rate than those in the state and local government sector. Alternately, the gap between federal civilian and state and local government wage rates has narrowed since 1972. Thus, while the case for excessive state and local government pay rate increases is questioned by comparison with private sector pay rates, it garners strength in a comparison with federal civilian pay rate increases.

TABLE 3.—AVERAGE ANNUAL WAGES AND SALARIES PER FULL TIME EQUIVALENT EMPLOYEE BY INDUSTRY, 1972-76¹

	Private industry	Federal civilian	State and local government
1962.....	\$5,082	\$6,239	\$5,017
1972.....	8,590	12,679	8,916
1973.....	9,106	13,497	9,505
1974.....	9,832	14,112	10,063
1975.....	10,690	15,195	10,862
1976.....	11,486	16,201	11,572
Average annual growth rates (percent):			
1962-72.....	5.4	7.4	5.9
1972-73.....	6.0	6.5	6.6
1973-74.....	8.0	4.6	5.9
1974-75.....	8.7	7.7	7.9
1975-76.....	7.4	6.6	6.5

¹ Calendar years.

Source: U.S. Department of Commerce, Office of Business Economics, The National Income and Product Accounts of the United States, 1929-1965, tables 6.2 and 6.4.

Wages and salaries are not the only components of employee compensation. Indeed, they are not even the fastest growing component. Fringe benefits and supplements such as pensions, health and hospital insurance, and social security coverage add considerably to employee costs (Table 4). Since 1971, these costs have grown quite rapidly in the private and federal civilian sectors (about 66 and 87 percent, respectively), as well as in the state and the local government sector (66 percent). Although wage and salary supplements in the federal sector have been and continue to be quite large, the advantage of private over state and local government employees has declined slightly since 1972. Still, in 1976, the cost of supplements averaged about \$1848 per employee in the state and local government sector. This is a significant amount, i.e., about 16 percent of average earnings.

The fact that pensions and fringe benefits have been growing more rapidly than total payroll outlays implies that governments have been more willing to provide increases in supplement and fringe packages than they have been

⁵ Similar conclusions have been drawn from case studies of city and State governments. See Roy W. Bahl, "The Long Term Fiscal Outlook for New York State" (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, mimeo, n.d.); and David Greytak, "Status and Prospects for Maryland's Public and Private Sectors" (Baltimore, Md.: Center for Metropolitan Planning and Research, the Johns Hopkins University, occasional paper, February 1978).

to grant wage and salary increases. Or it could be that employees have bargained more actively for fringe benefits than for wage and salary increments. Whichever the case may be, the data are consistent with the hypothesis that, rather than grant highly visible and immediately payable wage increments, state and local governments have provided compensation increases which have low public visibility and whose full cost may not appear on the public ledger for some time.

TABLE 4.—AVERAGE ANNUAL SUPPLEMENTS TO WAGES AND SALARIES PER FULL TIME EQUIVALENT EMPLOYEE BY INDUSTRY, 1962-76¹

	Private industry	Federal industry	State and local government
1962.....	\$482	(²)	\$431
1972.....	1,150	\$1,497	1,110
1973.....	1,331	1,689	1,248
1974.....	1,485	2,006	1,437
1975.....	1,706	2,442	1,619
1976.....	1,904	2,809	1,848
Average annual growth rates (percent):			
1962-72.....	9.1	(²)	9.9
1972-73.....	15.7	12.8	12.4
1973-74.....	11.6	18.8	15.1
1974-75.....	14.9	21.7	12.1
1975-76.....	11.6	15.0	14.1

¹ Calendar years.

² Data are not available.

Source: U.S. Department of Commerce, Office of Business Economics, the National Income and Product Accounts of the United States, 1929-65, tables 6.4 and 6.7.

Moreover, there is serious question as to whether levels of pension expenditures reflect the true cost of these programs. Indeed, the pension systems to which a number of state and local government employees belong are funded⁶ on a pay-as-you-go basis.⁶ A more appropriate means of financing pension plans is through full funding. In this case, the employer sets aside funds which, when invested, are sufficient to cover the claim on future benefits that employees accumulate during their working lives. Indeed, most pension plans in the public sector claim to be of the fully funded rather than of the pay-as-you-go variety. Still, there are strong reasons to believe that even these are under funded.⁷ If indeed this is the case, state and local expenditures have not increased sufficiently to cover their full obligations. Moreover, those governments which have underfunded pension plans will, at some later date, be faced with sharply increased employee pension costs, even with no increases in employment, pay rates, or benefit packages.

Be that as it may, even if the cost of fully funded pension plans were to be included in the figure of supplements, the true cost of fringe benefits would be understated. In all sectors of the economy, employees receive substantial fringe benefits in the form of paid vacations, holidays, sick leave, and the like. When the cost of these is added to that of wage and salary supplements, fringe benefit cost relative to pay for actual hours worked jumps dramatically (Table 5). The ratio of fringe cost to pay for hours worked is particularly high for police, 46.8 percent, and fire, 47.2 percent. The ratio for sanitation, 43.3 percent, is a good bit lower, but still 10 percent above that for other general municipal employees, 39.37 percent, which aligns closely with the private sectors of the economy.

Whether there is an appropriate relation between the full cost of fringe and supplements and pay for hours worked is not at issue here, nor is the question of whether these costs should be equated within the public sector or between the

⁶ For example, Pittsburgh, Seattle, Indianapolis, and Washington, D.C., are among the major cities which use pay-as-you-go financing.

⁷ Labor-Management Relations Service of the National League of Cities. U.S. Conference of Mayors. National Association of Counties. "First National Survey of Employee Benefits for Full Time Personnel of U.S. Municipalities." Special Report: A Spotlight on City Employee Benefits (Washington, D.C.: Labor Management Relations Service, n.d.); Thomas P. Bleakney, "Retirement Systems for Public Employees" (Homewood, Ill.: Richard D. Irwin, Inc., 1972); and Advisory Commission on Intergovernmental Relations, "City Financial Emergencies: The Intergovernmental Dimension" (Washington, D.C.: U.S. Government Printing Office, 1973).

public and private sectors. Rather, for present purposes, the point is that fringes and supplements account for a substantial share of government expenditures. Moreover, that share appears to be increasing even faster than average salaries.

The social security element of the fringe package is deserving of special note. Currently, about 70 percent of state and local government employees work for jurisdictions which participate in social security. As a result of recent legislation, the social security tax rate and the level of earnings subject to the tax are being increased in a stepwise fashion over a number of years. There can be no doubt that this will increase the employee compensation costs of state and local governments.

TABLE 5.—ANNUAL PAY FOR HOURS WORKED AND EMPLOYER COST FOR FRINGE BENEFITS, EMPLOYEES OF SELECTED MUNICIPALITIES AND ALL PRIVATE INDUSTRY, 1973 AND 1975

	Annual pay for hours worked			Employer cost of fringe benefits			Fringe benefit cost as a percentage of pay for hours worked	
	Amount		Percent- age change, 1973-75	Amount		Percent- age change, 1973-75	1973	1975
	1973	1975		1973	1975			
Police.....	\$9,170	\$10,699	16.7	\$3,878	\$5,002	29.0	42.3	46.8
Fire.....	8,973	10,194	13.6	3,969	4,812	30.2	41.2	47.2
Sanitation.....	6,868	8,232	19.9	2,737	3,567	30.3	39.9	43.3
Other general municipal employees.....	7,409	8,182	10.4	2,730	3,215	17.8	36.8	39.3
All private industry.....	8,167	9,318	14.1	3,007	3,713	23.5	36.8	39.8
All manufacturing industry.....	8,092	9,126	12.8	2,907	3,651	25.6	35.9	40.0
All nonmanufacturing industry.....	8,238	9,571	16.2	3,151	3,799	20.6	38.2	39.7

Source: Edward H. Friend and Albert Pike, III, 1975 National Survey of Employee Benefits for Full-Time Personnel of U.S. Municipalities, Washington, D.C.: Labor Management Relations Service of the National League of Cities, 1977, pp. 48 and 49.

Inflation

Although widely recognized as a factor underlying cost increases in all sectors of the economy, the impact of inflation on state and local governments is difficult to calculate from generally available price indexes. Under the sponsorship of the National Science Foundation, the Metropolitan Studies Program at the Maxwell School of Syracuse University has developed a set of inflation indexes which measures inflation's impact on both expenditures and revenues.⁸ These indexes have been calculated for the periods 1967-72, 1972-74, and 1974-76 (Table 67). Examination of these indexes reveals the susceptibility of government expenditures to inflationary pressure. For example, during the 1967-72 period, the rates of price increases were relatively modest, but sufficient to increase the costs of the goods and services purchased by state and local governments by slightly more than five percent per year, or roughly by 22 to 23 percent over the five-year period. During the 1972-74 period, inflation hit the double digit level, and resulted in a two-year increase in prices paid by state and local governments of 25 percent. The decline in the rate of inflation between 1974 and 1976 is reflected by a lower rate of increase in the prices paid by government. Still, over the two-year period, the indexes indicate that inflation boosted prices paid by governments by 12 percent.

Over the whole ten-year span, the prices of the goods and services purchased by local governments increased by a full seventy-five percent. That is to say that, if state and local governments did no more than absorb price and cost of living increases while holding service levels constant, the cost of the services provided in 1967 would be seventy-five percent greater in 1976. Note, however, the major part of these cost increases has occurred in the post-1972 period.

⁸ David Greytak and Bernard Jump, "Inflation and local Government Expenditures and Revenues: Method and Case Studies," "Public Finance Quarterly 5," No. 3 (July 1977); and "The Effects of Inflation on State and Local Government Finances, 1976-1974," (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, Occasional Paper No. 25, 1975).

TABLE 6.—INFLATION INDEXES FOR STATE AND LOCAL GOVERNMENT REVENUES, EXPENDITURES BY TYPE OF GOVERNMENT, SELECTED PERIODS, 1967-72

	Expenditure indexes			Revenue indexes		
	1967-72	1972-74	1974-76	1967-72	1972-74	1974-76
States	122.6	125.4	112.2	115.2	116.6	110.0
Counties	122.7	125.4	112.0	127.7	116.7	114.2
Municipalities	122.9	125.4	112.1	123.7	115.4	113.3
Townships	122.1	125.6	112.6	130.0	114.8	113.9
School districts	123.7	125.0	110.7	132.2	119.2	116.4
Special districts	121.8	125.7	113.4	114.8	113.3	109.6
All State and local	123.0	125.2	112.0	112.2	116.9	110.9

Source: Inflation indexes computed using methods and data sources noted in David Greytak and Bernard Jump, "The Effects of Inflation on State and Local Government Finances, 1967-1974," Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, 1975); and Roy Bahl et al., "The Outlook for City Fiscal Performance," Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, 1978.

TABLE 7.—SELECTED DATA RELATED TO THE GROWTH IN STATE AND LOCAL GOVERNMENT EXPENDITURES BY SOURCE, 1972-76

	State	Local	State and local
Total expenditure growth (millions) ¹	\$28,385	\$50,379	\$78,757
Growth index	152.30	150.57	151.05
Inflation index	140.80	139.87	140.18
Percent of expenditure growth due to inflation	42.81	67.94	64.09
Percent of expenditure growth due to employment increase	15.89	21.23	19.30

¹ Excludes intergovernmental expenditures.

Source: See table 6.

As indicated in Table 7, over the period 1972-76, the prices of goods and services purchased by state and local governments increased by roughly forty percent. That is to say that, if state and local governments had done no more than absorb the price increases on the goods and services they purchase from the private sector, while maintaining the real value of the compensation paid to their employees and transfer recipients, their cost would have increased by about forty percent between 1972 and 1976. However, the earlier discussion implies that state and local governments did not hold employment and real wage rates constant. Still, the data in Table 7 indicate that only a relatively small proportion of state, 15.9 percent, and local, 21.2 percent, expenditure increases can be attributed to additions to their work force. Alternatively, a large proportion of expenditure increases, fully two-thirds for local governments and 43 percent for state governments, can be attributed to inflation.⁹ There can be little doubt that inflation has been a major factor underlying the increasing cost of state and, more particularly, local governments.¹⁰

Inflation is also important on the revenue side of the government ledger, for inflation affects the monetary values of property, retail sales, and personal and corporate income as well as other components of the state and local tax base. However, none of the generally available price indexes provides an appropriate measure of the extent to which price increases have affected tax bases and tax revenues. Inflation indexes for state and local government revenue systems have been developed and implemented as part of the project mentioned earlier (Table 6).

An examination of these indexes indicates a number of interesting findings. First, there is a good deal of variability in the extent to which inflation impacts

⁹ The share of expenditure increases not associated with inflation or employment growth can be attributed to increased purchases of goods and services from the private market, increases in the real value of employee and transfer recipient compensation, and increased numbers of transfer recipients.

¹⁰ In an earlier analysis of the 1967-72 period, these proportions were reversed; i.e., employment accounted for the major share of expenditure growth, while only about twenty percent of cost increases could be attributed to inflation. See Greytak and Jump, "The Effects of Inflation on State and Local Government Finances * * *," op. cit.

on the revenue systems of various types of governments. For example, inflation appears to have a greater revenue potential for counties and school districts, while state systems appear to be somewhat less responsive. Second, during the 1972-74 period of double digit rates of price increases, inflation had a greater effect on expenditures than on revenues, although in the period 1974-76, the dampening of inflation did allow inflation induced increases in revenues to nearly match inflation generated expenditure increases.

Perhaps a more illustrative way to depict this effect is to consider the effect of inflation on the purchasing power of government tax bases (Table 8). This analysis clearly identifies the strain which has been placed on local governments by inflation. The purchasing power of state and local tax bases fell by about 8.5 percent between 1967 and 1972, and by another 7.6 percent between 1972 and 1976. Given this erosion in tax bases, there can be little doubt that inflation has been a major source of fiscal strain to state and local governments. However, during the period 1972-74, when price increases were at double digit rates, inflation reduced the purchasing power of state and local government tax bases to 93.3 percent of their 1972 level. Between 1974 and 1976, inflationary pressures declined such that purchasing power of the combined state and local tax base was eroded only slightly, i.e., by one percent. However, it must be noted that, between 1974 and 1976, when inflation really hit the land and housing markets, those governments heavily dependent on property taxes (municipalities, townships, and school districts) experienced an increase in the purchasing power of their tax bases. For no level of government was this increase sufficient to offset the purchasing power loss they had experienced since 1967. However, between 1974 and 1976, inflation so enhanced the tax bases of school districts that, by 1976, the purchasing power of their tax bases had been re-established at 1972 levels. No other level of government has been so fortunate.

What these data portray is the susceptibility of state and local governments to inflation. Moreover, they imply that inflation impacts on governments depend critically on the structure of their tax system and the pattern of price increases. For surely, if property values had not so greatly inflated between 1974 and 1976, property tax dependent governments (municipalities, townships, and school districts) would not have experienced the increases in tax base purchasing power they did.

TABLE 8.—PURCHASING POWER INDEXES FOR STATE AND LOCAL GOVERNMENT
REVENUE BASES, SELECTED PERIODS, 1967-76¹

	1967-72	1972-74	1974-76	1972-76 ²
States	90.59	92.98	98.04	91.12
Counties	92.43	93.06	98.04	94.88
Municipalities	91.39	92.03	101.03	92.96
Townships	92.51	91.40	101.11	92.37
School districts	94.32	95.36	105.15	100.00
Special districts	89.89	90.14	96.64	87.16
All State and local	91.54	93.30	99.00	92.44

¹ Excludes intergovernmental aid.

Source: See table 6.

There remains the question of whether these governments were able to realize the increase in tax base purchasing power which occurred between 1974 and 1976. Realization of the changes in tax base purchasing power requires a tax structure capable of capturing as revenues inflation-induced increases in the nominal values of tax bases, while maintaining compensation constant in real terms.¹¹ Realization of tax base expansion, whether due to inflation or not, essentially is automatic in the case of those taxes whose bases are defined in nominal terms, e.g., retail sales, personal income, and corporate income. Alternately, realization of the revenue potential of tax base expansion of those taxes whose bases must be measured is not automatic. The property tax is most representative of this type of tax. Reassessment lags are common, and suggest that the indexes and the analysis based on them would overstate effects of inflation on

¹¹ For an expanded discussion of these considerations, see David Greytak and Bernard Jump, "The Impact of Inflation on the Expenditures and Revenues of Six Local Governments, 1971-1979" (Syracuse, N.Y.: Metropolitan Studies Program, Syracuse University, Occasional Paper, December 1975).

tax revenues. However, in those jurisdictions where reassessments are frequent, base changes are quickly translated into revenues if tax rates do not decrease. One state in which prompt and accurate reassessment is the rule is California. This being the case, the analysis here suggests that the actual purchasing power of the local government, although declining between 1972 and 1974, increased markedly between 1974 and 1976.

The implication, of course, is that, for a period of at least seven years (1967-74), the pressure of inflation for expenditure increases exceeded that on the expansion of nominal tax bases. Then suddenly, between 1974 and 1976, a reversal occurred and the inflation-induced expansion in nominal tax base and, because of timely and accurate tax reassessment, tax revenues was greater than that for expenditures. In such a situation, it does not take much imagination to envision the plight of public officials. Conditioned by the experience of the past seven years, the budgetary slack produced by inflation between 1974 and 1976 was a surprise, and, no doubt, a welcome one. However, uncertainty as to the permanence of the newly emergent source of revenue growth most likely precluded either the adaption of new expenditure commitments via tax cuts, or the sharing of what might be a one-time shot of relief from the longer term pressures of inflation on public budgets. Such circumstances lead to tax burden increases unaccompanied by service level expansion, and they are fuel for tax revolt.

PART II

Public policy

There are at least three objectives which should guide public policy directed toward the control of local government cost increases. The first is the equity objective, i.e., to improve or at least not reduce the absolute or relative real income and living circumstances of the poor and disadvantaged. Proposals to cut local government service levels under this objective require close scrutiny and evaluation, for reductions in the major local government programs (police, fire, sanitation, and education) are likely to fall particularly on the poor and disadvantaged.

A second, or efficiency, objective of public policies should be to improve the management capabilities of local governments. Here, federal and state programs of technical assistance, improvements in financial management, programs of longer term facilities and fiscal planning, better coordination among governments, coordination of state and federal grant programs, and improved reporting and monitoring of all programs are all part of reforms that might improve the management capabilities of local governments.

A third objective should be the maintenance of local control over local expenditure decisions. This extends beyond the simple one man, one vote notion of local government. Rather, it refers to the ability of locally elected officials, first, to perceive the expenditure needs and preferences of their citizenry and then to move toward the satisfaction of them without undue interference from higher levels of government. In part, this requires that local officials be informed of and responsive to the desires of their constituents and the circumstances surrounding their lives. It also dictates a careful evaluation of federal and state mandated programs, as well as aid programs which are designed to promote priorities set above the local level.

In fact, the equity objective is the one which should dominate in the consideration of policy options. If the concept of expenditure control is to have substance, it argues for a realignment of expenditures consistent with the needs of local governments' clientele. In a real sense, it means excessive and unessential service must be cut back and the cost of increases of the necessary activities of local governments restrained. Since such a large part of the services and programs provided by local governments, especially education and police and fire protection, is of greater importance to the poor than to the rich, and since access to private market alternatives is greater among the non-poor, expenditure control means achieving the equity objective with a smaller share of local income.

The substance of the management and productivity objective is efficiency in the use of public resources to achieve public ends. In this sense, it is an objective which is subservient to the others. However, administrative and management reorganization have the appealing characteristic of being relatively inexpensive, although their success is difficult to evaluate.

Policy options and problems

If the pattern of past behavior of those governments which have attempted to reduce costs is indicative of what the future holds, then reductions in local government employment levels can be anticipated. Reduction in public employment levels, however, unless accompanied by major increases in employee productivity, will lead to reductions in the quantity or quality of public services. This alternative raises serious equity questions, since the economically disadvantaged are among the major beneficiaries of the local public services, particularly in central cities.

Moreover, this alternative must confront the resistance of public employee organizations to reductions in their numbers. While the fact that some cities and their unions apparently have been able to negotiate employment reductions, the potential for really major deductions is limited, for major service reductions are likely to accelerate the decline of at least some cities by aggravating their fiscal problems.

Alternatively, non-labor expenditures may be cut with little or no immediately perceptible impact on the quality of public services. In particular, capital expenditures for the maintenance and repair of public capital may be curtailed. The efficacy of such a move is indeed questionable for such a policy does not eliminate expenditures in a real sense, but rather simply defers them to a later date. Moreover, the deterioration of public facilities such as streets, bridges, schools, sanitation facilities, and the like may lead to outmovement of business and industry, as well as upper income populations. This, too, may result in complicating rather than relieving city fiscal problems, although this may not occur immediately.

Another often advocated alternative for reducing the scope of local government is that of shifting responsibility to higher levels of government. This is most often suggested in regard to courts, some aspects of education, finance, welfare, and health and hospital programs, as well as some administrative operations, e.g., property assessment. This alternative must confront a set of equity questions which are not always recognized. For, if states are to adopt the financial responsibilities for programs currently funded out of local revenues, then states will either have to cut back expenditures on other programs or raise additional taxes. State adoption of local programs, if financed by reducing expenditures on programs of primary benefits to the economically disadvantaged, are unpalatable on equity grounds. Alternatively, state assumptions financed by new state revenues may have adverse income distribution consequences. For example, if the state relies on sales taxes rather than on progressive income taxes, the aggregate tax burden on the poor will likely increase.¹²

Additional intergovernmental aid is often recommended as a means of reducing the local expenditure requirements associated with the services and activities of local governments. If intergovernmental aid money is fully substituted for local money, the serious issue is the same as that confronting state assumption of programs, i.e., the implications for the tax burdens of the poor. On these grounds, federal aid would seem preferable to state aid because of the greater progressivity of its tax system. Perhaps the more serious issue, which strikes at the heart of the argument for intergovernmental aid, has to do with the question of whether such aid substitutes for or stimulates the expenditures of recipients. Although this question has been subjected to a great deal of research, a definitive answer has not been produced as yet. However, in collaboration with the Advisory Commission on Intergovernmental Relations, the Metropolitan Studies Program of the Maxwell School has recently completed a review of the evidence and an analysis of the substitution-stimulation question of a wide variety of state and federal aid programs.¹³ Their findings, while not lending themselves to a single unqualified evaluation, strongly indicate that aid has generated increased local expenditures rather than reducing them. Whether the current dissatisfaction with the operation of the local public sector would be sufficient to make local officials see additional aid monies as a means of dollar for dollar

¹² Roy W. Bahl and Walter Vogt. "State and Regional Government Financing of Urban Public Services," in A. K. Campbell and R. Bahl (eds.), "State and Local Government: The Political Economy of Reform" (New York: The Free Press, 1976), pp. 96-126.

¹³ Advisory Commission on Intergovernmental Relations, "Federal Grants: Their Effects on State-Local Expenditures, Employment Levels, Wage Rates." A-61 (Washington, D.C.: U.S. Government Printing Office, 1977); and "The States and Intergovernmental Aids," A-59 (Washington, D.C.: U.S. Government Printing Office, February 1977).

tax reductions rather than providing the budgetary slack for additional expenditures is a question which cannot now be answered.

Finally, with regard to intergovernmental aid, there is the issue of whether programmatic aid leads to the provision of the types of service which are most desired by the constituents of local governments. If one takes the statements of the officials whose responsibility it is to implement state and federal aid programs at the local level as indicative of popular sentiment, then the efficacy of current aid programs is questionable. Generally, local officials are close to unanimous in the opinion that expenditure restrictions associated with aid programs mitigate their ability to provide the types and levels of service in conformity with local preferences and priorities.¹⁴ Thus, many aid programs are in conflict with the objectives of local control.

To many, however, this may not constitute a legitimate issue, for many aid programs have as their purpose the provision of services which, if left to local discretion, would not be provided; or, if provided, would be at levels not consistent with the preference of the broader society. While there can be little doubt that reduction or elimination of many of the expenditure restrictions associated with aid programs would accommodate the objectives of local control, there remains the question of their consistency with other objectives. As to efficiency, one would guess that restrictions and their monitoring generate a good deal of accounting and paperwork. If relieved of these encumbrances, some reduction in the costs of local government management could occur. However, it is unlikely that such savings would be sizable.

State and federal dictates as to types and levels of local expenditures extend far beyond aid programs. Mandates necessitating local expenditures are common, and extend from state safety specifications dictating the number and position of traffic lights to conventions governing property tax collections.¹⁵

These, too, may be deemed necessary and appropriate for social achievement, with benefits to broader society. As there is little known about the actual cost implications of such mandates, little can be said about the magnitude of local expenditure reductions which could be associated with the elimination of or compensation for state or federal mandated expenditures. What can be said, however, is that full reimbursement of the cost of local activities which are the results of state and federal mandates would relieve local governments of the associated financial burdens. It is difficult to identify the amounts of money that would be involved, for so little is known about the fiscal implications of mandating.

Perhaps the policy most often associated with attempts to restrain expenditure growth involves employment and wage freezes. In light of the labor intensity of local governments and the importance of labor cost in their budgets, such policies would seem appropriate. However, in addition to their unpopularity among employees and their bargaining agents, the effectiveness of employment and wage freezes depends on a number of factors. Indeed, it is possible that, even with employment or wage freezes, the number of public workers and/or their compensation rates may increase. Unless lids are placed on the number of actual employees rather than authorized positions, the actual government workforce can continue to grow as budgeted, but vacant positions are filled. Similarly, wage freezes may not eliminate labor cost increases, even if they are accompanied by no growth in the local government employment. This is so for wage freezes generally but do not apply to such things as seniority and cost of living raises, which are incorporated in salary scales and employment contracts. While these considerations question the efficacy of employment and wage freezes, there are other equally important considerations.

Employment and wage rate freezes, particularly those of the across the board variety, can interfere with the efficiency and local control objectives. On efficiency grounds, it can be argued that freezes preclude or make difficult the allocation of new resources, and perhaps the reallocation of existing public money to high priority activities or functions. The inefficiency is, of course, that government resources will not be allocated in a manner which conforms with public

¹⁴ Advisory Commission on Intergovernmental Relations.

¹⁵ The local government cost implications of state and federal mandates is an area in which our knowledge is vastly deficient. Initial study of this topic has been undertaken by the Advisory Commission on Intergovernmental Relations, "Tax Lids and Expenditure Mandates: The Case for Fiscal Fair Play," *Intergovernmental Perspective* 3, No. 3 (Summer 1977): 7-12. For a list of state mandates affecting local governments in one state, see Connecticut Conference of Municipalities, "State Mandates to Cities and Towns" (New Haven, Conn.: CCM, mimeo, March 1976).

priorities. Beyond this, policies which preclude or make difficult shift of public monies among local government activities may violate the equity objective. This would occur when priorities dictate that additional money be allocated to activities which are of particular benefit to the low income or needy population.

Limits on expenditures need not be the across the board variety. There are a variety of limits which could, in effect, limit the aggregate budget and/or its growth and provide the flexibility to accommodate the equity, efficiency, and local control objectives.

The most common alternatives to limits placed on expenditures are those placed on revenues. Local tax and revenue limits have a long history, although their effectiveness as a means of expenditure control is not a matter of certitude. However, the Advisory Commission on Intergovernmental Relations recently reported research findings which indicate that local taxes are associated with lower local expenditures from own sources.¹⁶ However, the bulk of evidence suggests that local tax limits have no effect on total state and local expenditures. The implication is that, to the extent that local tax limits are restraining taxation and spending by local governments, the state government adopts additional expenditure responsibilities. Whether a greater state role in combined state-local spending accommodates the equity objective is a serious question. A greater degree of progressivity in state tax systems does not guarantee that equity improvements in financing will be achieved by state financing. It is the source of finance for the expenditures in question which must be examined. The presumption is that financing out of a progressive state income tax would be equitable, while use of a sales tax would probably have inequitable effects.¹⁷ Equity issues aside, state financing raises the issue of local control for if state control accompanies state financing, then tax limits run contrary to the local control objective.

Within the class of actions which attempt to achieve expenditure control indirectly by limiting revenues are full disclosure restrictions. Generally, these restrictions require a public hearing and a vote by public officials whenever property tax is to be levied at a rate above some previously specified rate.¹⁸ Such procedures closely conform to the objective of local control. Since they do not in and of themselves have equity implications or hamper the efficiency of local government operation, this type of restriction would seem to be quite appealing.

CONCLUDING COMMENTS

Many of the possibilities for local government expenditure reduction involve activities which would reduce either service levels or local responsibility for the financing of service. The recent experience of California, as well as that of New York City, would suggest that state governments, however reluctant they may be, will be involved in any major attempts to cut local government expenditures. Whether this involves state aid increases or state adoption of local expenditure responsibilities, the implication is for a shift of tax burden from local to state taxpayers without any clear guarantee of a reduction in combined state and local tax burdens. Whether shifts in tax burdens are sufficient to dampen the forces of taxpayer revolt is a matter of speculation. If they are not, then the search for ways to cut the costs, or at least restrain cost increases, of state and local governments will gain force. The analysis of the factors related to the increasing cost of government has identified the growth in average employee costs as a major contributor to increases in the cost of government activities. However, despite the fairly large increases in employee compensation, the data reported herein indicate that wage rate increments in large part serve to offset increases in costs of living. In fact, inflation alone may have contributed more to the growth in local government expenditures than all other factors combined. Clearly, short of major service cuts, little relief from increasing costs of government can be expected unless the federal government is more effective in its fight against inflation.

¹⁶ Advisory Commission on Intergovernmental Relations, "State Limitations on Local Taxes and Expenditures," A-64 (Washington, D.C.: U.S. Government Printing Office, February 1977).

¹⁷ Although there is little question about the equity implications of income vs. sales taxation, the general presumption of the regressivity of the local property tax has been subjected to serious questioning. If in fact the property tax is progressive, then the degree of progressivity of local as well as state taxes would need to be considered.

¹⁸ Most commonly, these procedures are required whenever the property tax is to be set at a rate which would yield revenues greater than the previous year's revenues, or in some cases, a specified amount greater than the previous year's revenues.

Representative REUSS. Now, the widely respected Assistant Director of the Advisory Council for Intergovernmental Relations, the Honorable John Shannon.

STATEMENT OF HON. JOHN SHANNON, ASSISTANT DIRECTOR, ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

Mr. SHANNON. Thank you, Mr. Chairman, and members of the two committees involved in this hearing.

I have been asked to concentrate on the local tax situation, property tax, and certain other related issues, and that part of my prepared statement from page 14 on, I will summarize.

Actually there are two questions that I hope to answer for the committee.

First: Does it still make political and economic sense to retain the property tax as a major source of local revenue in an inflation-ridden economy?

Despite obvious defects and a very poor public image, the property tax has significant political and fiscal virtues. First, it is the one major revenue source directly available to local government and, therefore, serves as the traditional defense against fiscal centralization.

Second, it is the only major tax that can recapture for the community the property values created by the community.

Third, it has a high visibility and it can work in the direction of greater public accountability.

But beyond these three considerations there is an inescapable element of fiscal realism—the Nation's local governments will not quickly come up with an acceptable substitute for this powerful \$65 billion revenue producer.

That figure alone is more than the gross national product of most of the members of the United Nations. We are talking about a revenue instrument that produces more than the individual income tax and the sales tax of the State levels combined.

In view of the conservative mood of the country, it is also not likely that many State legislative bodies will be willing to solve the local property tax problem by granting broad discretion to local governments to levy income and sales taxes or by quickly relieving the local property tax of all responsibility for the financing of schools.

State legislators are much more likely to use their surplus funds to grant tax relief to property owners rather than work out fiscal relief strategies for local governments. The State-financed plans of aid to property owners will take a variety of forms, and we are seeing it now. Expanded circuitbreakers, State reimbursement for partial homestead exemptions or tax rebates for part of the school taxes—part, not all, of the school taxes borne by homeowners. There is a major proposition under consideration in Texas on that latter point right now.

Because State takeover of local school costs is an extremely expensive venture, we are not likely to see many dramatic breakthroughs on this front immediately. It is happening over time, but it is going to be slow going.

For all of these reasons, prudent public policy would dictate the adoption of measures at the State level, designed to conserve the

local property tax by reducing as much as possible the high irritant content of this levy.

Well, what is the ACIR prescription for keeping the irritant level of the property tax to tolerable levels, particularly during periods of inflation?

Our first prescription—and we think all of these need to be worked together—is a uniform system for administering the property tax.

For a market value appraisal of all taxable property, you need professional appraisers, strong supervision of local assessors, and the preparation and disclosure of assessment ratio findings to enable taxpayers to judge the fairness of their assessments. But that all goes under the traditional rubric of assessment reform.

Second, and this is very important, is a truth-in-property taxation process, along the lines of the Florida plan, that will enable taxpayers to fix political responsibility for higher property taxes without placing fiscal shackles on local government.

In my prepared statement I go into some detail explaining the Florida plan. Basically there has to be a rollback of rates roughly commensurate with the increase in the base unless the local spending authorities go through a very rigorous full-disclosure process so that the taxpayer knows that it's the school board, the city council, or the county board that is responsible for that tax increase and not the assessor.

The third element in this five-item protection program is a State-financed circuit breaker to shield homeowners and renters with low and fixed income from property tax overload situations. And, again, in my prepared statement I describe why we do consider the circuit breaker the instrument of choice for granting taxpayer relief.

The fourth—and this bears on the Federal policymakers as well as State—is an intergovernmental “fairplay” policy. When the State mandates additional expenditure responsibilities on local government, it should be prepared to help finance the added expenditure burden. When a State mandates a partial or complete exemption from the local property tax, such as a partial homestead exemption, it should reimburse the localities for revenue loss, and this fairplay concept also makes good sense at the Federal level.

And the fifth would be a tax utilization philosophy that recognizes that the best property tax is a moderate tax. As with any other tax, the heavier it becomes, the less obvious its virtues, the more glaring its defects.

In my view, a moderate property tax would fall into the 1 to 1.5 percent of market value range. Beyond 1.5 percent of market value, the amber warning light turns on, and beyond 2 percent, certainly the red light flashes.

If a State at least gradually can assume the full cost of welfare and Medicaid and at least 65 percent of the cost of local schools, it will probably be able to hold property tax levels below the 2 percent level.

A map¹ in my prepared statement gives FHA effective rates back in 1975. There has been some change since then, but basically the picture is that the Southern States have moderate rates, the Northern States are close to 1 percent or above. In the case of Massachusetts, the effective rate is by far and away the highest: it is 3.26 percent. So that on a home of \$100,000 in 1975 the property tax was \$3,260.

¹ See Mr. Shannon's prepared statement, p. 737.

There is room for guarded optimism. Many legislators may find that this five-point reform program more acceptable than the radical surgery alternative prescribed by Drs. Jarvis and Gann. If this turns out to be the case, June 6, 1978—proposition 13 day—will also become a red letter day in the long and troubled history of the local property tax.

Thank you very much.

[The prepared statement of Mr. Shannon follows:]

PREPARED STATEMENT OF HON. JOHN SHANNON

After Jarvis—A Tough Reappraisal of State-Local Finance

Shock waves of increasing intensity have jolted the state-local finance sector during the last four years. If their severity could be measured on a scale of 1 to 10, then the 1975 New York City crisis might register a Richter-type reading of 5, the 1974–1976 recession about 8, and the 1978 California tax revolt almost 10.

While the first two shocks—the New York City crisis and the recession—strengthened the hands of the fiscal conservatives, the California tax revolt provided them with a four-point action program for slowing down the growth of state and local government.

A Massive Local Property Tax Rollback.—Because property cannot be taxed at more than 1 percent of its estimated 1975–1976 market value, this necessitated a property tax cut of approximately \$7 billion.

A Partial Property Tax Assessment Freeze.—No property tax assessment can be increased in any one year by more than 2 percent unless that property is sold, at which time it can be reassessed on the basis of its market value.

Very Tight Constitutional Restrictions on Local Revenue Raisers.—After July 1, 1978 no tax can be increased or a new tax imposed without the approval of two-thirds of the qualified voters.

Fairly Tight Constitutional Restrictions on State Revenue Raisers.—No additional state taxes can be imposed unless approved by at least two-thirds of the total membership of both the Senate and the House.

Proposition 13 raises several hard questions for state and local policymakers.

First, does the Jarvis approach for controlling the growth of public spending represent the wave of the future? It is highly unlikely that many states could replicate all of the factors that gave such strong support for the massive rollback in local property taxes. California had a \$5.5 billion surplus to cushion the initial shock of the local property tax rollback. This extraordinary surplus, together with a well above average property tax burden, a high and rising fiscal blood pressure reading, a strong populist tradition, and an unusually rapid growth in residential property values in South California all combined to give explosive support for Proposition 13.

It should also be noted that the partial assessment freeze fairly bristles with equity and uniformity issues—not many states are likely to enter this legal thicket.

While huge local property tax rollbacks or partial assessment freezes appear unlikely in most other states, the strong support for Proposition 13 will certainly hurry history along on three fronts.

1. More Restrictions on Local Tax and Spending Powers.—Since 1970 at least 14 states have placed restrictions on the power of local officials to raise property taxes (Table 1).

2. More Restrictions on State Tax and Spending Powers.—Since 1976 New Jersey, Michigan, Colorado, Tennessee, and now California have taken various restrictive actions to check the growth of state spending (Table 2).

3. Greater Support for Home Owner Property Tax Relief.—Proposals calling for expanded circuitbreakers, split rolls, larger homestead exemptions, and tax deferrals will compete even more intensively for state legislative support.

Second, is it possible to moderate state expenditure growth rates without placing fiscal shackles on state legislative bodies? Two considerations give this question an urgency that cannot be denied. First, there is clear evidence that an increasing number of citizens no longer want the state-local sector to keep growing at a faster clip than the growth in their own income. Ever since World War II all systems have been “go” for the Nation’s largest growth industry.

GROWTH OF THE STATE-LOCAL SECTOR, 1948-77

[State-local expenditures and taxes as a percent of State personal income]

Fiscal year	State-local direct general expenditures (percent)			
	Total	From own funds (excluding Federal aid)	State-local tax revenue (percent)	Exhibit: State-local employees per 10,000 population
1948	9.32	8.34	7.03	1 240
1958	12.93	11.53	8.85	298
1968	16.38	13.64	10.81	396
1976	20.32	15.90	12.47	475
1977 estimate	20.75	16.05	12.87	485

¹ Based on population including Armed Forces overseas.

² This 1976-77 slight increase varies from an earlier ACIR finding of a slight decrease in the relation of State and local spending to gross national product. This tabulation used census data, fiscal year, and personal income. The earlier analysis used national income accounts, calendar year, and gross national product.

Source: ACIR staff computations based on U.S. Bureau of the Census. Governments Divisions various reports, and staff estimates.

TABLE 1.—STATE LIMITATIONS ON LOCAL GOVERNMENT POWER TO RAISE PROPERTY TAX REVENUE, 1977

[Key to abbreviations: C—counties; M—municipalities; S—school districts (in some States school districts have no independent taxing authority or depend on county government for taxes, in which case the limits on the independent general government impact on school districts.)]

State	No limitations	Full disclosure of effect of assessment increases on property tax rate ¹	Property tax rate limitation ²	Property tax levy limitation ³ (levy equals rate times tax base)	Expenditure limitation
Alabama			CMS ⁴		
Alaska			M	M (1973)	
Arizona			M	CM	S.
Arkansas			CMS ⁴		
California			CMS ⁴		
Colorado				CMS	
Connecticut	M				
Delaware	MS		C		
District of Columbia		M (1975)			
Florida		CMS (1970)	CMS ⁴		
Georgia			CMS		
Hawaii		C (1976)			
Idaho			CMS		
Illinois			CMS		
Indiana			CMS	CMS (1973)	
Iowa			CMS	CM (1972)	
Kansas			CMS	CMS (1970)	S.
Kentucky			CMS ⁴		
Louisiana			CMS ⁴		
Maine	CM				S.
Maryland		CM (1977)			
Massachusetts	M				
Michigan			CM		
Minnesota			MS	CM (1971)	
Mississippi			CMS		
Missouri			CMS ⁴		
Montana		CM (1974)	CMS		
Nebraska			CMS		
Nevada			CMS ⁴		
New Hampshire	M				
New Jersey					CM (1976).
New Mexico			CMS ⁴		
New York			CMS ⁴		
North Carolina			CM		
North Dakota			CMS		
Ohio			CMS ⁴		
Oklahoma			CMS ⁴		
Oregon				CMS ⁴	
Pennsylvania			CMS		
Rhode Island	M				
South Carolina	CM		S		
South Dakota			CMS		
Tennessee	CM				
Texas			CMS ⁴		
Utah			CMS		
Vermont	M				
Virginia		CM (1976)			
Washington			CMS ⁴	CM (1971) ⁴	
West Virginia			CMS ⁴		
Wisconsin				CMS (1975)	
Wyoming			CMS ⁴		

¹ Under a full disclosure procedure, a property tax rate is established that will provide a levy equal to the previous years when applied to some percentage of the current year's tax base. In order to increase the levy above the amount derived by using the established rate the local governing board must advertise its intent to set a higher rate, hold public hearings, and thereafter approve, the higher rate by vote of the board.

² Property tax rate limitation sets a maximum rate that may be applied against the assessed value of property.

³ Levy limitation places a maximum on the amount of revenue that can be raised by the property tax (e.g., 106 percent of the prior year levy).

⁴ Restriction is constitutional.

TABLE 2.—RECENT STATE RESTRICTIONS ON STATE TAX/SPENDING POWERS

State	Type of restriction and year of enactment		Remarks
	Constitutional	Statutory	
Colorado.....		1977	Allows a 7 percent increase in general fund spending with an additional 4 percent to reserve fund. Amounts over 11 percent refunded to taxpayers.
		1978	Indexation of the State personal income tax to prevent inflation from pushing taxpayers into higher tax brackets.
Michigan.....		1977	Budget stabilization fund provided. Amounts in excess of 2 percent of adjusted personal income multiplied by previous year general purpose revenue to determine amount to be deposited in budget stabilization fund. Withdrawals are provided if there is a decrease in adjusted personal income.
New Jersey.....		1976	Spending increase limited to increase in the State personal income (Federal series). Increase of between 9 and 10 percent for this year.
Tennessee.....	1978.....		Spending increase limited to growth in the economy. Increase approximately 11 percent this year. Provisions for full or shared costs for mandated programs to local governments.
California ¹	1978.....		

¹ Proposition 13 (Jarvis-Gann), by constitutional revision, provides that any changes in State taxes enacted for the purpose of increasing revenues must be imposed by an act passed by not less than $\frac{2}{3}$ of all members elected to each of the 2 houses of the legislature, except that no new ad valorem taxes on real property or sales or transaction taxes on the sales of real property may be imposed.

Note: Legislation restricting State spending powers by either constitutional or statutory means is under a consideration in the following States: Arizona, Florida, Georgia, Hawaii, Idaho, Illinois, Iowa, Maine, Maryland, Massachusetts, Minnesota, Missouri, Ohio, South Dakota, Texas, Utah, Virginia, Washington, and Wisconsin.

Source: ACIR staff compilation, June 9, 1978.

Second, there is also evidence to suggest that a part of this growth rate can be traced to imperfections in our system for holding elected officials clearly accountable for the growth in taxes and expenditures—imperfections that become more serious during inflation in these ways:

Unlegislated Tax Rate Increases.—Inflation subtly pushes taxpayers into higher federal and state income tax brackets.

The Diffusion and Misdirection of Political Responsibility for Higher Local Property Taxes.—Is the taxpayer to blame the assessor, the school board, the city council, or the county board for his tax increase?

Diffusion and Misdirection of Political Responsibility for New Spending Programs.—In many instances, Congress takes the political credit for enacting a new program (such as the Safe Drinking Water Act) while mandating the additional expenditure requirements on states and localities. Similarly, state legislatures often mandate new services or the upgrading of the wages and pension benefits of local employees and force the added expenditure requirements on local governments. There is also the frequent case in which one legislature will take political credit for the enactment of a new program but leave to the next legislature the task of funding it.

In order to remove these imperfections from the political marketplace, the political accountability of elected officials must be strengthened. By so doing, expenditure growth rates can be slowed down without doing violence to the concepts of representative government, majority rule, and fiscal flexibility. Examples of this strengthened accountability approach can be found on both the tax and expenditure sides of the fiscal equation.

A good example of strengthening political accountability for expenditure decisions is the 1978 Tennessee constitutional amendment that restricts state spending to the growth in the state economy. The state legislature can exceed this limit by a simple majority vote, provided it follows a full disclosure procedure. This amendment also directed the state legislature (a) to at least partially reimburse local governments for state expenditure mandates, and (b) to fully fund the first-year cost of all new state programs. In effect, then, it directs the state legislature to put its money where its mouth is.

The state of Colorado strengthened political accountability when it indexed the personal income tax this year so as to prevent inflation from pushing taxpayers into higher tax brackets. Similarly, Arizona passed a law indexing its deductions, credits, and exemptions. The ACIR has recommended this action on the grounds that higher income tax rates should result from overt state legislative action rather than as the silent consequences of inflation.

Admittedly, these various means for focusing a sharper spotlight on tax and expenditure decisions will come under attack from the hard line fiscal conservatives as very "weak tea." Underpinning their objectives is the firm conviction that elected representatives can no longer say "no" to all the various pressure groups—that their backbones must be stiffened by replacing a simple majority requirement with a constitutional provision that calls for two-thirds majority approval as the prerequisite for either the enactment of new taxes or a decision to raise expenditures significantly. In effect, this hard line approach gives the conservative minority a veto power over all major tax or expenditure decisions. It, of course, completely undercuts the concepts of representative government, majority rule, and fiscal flexibility—the Jarvis prescription.

A policy of strengthening political accountability will also come under fire from the left side of the political spectrum. Liberals are apt to oppose some of these policies in the grounds that they represent a foot in the door for the fiscal conservatives. Many liberals believe that the public sector is still undernourished, particularly in those program areas that are of most concern to the poor and minority groups. Thus, in their judgment, tax and expenditure questions should be resolved in favor of meeting these urgent public needs—not in figuring out new ways to slow down the growth in state and local government.

Confronted with these conflicting demands and philosophies, many policymakers will opt for the middle course—that of slowing down expenditure growth rates by strengthening the political accountability of elected officials.

Third, when is a state justified in imposing a tight, permanent, lid on local property tax authorities? In the judgment of the Advisory Commission, the state is justified in adopting a permanent, tight lid policy only if the state is willing to provide adequate financial compensation to local governments. The tighter the lid, the more persuasive the case for a new source of local revenue. Adequate compensation could take the form of a major new source of tax revenue for local governments or the enactment of a substantial state program of unconditional aid to localities.

Without this compensatory action, the trend toward fiscal centralization will become even more dramatic. This centralizing tendency was clearly underscored by our findings—while state lids on local levies reduced property tax levels, this effect was offset by higher state taxes.

Fourth, can state policymakers prevent locally elected officials from reaping inflation "windfalls" from rapidly rising property tax assessments without imposing arbitrary tax and/or spending lids on localities? This issue becomes especially acute during periods of inflation when property values generally and residential property values in particular rise at a faster clip than the income of the property owner.

In many cases, local legislative bodies fail to cut back their property tax rates roughly commensurate with a substantial hike in the tax assessment base. Thus the assessor—not the local spenders—is mistakenly blamed for the resultant increase in the property tax load.

Florida has resolved this property tax windfall issue and thereby helped to moderate the growth in local spending through the adoption of a "truth-in-taxation" procedure—rather than through the imposition of arbitrary lids on local fiscal action. The author of this pioneering legislation, State Representative Carl Ogden of Florida, recently described the full disclosure procedure:

"Every year, the tax appraisers reassess homes in light of current market values, which generally are higher than the year before. The tax rate is then reduced, so as to generate no additional revenue from the reassessment. The only 'fudge factor' is new construction, which can be taxed outside the normal rolls for the first year.

"If last year's revenues plus the fudge factor aren't enough for this year's public expenditures, the taxing unit—for example, the city council—has to put the following quarter-page ad into the local newspaper of largest circulation: 'The City Council proposes to increase your property taxes. Hearings will be held on (such-and-such a date).'

"Lest you overlook the ad, it must be surrounded by thick black border.

"If after the public hearing, the council goes ahead and raises taxes, another black-bordered, quarter-page ad must be placed: 'The City Council has voted to raise your property taxes. Hearings will be held (on such-and-such a date).'

After the second set of hearings, there's another vote. Only then can taxes actually be increased."¹

While such a procedure may appear restrictive to many local officials, it nevertheless permits them to raise rates as high as they want by a simple majority vote. In effect, local officials have as much fiscal leeway as they want to exercise—provided they're willing to accept full responsibility for their decision to raise taxes.

Fifth, what is the instrument of choice for providing property tax relief to home owners? In the judgment of the Advisory Commission, a state-financed "circuit-breaker" gets the nod. Three considerations support this judgment.

First, the circuit-breaker can provide tax relief to those who need it most at a lower cost than the homestead exemption. If the objective is to relieve residential property taxes that are unduly burdensome, the circuit-breaker can provide more meaningful relief at less cost. It targets relief dollars to those most in need of relief—those who are carrying extraordinary tax loads in relation to family income.

Second, in contrast to homestead exemptions, renters as well as home owners can be given relief under circuit-breakers. On the assumption that landlords pass on a good share of their property taxes to renters in the form of higher rents, the majority of circuit-breaker states designate some percentage of rent as a property tax equivalent which enters the circuitbreaker calculation in exactly the same manner as owners' tax payments.

Third, the circuit-breaker is less likely to encounter legal obstacles than the homestead exemption or the "split roll." Because of uniformity provisions, a constitutional amendment appears to be a prerequisite in many states for homestead exemptions on proposals to tax business property more heavily than residential property. By contrast, because the circuit-breaker can grant relief from residential property taxes without adjusting tax assessments or tax liability, the courts have consistently held that the circuit-breaker does not violate state constitutional uniformity provisions.

Our latest survey reveals a sharp increase in state reliance on circuit-breakers. In 1977, 30 states paid out almost \$1 billion in circuit-breaker relief to five million householders—contrasted to \$500 million in tax relief payments to three million householders in 1974 (Table 3).

¹ The Washington Post, June 19, 1978, p. D10.

TABLE 3.—COSTS AND PARTICIPATION RATES OF STATE PROPERTY TAX CIRCUIT-BREAKER PROGRAMS: FISCAL YEARS 1974 AND 1977¹

State	Total cost of programs (thousands)		Number of claimants		Average cost per claimant		Cost per capita	
	1974	1977	1974	1977	1974	1977	1974	1977
Arizona.....	(²)	\$7,762	(²)	38,619	(²)	\$200.19	(²)	\$3.45
Arkansas.....	\$166	676	2,798	8,916	\$59.34	75.76	\$0.08	.36
California.....	61,000	95,000	302,000	440,000	201.98	215.91	2.96	4.25
Colorado.....	2,355	11,003	27,251	58,875	86.41	187.00	.96	4.20
Connecticut.....	6,193	24,754	19,533	101,574	317.05	243.70	2.10	7.96
District of Columbia.....	(²)	600	(²)	6,000	(²)	100.00	(²)	.87
Hawaii.....	(²)	4,200	(²)	(²)	(²)	(²)	(²)	4.65
Idaho.....	1,871	4,000	15,924	17,323	117.49	231.00	2.42	4.67
Illinois.....	21,950	100,000	144,647	405,000	151.74	250.00	1.95	8.85
Indiana.....	1,800	844	44,000	28,665	40.90	29.45	.33	.16
Iowa.....	2,540	9,600	37,000	83,800	68.64	114.56	1.26	3.34
Iowa.....	3,149	8,824	31,307	62,955	100.58	140.17	1.38	3.84
Kansas.....	1,974	4,347	13,468	20,786	146.56	209.10	1.92	4.06
Maine.....	(²)	20,808	(²)	83,863	(²)	248.12	(²)	5.03
Maryland.....	129,000	275,582	810,000	1,234,800	159.25	223.18	14.26	30.24
Michigan.....	10,010	134,200	110,000	857,277	91.00	156.54	2.56	33.94
Minnesota.....	4,709	7,008	58,031	56,260	81.14	124.57	.98	1.46
Missouri.....	80	1,350	1,994	10,560	40.12	127.84	.14	2.20
Nevada.....	(²)	1,500	(²)	40,000	(²)	37.50	(²)	1.26
New Mexico.....	(²)	(²)	(²)	(²)	(²)	(²)	(²)	(²)
New York.....	35	1,198	5,052	9,969	70.00	120.20	.55	1.86
North Dakota.....	33,000	44,614	264,300	329,462	124.86	135.42	3.20	4.26
Ohio.....	(²)	357	(²)	4,159	(²)	85.93	(²)	.13
Oklahoma.....	70,730	74,140	509,000	502,575	138.95	147.52	31.78	31.20
Oregon.....	56,100	58,918	410,000	413,974	136.82	142.32	4.71	4.99
Pennsylvania.....	(²)	12	(²)	249	(²)	51.92	(²)	.01
Rhode Island.....	(²)	1,487	(²)	15,095	(²)	98.51	(²)	2.17
South Dakota.....	(²)	950	(²)	10,000	(²)	95.00	(²)	.75
Utah.....	4,731	7,670	16,400	36,516	288.47	210.05	10.19	16.08
Vermont.....	166	18	8,529	1,265	19.46	13.94	.09	.01
West Virginia.....	35,411	48,139	189,521	234,201	186.84	205.55	7.75	10.31
Wisconsin.....								
Total (21 States in 1974, 29 States plus District of Columbia in 1977) ³	446,970	949,561	3,020,755	5,112,738	147.97	185.72	4.41	6.90
Percentage increase.....		112.4		69.3		25.5		56.5

¹ For several States data are for other than year indicated, see appendix table 6.

² Not available; new program for year indicated.

³ No circuit-breaker program in 1974.

⁴ New program, data are for period Jan. 1 through Apr. 10.

⁵ Excludes the following new programs for which data was not available: 1974—Arizona, District of Columbia, and Oklahoma; 1977—New York.

Source: Appendix table 5.

Sixth, does it make political and economic sense to retain the property tax as a major source of local revenue in an inflation ridden economy? Despite obvious defects and poor public image, the property tax has significant political and fiscal virtues. First, it is the one major revenue source directly available to local government and therefore serves as the traditional defense against fiscal centralization. Second, it is the only major tax that can recapture for the community the property values created by the community. Third, its high visibility works in favor of greater public accountability.

Beyond these three considerations there is the inescapable element of fiscal realism—the Nation's local governments will not quickly come up with an acceptable substitute for this powerful \$65 billion revenue producer.

In view of the current conservative mood of the country, it is not likely that many state legislative bodies will be willing to solve the local property tax problem by granting broad new discretion to local governments to levy income and sales taxes. The legislators are far more likely to support proposals granting fiscal relief to taxpayers than to local governments.

The state financed relief will come in a variety of forms— expanded circuit-breakers, state reimbursement for partial homestead exemptions, or tax rebates for part of the school taxes borne by property owners.

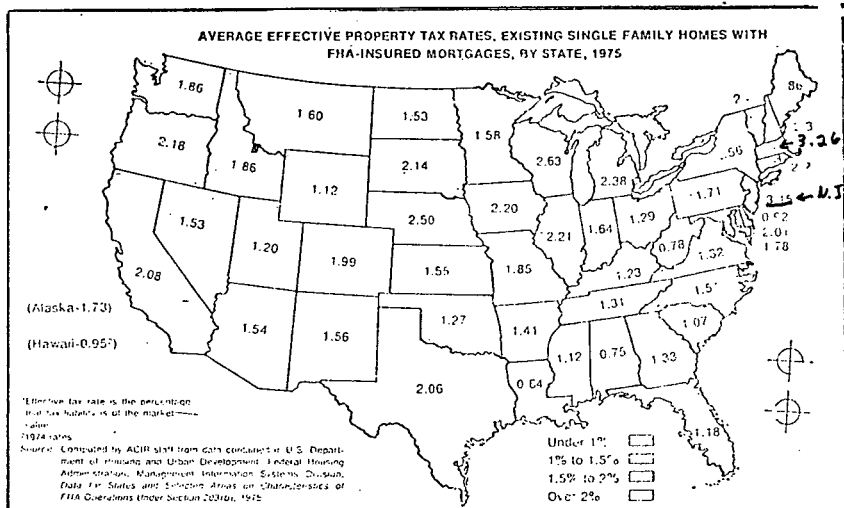
Because state "takeover" of local school costs is an extremely expensive venture, we are also not likely to see many dramatic breakthroughs on this front.

Prudent public policy, therefore, would dictate the adoption of measures designed to reduce the irritant content of the property tax levy.

Seventh, what is the ACIR prescription for keeping the irritant level of local property taxes at tolerable levels—particularly during periods of inflation?

1. A uniform system for administering the property tax marked by:
 - (a) market value appraisal of all taxable property;
 - (b) professional appraisers;
 - (c) either strong state supervision of local assessors or state administration of the tax assessment system;
 - (d) the preparation and disclosure of assessment ratio findings to enable taxpayers to judge the fairness of their assessments.²
2. A "truth in property taxation" process along the lines of the Florida plan that will enable taxpayers to fix political responsibility for higher property taxes without placing fiscal shackles on local government.³
3. A state-finance circuit-breaker system to shield home owners and renters with low and fixed income from property tax overload situations.⁴
4. An intergovernmental "fair play" policy. When the state mandates additional expenditure responsibilities on local government, it should be prepared to help finance the added expenditure burden. When a state mandates a partial or complete exemption, from the local property tax (i.e., homestead exemption), it should reimburse the localities for the revenue loss.⁵
5. A tax utilization philosophy that recognizes the best property tax is a moderate property tax. As with any other tax, the heavier it becomes the less obvious are its virtues and the more glaring are its defects. In my view, a moderate property tax should fall in the 1 to 1.5 percent of market value range. Beyond 1.5 percent of market value the amber warning light turns on—beyond 2 percent the red danger light flashes. If a state assumes the full cost of welfare and Medicaid and at least 65 percent of the cost of local schools, it will probably be able to hold local property tax levels below 2 percent of market value. (See map).

There is room for guarded optimism. Legislators in many states may find this five point reform program more acceptable than the radical surgery alternative prescribed by Doctors Jarvis and Gann. If this turns out to be the case, June 6, 1978—Proposition 13 Day—will also become a red letter day in the long and troubled history of the property tax.



² ACIR, "The Role of the States in Strengthening the Property Tax," A-17, reissued 1976. ACIR has drafted suggested legislation to implement these recommendations.

³ ACIR, "State Limitations on Local Taxes & Expenditures," A-64, 1977. ACIR has drafted suggested legislation to implement this recommendation.

⁴ ACIR, "Property Tax Circuit-Breakers: Current Status and Policy Issues," M-17, 1975. ACIR has drafted suggested legislation to implement this recommendation.

⁵ ACIR, "State Mandating of Local Expenditures," forthcoming report. ACIR has drafted suggested legislation to implement this recommendation.

Representative MOORHEAD. The two committees would now like to hear from Mr. Lyle C. Fitch, president of the Institute of Public Administration.

STATEMENT OF LYLE C. FITCH, PRESIDENT, INSTITUTE OF PUBLIC ADMINISTRATION

Mr. FITCH. Mr. Chairman and members of the two committees, I have filed a prepared statement with the committees which says "Better Government or Less Government—the Response to Taxpayer Revolt." I would like to summarize the major points of that statement.

The first point follows Mr. Greytak in its emphasis on inflation in State and local government costs and the role of inflation in precipitating the taxpayer revolt. In brief, what has happened in the last 20 years is that the unit cost of goods and services purchased by local governments in order to provide public services, unit costs have increased by some 189 percent compared with an increase in the cost of consumer goods and services of something like 104 percent. So there has been a dramatic inflation and the cost of the inflation going into the State and local government process, compared with the cost of consumer goods.

Second, the amount of resources used by State and local governments, per capita increased by 100 percent in the last two decades. In other words, State and local governments are now using twice the amount of resources for each man, woman, and child that they did two decades ago.

Now I doubt if many taxpayers are getting double the services. On the contrary, we have seen services declining with the result of increasing school dropouts, more traffic congestion, dirtier streets, worsening public transportation, rise in delinquency, and the rest.

There are many reasons for the rise in per capita costs and some of them do reflect increased services. But being a battered old public administrator, I conclude that there was a substantial drop in productivity of State and local government services industries and that the average citizen is not wrong in concluding that he is getting relatively less from his taxes than from most other purchases that he makes.

Of course this is what the antigovernment people of whom I do not count myself one have been telling us all along.

We next have to consider whether the eating up of the heating up of the taxpayer revolt can return to good account in providing better government as opposed to merely cutting services and having less government because of the fact that government reforms usually result when the money runs out or when the machinery becomes glaringly inadequate or when the existing power structure gets into difficulty because of corruption or mismanagement.

There are two main approaches which I would like to mention briefly. The first is structural and administrative overhaul.

There is a long and lengthy agenda of structural procedural reforms. Most of them have long been advocated by your distinguished chairman, Congressman Reuss, and I won't go into this. But the greater structural deficiencies are in the large urban areas where

government is a thicket of municipalities, regional agencies, and special districts, counties, all of which are incomprehensible to most stages.

Ten years ago the Committee for Economic Development noted that there were 80,000 local governments in the United States, most of which were too small to function efficiently. The CED thought the country would be much better off with only one-tenth of that number. With local governments large enough to operate efficiently. However, I have always had some reservations about cutting back so drastically because structural reform and paraphernalia by themselves don't assure good performance. New York City is the case of a government with all the paraphernalia of modern administration. It was the first and is still the largest metropolitan consolidation with well-staffed planning and personnel agencies. It has a strong executive equipped with professional assistants and it has gone through periodic charter revision to keep the system up to date. But all of this doesn't keep the city from getting into a horrendous financial pickle, mainly through skyrocketing costs financed by short-term borrowing. We have had tax and debt limits, but these are circumvented with connivance and assent of the State government, the cities' elected officials, the public employee unions, and the banks; all of which stood to gain in the short run by the city's financial irresponsibility.

I, therefore, suggest that the main problem of many governments is not an adequate size by arteriosclerosis of the bureaucracy and the lack of incentives for economizing. Government agencies by nature are more interested in organizational growths, status, and power than service improvements and economical functioning. I think this is one thing we have to keep hammering at.

The second thing toward improving government costs is through productivity which implies providing more government services and more relevant services, with less resources. A raise in productivity involves overcoming a lot of negative factors, using crude and effective management and supervision, lack of employee incentives, and hostility of employee organizations to the very notion of productivity. It also involves putting greater emphasis on a number of positive factors, including greater utilization of technology, more effective job analysis, overhauling antiquated civil service systems, and introducing better definitions of agency objectives and measures of performance.

On a still higher plane productivity means modifying those notions of hierarchical control and devising new patterns of organizational structure and new incentive systems for executive supervisors and street level workers. Such things are especially difficult to achieve when programs are being cut back and workers are being laid off. When layoffs are by seniority, there is no relationship between quality and performance and job security. New methods, new machines, and innovations cannot be financed when money is tight.

But in conclusion, I think that the taxpayer revolts manifested by Proposition 13 and less drastic measures can accelerate the pace of Government improvement. Both structural improvement and productivity improvement depend on strong political leadership which can mobilize and sustain support from citizens, business and taxpayer groups, and other constituencies. But the payoff is long run, not short

run, and this is a heavy handicap for elected officials where horizons extend only until the next election.

Continued interest is most likely centered on officials dependent on the number of votes which can be garnered by vigorously sponsoring Government reform, which is a grubby business at best. The Federal and State governments can lend a hand by putting their own grant programs in better order and making judicious use of the power of the purchases to promote structural reform and encourage productivity.

Finally, how can taxpayer resistance constructively affect government expenditures in the short run? I would say mainly by flashing the "go slow" signals to officials, legislators, and employee unions. As Governor Carey of New York put the matter in his inaugural address in January 1975, "The days of wine and roses are over."

The great danger is that cataclysms like Proposition 13 will lead to drastic expenditure reductions which wipe out the amenities of urban existence beginning with parks, recreation, libraries, and the arts. This leads me to say that crash economy programs, like crash diets, are almost invariably ineffective; they usually damage the patient, they are painful, and are soon abandoned. Truly effective government economizing, like weight reduction, requires laying out a well-balanced diet and sticking to it.

Thank you.

Representative REUSS. Thank you very much, Mr. Fitch.

[The prepared statement of Mr. Fitch follows:]

PREPARED STATEMENT OF LYLE C. FITCH

Better Government or Less Government?—The Response to Taxpayer Revolt

WHY TAXPAYERS REVOLT—THE COST EXPLOSION

Whether Proposition 13 is a highwater mark or only an interim marker in the contemporary American tax revolt, it clearly calls for greater effort than we have seen to date to check government expenditures and taxation. California voters opted for an absolute reduction of property taxes while making it difficult to replace them with increased state or local nonproperty taxes. It is less clear that they opted for reduced services, but many seem to have felt that the cost of public services has been outrunning benefits, implying that the extra bang is not worth the extra buck.

The revolt has been gathering steam for years, of course, with many communities vetoing increases in school and other budgets, and several states putting new limits on state-local expenditures and taxes. For example, New Jersey two years ago tied state expenditure increases to the growth in New Jersey state income payments, and put a 5-percent limit on annual increases in local government budgets. Tennessee is moving to put similar restrictions into the state constitution. More or less draconian measures are being urged on many other states.¹

How account for the whopping increase in state-local government expenditures in the postwar period? Professor Greytak has discussed the factors accounting for recent increases in government expenditures. I want to emphasize two points which bear on what I will say later.

1. In the twenty-year period 1957-77, the unit cost of state-local government increased 179 percent compared with an increase of 108 percent in the price of goods and services purchased by consumers.² This was in large part due to the fact that average wages of state and local government employees more than

¹ "States Vie to Curb Taxes, Spending." *Congressional Quarterly*, July 8, 1978, pp. 1727-30.

² The indices referred to are the Gross National Product deflators for state and local government and consumer goods and services, *Economic Report of the President*, 1978, Table B-4.

trebled. Contrary to the claims of public employee unions, the average wage of state-local government employees started higher and rose faster than the average wage in the private sector until the early 1970s when taxpayer resistance began stiffening and the increase rate slowed to approximately the pace of private-sector wage increases.³

2. Adjusting for inflation and for population increases, we find that per capita real expenditures on state-local government services approximately doubled. This datum measures the amount of manpower and other resources which state and local governments bought in order to provide public services.

To complete the picture, transfer expenditures, mainly welfare and related grants, went from \$4.8 billion to \$20 billion.

The most significant fact is that the per capita real cost of state and local government doubled. Other things being equal, the quality and quantity of public services—government outputs—also should have doubled, to match the increase in input. But while it is impossible to measure the quantity of government outputs, let alone the quality, I see little reason to believe that per capita output rose by anything like 100 percent. On the contrary, many indicators point to a decline in the quality and quantity of amenities affected by public services as evidenced by increasing school dropouts, growing traffic congestion, worsening public transportation, dirtier streets, deteriorating housing stock, and other indications of declining public-sector effectiveness.

Granted that for several reasons the real cost and difficulty of providing some types of public services did increase, particularly in central cities which had to take care of increasing proportions of low-income groups in need of special education, social and other services. Nonetheless, it is difficult to escape the conclusion, which is supported by special studies of several limited areas,⁴ that productivity of state and local government service industries declined substantially over the period. Averages are deceptive, and we can expect great variation in the performance of state and local governments. But the average citizen of many states and localities is not wrong in thinking he is getting less from his tax dollar. Parallel data from the federal government, on the other hand, indicate moderate increases in productivity and this indication is borne out by reports of the federal government's Joint Financial Management Improvement Program.

Meanwhile, inflation and declining productivity in the economy at large frustrated taxpayers by whittling away their purchasing power. The weekly wage of the average private-sector worker bought less in 1977 than in 1969, and this is true of wages in most occupational sectors. The purchasing power of per capita disposable income (income after taxes) was lower in 1974 and 1975 than in 1973, and modest increases in 1976 and 1977 barely made up the gap. In other words, per capita purchasing power in 1973 approximately equalled the average of the following four years.

To cap the climax, the eruption of the Watergate scandals created an atmosphere of distress in national government which overflowed into state and local governments. This, added to inflation and depletion of purchasing power and the soaring costs of state-local government, contributed to the growing taxpayer revolt by giving plausibility to the conservative credo that government has gotten out of hand.

Financial brinksmanship

Fiscal emergencies are nothing new to state and local governments. In particular, large cities in the midwest and east such as Cleveland, Detroit, St. Louis, Philadelphia, and Newark have been living for years in a state of financial desperation stemming partly from economic decline and partly from taxpayer resistance.

Responses to revenue shortfalls come more or less in the following order:

1. Position freezes and vacancy controls, and suspension of travel allowances and transportation and other perquisites of higher-level employees. Position freezes are economy by happenstance since they fall wherever vacancies happen to occur. Economizing out on executive perquisites may strike at needless ex-

³ The averages conceal a great diversity among governments and among employee groups. In some states and cities public employee compensation still lags behind that of comparable jobs in the private sector, in others, public pay rates have exceeded private. Usually this situation is found in the mass-employee occupations, though in a few cases middle- and higher-level occupations have outrun lower.

⁴ John P. Ross and Jesse Burkhead, "Productivity in the Local Government Sector," Lexington Books, 1974; David Greytak, Donald Phares and Elaine Morley, "Municipal Output and Performance in New York City," Lexington Books, 1976.

penditures but may also reduce employee effectiveness and deter professional development, and thereby increase the difficulty of recruiting management talent.

2. Reductions in force. These are usually in order of seniority, striking the younger and more vigorous employees and the minority groups who are particularly dependent on public employment because they have fewer private-sector opportunities. Many people laid off will draw unemployment compensation and eventually public assistance, so that the net effect is to shift the cost of maintaining them to other pockets while wasting whatever contributions they might have made if employed.⁵ Layoffs may be across-the-board or may reflect a considered set of priorities in which basic services such as police, fire, sanitation and health are favored at the expense of amenities such as libraries, parks and recreation, school enrichment programs, and the arts.

3. Top administrators and legislators, who are usually most careful about new programs, will give more attention to ongoing ones and will comb over old programs in search of places to cut, even though they do not go all the way with zero-base budgeting. Managers may uncover opportunities for genuine economies or may employ the old trick of cutting services whose loss will be most conspicuous and keenly felt, but this has dangers since it is likely to be exposed by unsympathetic sources—the party out of power, the media, or sharp-eyed civic organizations. Alert agency heads will draw upon program planning and budgeting techniques, better to justify their program requests. In governments which have long been strapped for funds, however, there is little room for reordering priorities and savings through administrative reform because existing agencies and ongoing programs have survived the harsh political test of survival of the fittest. The budget-making process of one such government has been described as follows:

“There is loose talk to the effect that budgetmaking involves resources allocation. So far as the few American cities we know are concerned, we believe this rumor to be unfounded. . . . Since cities are in a financial straitjacket and officials can make only small changes in their budgets, the rationale for resource allocation is not entirely clear.”⁶

4. All expenditures that can possibly be deferred will be, particularly maintenance expenditures and capital outlays. Hard-pressed city and county governments have already been doing this for years; consequently vast amounts of deferred maintenance are accumulating, with water and sewer mains falling apart, streets filled with potholes, and deterioration of highways and bridges to the point where they have to be closed. Bridges are an especially serious problem in cities which depend heavily on them, such as New York and Pittsburgh.

5. Since a major cost-increasing factor in many jurisdictions has been large wage and pension increases, one of the most important effects of taxpayer resistance may be to stiffen resistance to pay any fringe benefit increases while tempering union demands. It is unfair to blame unions alone for kiting labor costs, however, since management has to agree to settlements. New York City got into trouble because its management not only agreed to impossible settlements but borrowed money to pay the bills until the city's credit was gone.

How to economize

In considering how to hold down government costs, taxpayers need to determine whether they want less government or better government, or perhaps both. A distinction must be drawn between the anti-government people who want government cut back on ideological grounds, and those who have concluded that government is simply wasteful and ineffective and need to be assured that it can perform better. I think that results of recent polls show that a majority of protesting taxpayers are in the latter group; they simply have concluded that they are not getting their money's worth and are demanding tax reductions even if this means giving up some overpriced services. The fact that so many single out welfare is probably a result of seeing their own aspirations frustrated by inflation and the economy's mediocre performance.

Government reforms commonly result when the money runs out, or when existing machinery becomes glaringly inadequate, or when the existing power

⁵ Federal CETA grants have made it possible for states and localities to avert some of this waste.

⁶ Arnold J. Meltsner and Aaron Wildavsky, “Leave City Budgeting Alone!” in John P. Creene, ed., “Financing the Metropolis,” Sage Publications, 1970, p. 311.

structure gets into trouble because of conspicuous incompetence or corruption. The contemporary taxpayer revolt and financial troubles of many local governments may give new impetus to government improvement through structural and administrative reform and to more rigorous cost controls as an alternative to drastic cutbacks in public services.

Lagging capacities of State and local governments

In discussing whether the taxpayer revolt can be put to good account in improving state-local government, I will look first at existing deficiencies and the agenda for reform.

State governments have come some distance in the last decade since the Committee for Economic Development complained (in 1967) that many of them lacked the requisite organizational and administrative tools for effective performance,⁷ and the Advisory Commission on Intergovernmental Relations noted (in 1970) that most state governments are on the verge of losing control over mounting problems of central-city deterioration and the rapid growth of metropolitan areas.⁸ To mention a few areas of improvement:

States have proceeded with a standard agenda of administrative reform, including departmental restructuring, strengthening of accounting and budgeting, etc.; taken over functions formerly performed by local governments; increased grants to local governments; established agencies which furnish information and technical assistance to local governments; passed enabling legislation for intergovernmental service agreements, regional organization, service transfers to county governments, etc. On the debit side they have yielded to pressure from local government employee groups, piling costs on local governments in violation of home rule principles; harpooned municipal administrative and planning reforms; further complicated local government structure by creating new special districts and substate regional agencies; and engaged in other disorderly conduct. But most conspicuous have been their sins of omission—not moving faster to tidy their own houses; rescue their faltering cities; and prune their local government jungles. It should be noted, however, that without local support and cooperation state governments are limited in what they can do, particularly in the strong home rule states.

As for local governments, the Committee for Economic Development in 1966 noted the following deficiencies, most of which are still around.

Very few local units are large enough—in population, area, or taxable resources—to apply modern methods in solving current and future problems. Even the largest cities find their major problems insoluble because of limits on their geographic areas, their taxable resources, and their legal powers.

Overlapping layers of local government abound—municipalities, townships, school districts, special districts—which in certain areas may number ten or more. They may all have power to tax the same land, but frequently no one has the power to deal with specific urban problems, or to coordinate related activities.

Public control of local governments is ineffective or sporadic, and public interest in local politics is tepid. Contributing factors are the confusion resulting from the many-layered system, profusion of elective offices without policy significance, and increasing mobility of the population.

Most units are characterized by weak policy-making and antiquated administrative machinery. Organizational concepts considered axiomatic in American business firms are unrecognized or disregarded in most local governments.

The administrative process is handicapped by low prestige of municipal service, low pay scales of administrative and executive personnel, and lack of knowledge and appreciation on the part of elected officials and legislators of professional qualifications.⁹

Structural reform

A CED policy paper drafted by Dr. Alan K. Campbell, present Civil Service Commission chairman, advocated two-tier metropolitan government with region-wide jurisdictions performing functions which for various reasons need to be handled on a metropolitan scale, and community jurisdiction performing

⁷ "Modernizing State Government." 1967.

⁸ ACIR, "Federalism in 1970." 12th Annual Report, p. 7.

⁹ CED, "Modernizing Local Government." 1966.

community-scale functions.¹⁰ Subsequent ACIR reports have explored at length the various functions and sub-functions appropriate for each level.¹¹

The concept of metropolitan jurisdictions—to administer and coordinate metropolitan-scale functions and to equalize the financial burdens of providing urban services—has been around for some decades without having made any great impact on the American governmental system. New York City's consolidation, which occurred in 1898, is still the only example of consolidation on a grand scale. Other metropolitan organization has been on a much less ambitious scale, with a dozen or so county-city consolidations, mainly in the south, and expansion of city boundaries through annexation in states which permit this solution; multi-purpose regional organizations in Seattle and Portland, and the well-publicized Twin Cities Metropolitan Council. County governments have increasingly taken over and coordinated large-scale functions and are the handiest solution where they are big enough, but in many metropolitan areas functions spill over county boundaries and in some areas over state boundaries.

Purposes of metropolitan organization

There are three main purposes: (1) scale economies involving functions which can be performed most cheaply, or performed at all, only by metropolitan-wide agencies; (2) coordination of metropolitan functions; and (3) fiscal equity which involves sharing tax burdens of services which benefit both city suburbs, and of special services required by low-income disadvantaged groups.

Scale economies are most adequately achieved of the three purposes, usually by single-function special districts or authorities, of which there are now some 8,000 in the country's metropolitan areas.

Coordination of metropolitan functions is much less adequate because of the penchant for special districts. Some coordination is achieved through the numerous councils of governments (COGS) and federal requirements for grant application review (commonly handled by the COGS), but most COGS have little muscle beyond their review powers and correspondingly little control of the policies of their member jurisdictions or of the special districts. The ACIR has recommended the creation of umbrella multijurisdictional organizations (UMJOs) as a means of improving coordination.¹²

Equalization of fiscal burdens, the third main objective of metropolitan organization, is usually desired by the central cities but almost everywhere opposed by most suburbs. It is more amenable to alternative solutions than are the other objectives, since state and/or federal governments can assume the cost of providing welfare benefits and special services to low-income groups who congregate in central cities and older suburbs.

Another and separate problem is the continuance in some areas of many general-purpose municipal governments which are too small to perform efficiently or adequately the functions assigned to them. The solution of combining small units into larger ones, or into metropolitan general governments, has never taken hold in the United States (except in the instances noted above) for several reasons. One is the attachment of residents to their own communities and their fear of domination by larger entities. Another is the people's choice principle, particularly admired by economists, of maintaining a number of jurisdictions with different amounts and kinds of services in order to provide a variety of choices to urban residents. A third is the principle of neighborhood or community control, which argues for smaller jurisdictions as a means of giving residents a larger voice in the decisions that affect them.

There are two other obstacles to metropolitan consolidation, less justifiable but still politically potent. The first is a fear of racial integration on the part of suburban whites, primarily concerned with the impact on property values, and central-city blacks who fear that black dispersal would diminish their political power. The second obstacle is officials of small municipalities who resist the idea of displacement and possible unemployment which would result from consolidation.

Bottom-up reform

The CED's second proposed reform is based on the premise that units of government wherever possible should be small enough to enable residents to

¹⁰ Committee for Economic Development, "Reorganizing Government in Metropolitan Areas," 1970.

¹¹ Advisory Commission on Intergovernmental Relations, "Government Functions and Processes: Local and Area Wide;" Substate Regionalism and the Federal System, vol. 4; A-45, 1974; also, "Improving Urban America: a Challenge to Federalism," M-107, 1976.

¹² ACIR, "Improving Urban America," Chapter 4.

have some voice and control. This version of "maximum feasible participation" applies to a variety of services which may appropriately be handled by small to medium sized units. "Voice and control" might include the power to allocate part of all of the funds available for public services in the community, and the power to implement such decisions by hiring personnel, purchasing materials, and making contracts, and the power to sign checks—in short, the budgetary—expenditure powers ordinarily exercised by municipal general governments. There are several arguments for such decentralization, including the public-choice principle and the participation principle—previously noted in the discussion of consolidation.

Also there is an administrative efficiency argument which holds that giving a community greater control over suppliers through the power to hire, fire and make contracts will compel a bureaucracy to pay attention to clients' needs and serve them more effectively.

Though I am not unsympathetic with these objectives, I have always wondered why deconsolidating existing urban governments should produce any better results than the already-existing small suburban governments whose members, particularly the poor ones, are not models of administrative competence, however much beloved by their residents. I am also bothered by the fact that in most experiments with decentralization I have observed, the decentralized units have failed to improve services regardless of their other achievements. Decentralization in New York City's educational system was followed by an accelerated decline of pupil performance, a sharp increase in administrative costs, and in most districts minimal involvement in communities.

I would certainly agree that the urban poor generally, and large-city poor minority groups in particular, should be more involved with public decisions that affect them. But there are less drastic mechanisms for achieving participation, including community councils which are consulted on development plans, service priorities, and similar matters; neighborhood service centers to make health, welfare and other services more readily accessible to clients with regard to both hours and locations; and devices for improving communication between neighborhoods and central agency administrators. Even such relatively simple measures have not been exploited by most cities, although an increasing number are moving to improve communication and access, including access to services.

One difficulty is defining "communities." Sometimes they already exist but more often they do not. Annmarie Hauck Walsh has observed that:

"Power never did reside in general population groups within the neighborhoods of our large cities, and it remains to be seen if there is any sense of community in most of them. Their image of neighborhood power has cultural roots in our ideology, namely our yearning for a town-meeting society, but it has little place in urban political history."¹³

The taxpayer revolt and structural reform

Can action on the long agenda of needed structural reforms be accelerated by taxpayer revolts? I think it can be, but only if there is forceful political leadership to mobilize taxpayer support. California's governor, as part of the response to Proposition 13, appointed a commission to consider the state's basic condition, including its economy and governmental organization. Already there have been some significant changes in state intergovernmental relations as a result of the fiscal rescue effort designed by the governor in cooperation with a select legislative committee and passed by the legislature. These changes include:

A state takeover of county welfare, food stamps and health functions.

Allocation to counties of funds for special districts and authorities, which makes these units dependent on locally elected county officials. This may pave the way for creation of multipurpose authorities, which may in turn achieve better coordination and reduce overhead costs.

City authorization to raise charges and impose new charges, which may lead to greater use of public pricing—an objective advocated by many economists.¹⁴

In addition, the diminished fiscal capacity of local government and increased dependence on the state will inevitably trigger other moves, including moves required for maximum utilization of federal grant programs.

A degree of preference to poor districts in allocating school funds, continuing the state's gradual adjustment to the Serrano decision requiring more equitable access to school finance resources.

¹³ "What Price Decentralization in New York?" "New York City Almanac," June 1972.

¹⁴ See Selma Mushkin, "Public Prices for Public Products," The Urban Institute, 1972.

The most significant single effect of Proposition 13 has been the shift in financial and other powers to the state government in what traditionally has been a strong home-rule state.

New York State also moved strongly to rescue several of its faltering cities from financial collapse, most prominently the Big Apple. When New York City proved unable to handle its own finances and required outside help to get the budget under control, the state created the Emergency Financial Control Board with wide powers over city budgeting, including the authority to review financial plans and modifications, contracts and proposed borrowing for conformity with the long-term objective of restoring a balanced budget. The EFCB was an important structural change which now seems likely to endure indefinitely, though it is hotly opposed by the city employee unions.¹⁵

The New York State intervention was an emergency measure, not concerned with government organization or managerial structure. But many other things have been going on, including increased financial assistance to local governments, including New York City. The governor also set in motion the latest round of New York City charter reforms which culminated in the adoption, in 1975, of a new city charter designed in part to correct the management deficiencies which had led the city to the verge of bankruptcy. Thus far, however, the new charter changes have made little difference in the way the city actually operates or in its management structure.

Another interesting organizational innovation prompted by financial desperation was creation of the Metropolitan Transportation Authority, which in 1967 put under one organizational roof the city's subway and bus agencies, the New York commuter rail services, and the Triborough Bridge and Tunnel Authority. The basic purpose of the consolidation was to enable the use of the Triborough Authority's surplus revenues, derived from auto tolls, to meet transit and commuter rail deficits. As a management organization, however the MTA has been ineffective; it lacks even the information for managerial supervision. Operations, long-term planning, budgeting and policy coordination are still largely in the hands of individual agencies which were brought together in the consolidation.

Without going into more detail, I will jump to a conclusion about structural changes which involve established organizations: they usually take a long time in gestation and winning approval, and a long time for effective implementation. Government reorganization, whether toward metropolitan consolidation or deconsolidation of existing government, is not calculated to produce savings in the short run. Metropolitan consolidation has been primarily a means of spending more money more efficiently, not of spending less money. It ordinarily concerns regional water, sewage disposal, air pollution control, transportation and, more recently, manpower programs, economic development, and health programs. Most of these involve raising expenditure levels to meet needs not previously met or, in many cases, not even recognized.

IN QUEST OF PRODUCTIVITY

Despite the fact that governments have fallen far short of meeting organizational and other standards which most of the experts tell us are needed for effective performance, many state and local governments have made some progress in the last two decades, a few have made considerable progress. Notwithstanding, productivity seems to have declined, as measured by results. But are the indifferent results attributable merely to the fact that the difficulty of the problems increased so greatly that they couldn't be handled as well even by doubling the resources employed? I think not, for we can identify a number of other factors associated with productivity decline.

1. The considerable amount of manpower going to make up for improvement in working conditions: shorter work weeks, lighter work loads, increased vacation time and work breaks, more sick leave, et cetera.

2. The continued deterioration in many state and local governments of technical, professional and managerial positions, three occupational groups which generally are not protected by strong unions, by adequate civil service structures or by political constituencies.

¹⁵ The State also created the Municipal Assistance Corporation (MAC) to serve as a surrogate borrower for the city. MAC obligations are backed by a first claim on city sales tax revenues.

3. The continued degeneration of civil service and merit systems into instruments for protecting mediocrity and defying administrative control, tendencies which are strengthened by the increasing power of public employee unions.

4. Whereas capital-intensive industry, notably manufacturing, offsets such productivity-reducing factors by providing workers with more machine power, in government, which is labor-intensive, opportunities for mechanization have been more limited and existing ones tend to be smothered by featherbeds.

5. The anti-poverty programs of the 1960s encouraged the creation of new organizations—community action agencies, concentrated employment programs, neighborhood service centers, model cities programs, etc.—in many cases outside the established political and administrative framework. In the process, old-fashioned notions of organization, management, and accountability went largely down the drain, and many cities are still repairing the damage.

6. The most important fact that elected officials and legislators tend to be more interested in inputs—jobs, franchises, contracts—than in outputs—delivery of goods and services. Dominance of output interests leads naturally to rising government costs and deteriorating government outputs.

I continue to be impressed by the multiplicity of demands on the public sector. One of the greatest impediments to economy in government is that the interests of those who want economical and efficient public services frequently clash with the interests of those who want jobs and contracts, union expansion and security, welfare and other direct grants, and other rewards of political influence. These conflicts tend to be greatest in heterogeneous jurisdictions, particularly the large cities with heavy concentrations of poor minorities. Smaller and medium-sized cities, dominated by middle-class interests, tend to put greater stresses on services, good management and productivity.

Chances of cost reduction through productivity

Like the abominable snowman, productivity in state and local governments has a devoted body of faithful believers, while skeptics believe it is largely mythical.

Views and hopes for the potential of achieving productivity for the public sector in general and state-local governments in particular span the spectrum. At one end is the view that the service industries, including public service, are inherently resistant to productivity measures—a view that is based on rather superficial examples such as services of barbers, musicians, and like occupations. At the other end is the view that the service industries are an undeveloped frontier of productivity, and that there have already been enormous gains; for example, recordings and electronic transmission enormously multiply the listeners served by musicians and musical ensembles; home kitchens have become heavily mechanized; earth-moving equipment has replaced the pick and shovel; and so on. More pertinent to government paper and data processing are the computer and word processing revolutions.¹⁶

In the opinion of management enthusiasts, equally significant potentials lie in management improvement with the main emphasis on planning, goal setting, program development, program monitoring and evaluation, continuing appraisal of employee performance and accountability, reiterative use of information for program improvement, and responsiveness to changing client needs.

My own appraisal of the potential runs somewhat along the following lines. In some cases agencies faced with loss of funds may accept the challenge and find ways of maintaining their level of services as by improving procedures or redeploying personnel, or redefining the services. But more basic programs to get at the root causes of low productivity, involving subtle changes in techniques, attitudes, communication, worker-supervisor relationships, and incentive structures, cannot be developed and implemented under a fiscal gun. Programs are being cut back and workers are being laid off, when tensions and resentment are usually high, and workers are preoccupied with fear of the pink slip and the falling axe. Even where the layoffs go largely by seniority, there is no relationship between quality of performance and continuance on the job, and correspondingly little incentive for extra effort. It is difficult to increase personnel productivity by machine power if there is no money to purchase and install machines and go through the necessary period of breaking in and adjustment which usually attends any innovation that involves a change in routine. Training and executive development programs are likely to be pruned, and short-

¹⁶ See Theodore Levitt, "Management and the Post Industrial Society," *The Public Interest*, Summer 1976.

handed agencies ordinarily must spend all of their time dealing with exigencies of the moment and have little left over for devising more effective means of operation.

Back to management

"The gloomy account of a low-productivity service economy," Leavitt observes, "is rooted in an almost wanton disregard of the historical role and future possibilities of the managerial arts for improving labor productivity."¹⁷

There is a familiar litany of management deficiencies which includes: lack of a progressive management philosophy, lack of provision for an effective administrative class in the civil service, too few management positions, erosion of management authority and effectiveness through expansion of collective bargaining; a long-standing lack of adequate compensation for managerial positions; lack of incentive for and bureaucratic obstacles to productivity innovations; inflexible and inappropriate civil service regulations. However, productivity problems cannot be solved simply by enlisting a corps of trained management people and handing them authority to "manage." To begin with, government bureaucracies, particularly the more professionalized ones, resist outside control whether from chief executives, citizens boards or legislatures, as "political interference" with their functions and prerogatives.

Moreover, management control, particularly in large public-sector organizations, is limited by the fact that the actual work is done by the "foot soldier out on his own on the beat, on the garbage truck, or in the classroom," so that "urban bureaucracies have precious little administrative control over service delivery at the crucial point of contact between city and citizens.¹⁸ In such a context, productivity is at best a gossamer concept, much easier to damage than to improve.

Management experts, particularly those with business or engineering orientations, put great stress on defining and measuring outputs. My own observation is that unless handled very carefully they will likely be seen as aspersions on professional integrity, or threats to employee security or working conditions. Moreover, as I have previously stressed, outputs of many government activities cannot be closely defined and the objectives of government activities are frequently vague and conflicting.¹⁹

The attitude of workers toward productivity in some degree reflects the attitude of the top executives who in turn take their cues from public attitudes. Unless business and citizen groups show an active interest in productivity, it is likely to have low priority and the expert personnel required will be crowded out by patronage requirements.²⁰

The public employee unions have been suspicious of productivity, which is at odds with the traditional goal of more pay for less work and which implies stretchouts, work quotas, and management snooping. Such biases may be softened by relating productivity to compensation gains and making cost-of-living adjustments dependent on demonstrated "productivity savings." But such measurements tend to degenerate into a mere numbers game unless they are carefully supervised and audited from the outside. In any case, they run into the familiar difficulty of measuring public-sector productivity.

In some cases, a fiscal crunch can help avert productivity losses by easing pressure for employee benefits which reduce working time. However, it should not be imagined, as naive consultants sometimes do, that productivity can be increased by eliminating benefits already won, such as holidays, training and vacation time, and so on; once having become imbedded in the system, productivity-defeating benefits are almost impossible to dislodge. New York's mayor rediscovered this fact during the wage negotiations in the spring of 1978 when he insisted on "givebacks" in return for wage increases, and lost the argument. On the other hand, skillful and persistent bargaining, can obtain important concessions—for example, the Seattle transit system has obtained union agreement to use part-time workers to handle rush hour shifts; a similar limited conces-

¹⁷ *Ibid.*, p. 71.

¹⁸ Douglas Yates, "Service Delivery and the Political Order." in Willis D. Hawley and David Rogers, eds., *Improving the Quality of Urban Management*, Sage Publications, 1974, p. 219.

¹⁹ Aaron Wildavsky, *New York Affairs*, Spring 1977.

²⁰ The poverty-prone minority groups pay little attention to productivity issues; although they suffer from poor services they ascribe them to the discriminatory system rather than to low output-input ratios. Their leaders tend to be more concerned with jobs and status symbols than with service improvement.

sion was obtained by the New York City transit system. This one innovation could significantly reduce costs of the labor-intensive transit industry.

A major problem of state and local government labor negotiations is that government representatives tend to regard themselves as mediators between workers and taxpayers rather than as negotiators. Until recently the rewards of meeting employee demands and of avoiding strikes and other job actions have been perceived to outweigh taxpayer protests. Stiffened taxpayer resistance is changing this attitude, but the responses vary. California has imposed a wage freeze on state employees, and local governments must follow suit. In New York City, the unions hung tough, fortified by the city's continued dependence on pension funds as a source of financing. Despite an ostensible wage freeze, employees have continued receiving cost-of-living adjustments (COLAS) plus substantial increases in the 1978 round of wage negotiations.²¹

Outside support for productivity

State and federal governments can help the cause by measures to encourage productivity in lower-level governments and judicious use of the grant system for this purpose. The Committee for Economic Development has recommended "that state governments establish and enforce minimum standards for local government budgeting, accounting, and performance and reporting systems that would provide data on the level, quality, results, and costs of services. . . . where enforcement [of data requirements] proves difficult, states could require compliance as a condition for receiving state grants." Also, "State governments should provide financial assistance to local governments for the purpose of developing and implementing performance measures, experimenting with or implementing techniques or programs that have the greatest likelihood of success, and undertaking other programs that would improve productivity."

As for the federal government, "we recommend that federal grants, including revenue sharing, block grants, and categorical programs be redesigned to encourage improvements in the structure and internal management of state and local governments that will enhance productivity."²²

In considering upcoming legislation for Federal grant reform, the Congress should also keep in mind last year's complaint of the National Governors' Conference that:

"Congress continues to legislate more narrow and special purpose programs which, added to hundreds of existing programs, lead directly to an unmanageable maze of conflicting regulations and requirements. These impediments unnecessarily divert state and federal resources to paperwork and other overhead which should be used for services. Programs are often poorly drafted and passed without a clear understanding of their impact on state and local budgets or administrative structures. Federal, state and local program administrators cannot make rational budgetary or administrative decisions, recipients cannot understand what is expected of them, and the public is irate over government's inability to be responsible.

"The Ninety-Third Congress passed 'landmark legislation' to reform the way in which it dealt with the budget. . . . The same principle must now be extended to the process by which programs are created, amended and extended. The intergovernmental process cannot be effectively managed until it is simplified and categorized; the creeping recategorization of existing block grants must be reversed."²³

Obviously there is a lot of ground to be plowed, and higher-level governments which dispense program funds should be sticking closer to the plow. It should be noted, however, that program evaluation as a basis for continued funding has many problems which go beyond performance measurement. Once programs have been launched, personnel hired, managers selected, and money begins flowing, the shutting off of funds because management is sloppy or federal or state directives are not followed is like taking a lamb chop away from a

²¹ In principle, the cost-of-living adjustments were to be based on productivity improvements formulated through joint labor-management committees on productivity. Although there seem to have been a few genuine instances of productivity improvement, few observers believe that they are in any way commensurate with the cost of the COLAS. In fact, one union whose members claim substantial productivity increases is demanding a special wage increase in recognition thereof, over and above the COLAS and increases granted to other city workers.

²² "Improving Productivity in State and Local Government," 1976, pp. 70-1, 75.

²³ "Federal Roadblocks to Efficient State Government," an agenda for intergovernmental reform, National Governors Conference. February 1977.

hungry wolf or trying to fire a civil servant for poor work. Funding agencies may conclude that the struggle is not worthwhile and go on tolerating indifferent performance and misfeasance. Or they may be caught between a rock and a hard place with the continued dangers, on one hand, of vengeful congressmen seeking to reduce appropriations if their constituents have been damaged by strict supervision and, on the other, danger that the GAO will conduct a management audit and produce a damaging report.

To reiterate a previous point, however, productivity is not an emergency measure but the result of continuous attitude and process which will help avoid emergencies. A recent study of productivity programs put the point thusly :

"Previous experience with crash programs to improve decision systems overnight have been disillusioning. A productivity program may best evolve naturally out of continuing attention to improving the overall management of state government, beginning with a few carefully selected targets of opportunity, where opposition would not be likely to destroy the effort, where significant results are anticipated, where activities are most susceptible to measurement, and within the limitations of a available staff."²⁴

Epilogue: Congressman Reuss's reform program and what happened to the Big Apple

Congressman Henry Reuss, a long-term advocate of government modernization, wanted to use federal grants as incentives to improve state-local government machinery. The list of criteria included in the Reuss-Humphrey bill, for example, included personnel reform, overhauling state and local fiscal systems according to long-accepted principles, liberalizing municipal annexation powers, authorizing city-county consolidation, intergovernmental contracts, metropolitan councils of government, metropolitan study commissions and planning agencies, and making local governments more responsible and democratic by decentralizing power and functions back to the neighborhoods.

Recent experience has emphasized that these are essential but not sufficient conditions. New York City long ago adopted most of them. It was the country's first and largest metropolitan government; it has most of the formal apparatus of good government, including well-staffed planning, budgeting, and personnel administration; has put through three charter reforms in the last forty years (the last in 1975), and has launched productivity drives which attracted national attention. But it managed to get into a horrendous financial pickle from which it has not yet extricated itself. Underlying the city's problems were its economic decline, the arteriosclerosis of its elephantine bureaucracy, the number and range of services it tried to maintain, and low productivity. The immediate cause, however, was simply bad management and a refusal to recognize that city expenditures could not indefinitely continue rising at an annual rate twice that of revenue increases. In the period 1971-76, debt service and pension costs alone absorbed three-fourths of the increases in city-financed expenditures. By 1976 these two categories amounted to some 56 percent of the city's total revenues from its own sources.

The city's fiscal streamlining included the familiar moves previously mentioned, including laying off employees, paring services and reducing maintenance. And like a football club owner changing coaches it mounted new productivity drives. Productivity gains offer the only hope of containing the cost of government, and we are always driven back to it, even though it is often difficult to measure or even define, lacks political sex appeal, and requires the patience of Job.

But we have to keep hammering away.

Representative REUSS. Now, the very patient Congressman Cavanaugh.

Representative CAVANAUGH. Thank you, Mr. Chairman. I want to commend the chairman and cochairman of these committees for the excellent panel you have convened. It has been a remarkable education for me and I think we run the gamut of opinion on tax revolt and reform expressions.

²⁴ Edgar J. Crane, Bernard F. Lentz, J. M. Shafritz, *State Government Productivity: the environment for improvement*. Praeger Publishers, 1976.

And Mr. Fitch, you are an appropriate anchor, I think, to this panel. You have quite articulately drawn together many of the conflicts which this issue presents us. I think that the dichotomy between Mr. Jacoby and Mr. Cooper is the most dramatic that we are presented with.

Mr. Cooper, you seem to indicate that you saw in the vote for Proposition 13 no demand from the public for less government and less services; and in fact seem to indicate the contrary, that there is an ever-increasing demand and a more sophisticated demand for government services, in an ever-widening array of human activities. But what you see is an erosion of local control and an increased demand for Federal spending to provide those services.

I would have to say that there have been strong indications to support your contention. We received a resolution from the Los Angeles City Council urging a continuation of Federal funding and matching grants and a change in the criteria. Immediately after the vote, the Governor of California made that same expression to the President. And I would presume that after the State surplus is dissipated—after the first year—that the California congressional delegation is going to be under increasing pressure to approach the Congress on the basis of replacing those local funds with Federal revenues in order to continue the services.

Mr. Jacoby, on the other hand, you seem to express that it was a demand not for reduced taxes, but an educated demand for less services. I think that brings me to the following point. What are those services? It does get back to some extent to Senator McGovern's problem. Were the people of California—and I know they have cut back some library services—did they feel that their library services were excessive? Did they feel that they had too much road building? Did they feel that they had too many parks, or that expenditures on parks and recreation have been extravagant and beyond what they desired for their recreational purposes?

I notice that in education, the summer school and extracurricular athletic programs have been reduced. Were those intelligently understood and anticipated consequences by the people of California; did they determine that summer school or extracurricular recreational athletic programs were excessive and unwanted uses of their tax money?

In those particular categories, which are some of the implications of Proposition 13, were those valid and intelligent judgments and anticipations made by the people of California? Is that what they wanted?

MR. JACOBY. I think you misinterpreted my earlier remarks. In my view—and I think I was a rather close observer of the whole Proposition 13 episode—the overwhelming vote of the public Proposition 13 may be attributed not to a rejection of governmental services that were being performed, but to a belief that, as Mr. Fitch has pointed out, they were being inefficiently performed.

Every study that I am aware of has shown that productivity in the public sector—that is actual output of service—is low compared to the private sector.

Representative CAVANAUGH. I would like to examine that because you seem extremely supportive of the consequences of Proposition 13,

Mr. JACOBY. Yes, sir.

Representative CAVANAUGH. In education, it is my understanding that summer school activities have been curtailed in most school districts.

Mr. JACOBY. I believe that is true.

Representative CAVANAUGH. Now, my question is: Was that an unintended consequence? Did the people expect they could get the same level and quality of education for their children, including summer school, with this reduction in taxes? If that is true, it would be my interpretation that the implementation of Proposition 13 is not going as intended. Is that a correct interpretation?

Mr. JACOBY. No, I think not. I cannot, of course, tell you what all the people of California believed about the great coterie of services. I can say this, that the people of California have seen the cost of education soar upward in terms of amounts spent for pupil-year while the quality of education has gone down.

I think they are asking themselves the question, is more money the answer?

As far as summer school is concerned, a number of school districts have eliminated it and voluntary efforts have been made by parent groups to get together to form summer school groups.

But there has been no general cutback in educational outlay of California. The Los Angeles School District, which initially terminated 30,000 teachers, has rehired them all and is now advertising in two adjoining States of Arizona and New Mexico for 1,800 additional teachers. So there has been no general cutback in education.

Mr. COOPER. I would like to comment. People did not vote for 13 in a mass or a block. There are about five different groups that voted for 13 for five different reasons.

Some people were upset with the schools' feeling that they do not get their money's worth out of the schools. On the other hand, many of those same people will object when the law goes into effect that says: "Your kid doesn't leave the sixth grade until he passes certain tests." The same people that will object that the schools are not adequate will also want their kid promoted every year regardless of how well he does.

The services that are being cut, however, are those not mandated by law. We are mandated in the county by law to provide the courts, the jails, welfare, hospitals and clinic, public health, and police and fire services, so that means when you have to cut, the cuts come in things that are not mandated by law, mental health, service to the aging, disabled, social services.

Now that may change. The legislature added some this year, but they may add more next year. But if you have to cut 10 percent and you can't cut certain programs because they are mandated by law, then you are stuck with cutting the others.

When you run public opinion polls in California, there is only one service, that about 50 percent want cut. That is welfare. Yet Congress and the State legislature set the eligibility requirements and benefit levels, and the legislature says: If we cut the staffing too much and make too many mistakes, they will charge us for 100 percent of the extra mistakes."

So it is one of the programs that cannot be cut at all. But 48 percent of the people in California want to cut that.

The next most popular program for cutting is support of chambers of commerce, which only 20 percent of the people of California want cut.

So it is not a conscious thing and you know some people voted for Proposition 13. There was a woman who said: I will use the money I save to go to Europe. That was her idea. Others said I want to send a message to Sacramento and this is the only game in town.

Representative CAVANAUGH. Of course, I understand that and we all agree with that, there was no referendum on services. But the problems it presents to us in the decisionmaking process is we will have to make those and we will have to make them in the public interest.

Mr. COOPER. Everything will have to be cut.

Representative CAVANAUGH. My problem with Mr. Jacoby is he doesn't seem to address that.

Mr. COOPER. Many people wanted everything cut. I presented messages to the chairman from my constituents, that some of the people said that. Others said other things.

Representative REUSS. Mr. McKinney.

Representative MCKINNEY. Gentleman, this is a little bit like covering the globe on a bicycle in 1 day. I must say I enjoyed your testimony and I will read it. I would just like to add to the discussion going on. I find people don't want less services; I find people want more.

For instance, I am continually being told, particularly by senior citizens. "We cannot afford inflation today, but increase our pensions." But I find many people who are angry at government, but this is the only ball game in town. All you have to do is ask anyone about a simple little trivia of government—any type of local licensing their doing or getting their car registered—the people are irritated by all of those things. They don't see government being delivered to them. Yet they see their taxes going up and up.

The real message here is that the Government has got to be run—which it is not being done now in many cases—for the people that pay for it. I constantly have walked into the Federal building where I have my office and find an old lady crying in the hallway. I said, "Why are you crying?" and she said: "The girl gave me these forms and I cannot understand them. I don't read English very well."

So I took the little old lady in to the Social Security clerk and I said, "What is the problem?" And she said, "Well, just fill in these forms." I said, "Who do you work for?" She said, "I work for the Social Security Administration."

I said, "You do not; you work for this lady. So fill out the forms for her."

But that was absolutely untold. The supervisor came over and asked why I was interfering. I said, "Because you people in this place work for the taxpayer; you don't work to abuse the taxpayer."

I could go on and on and on on this subject forever. I wanted to ask a couple of technical questions, Mr. Peterson. One of the things that bothers me about the surplus figures I see in the local and State government is: Do you have any idea of how many of that quote-

unquote surplus is really depreciation on what we would call a depreciation loss in business or what is deferred maintenance, things that are just not being done?

Mr. PETERSON. Well—

Representative MCKINNEY. Just because the pressure is on to show a surplus so the State and local government are ignoring the truth that the bridge has to be painted every 2 years?

Mr. PETERSON. We don't know the answer to that question presently. We in the Urban Institute are in fact engaged in a study which we hope will produce an answer to that question, but we do know that the number in some cities is substantial. A sizable part of the apparent surplus is being taken out of assets through depreciation.

I might add that locally reported surpluses are in any event highly inexact figures. If you look at almost any city which is laboring under hard fiscal circumstances and start to scrutinize its accounts, you will find some ingenuity in moving cash back and forth to affect the reported budget balance.

Let me cite two alarming trends. One is that almost all of the large cities under fiscal strain are transferring large sums from enterprise accounts which have been used in the past to provide water, sewer services and so forth, and which provide the principal source of funding for capital investment in those functions, to cover operating deficits under their general funds. This has accelerated greatly.

Second, several of the cities, Cleveland the most conspicuous example, are not just undermaintaining, but selling off their physical assets and using the profits to close their current account deficits. Cleveland sold its sewer system and covered its operating deficits for 3 years. It now has suburban land up for sale that the city had the foresight to buy in the 19th century. They have been renegotiating the sale of their electricity generating system for the last couple years.

This is an extreme example, but on a lesser scale it is found in several of the cities; they are unloading their assets to get cash to cover operating deficits.

Representative MCKINNEY. I was going to say that I sit on the Audit Commission, and we have a tendency to move money around, too.

Mr. COOPER. I would like to point out, our yearend balance in my county is \$16 million. That is 4 percent of our annual budget. We can't go into that; that is a contingency fund. But what seems to be overlooked is that, if Proposition 13 had not passed, this coming fiscal year we would analyze, we would prepare a budget, we would say, "All right, we need \$180 million; we will carry over \$16 million from last year, so that means we only have to raise property tax to the tune of \$164 million."

Now, you know, it isn't like the surplus is passed out as a dividend: it goes into your next year's budget, and it's taken into account, and the bigger the surplus, the fewer property tax dollars you levy. That is the standard way we operate, and I would assume most jurisdictions operate that way.

Of course, we do have special funds for capital improvements or various things that in an emergency you can raise, and a lot of jurisdictions do that.

Representative McKINNEY. The best examples are Cleveland and Boston, New York, or Washington, D.C., that their auditing system is so poor that they cannot operate in the cool way you suggest, which is one of the underlying things that bothers me.

You read today that we have a \$112 billion bill facing us on fixing the highway system we have not finished building yet. I wonder what's going on at the—I guess my time is up.

Representative FENWICK. May I make a comment?

Representative REUSS. The time of Mr. McKinney is up.

I recognize the gentlelady from New Jersey.

Representative FENWICK. What is driving people crazy, are the questions Mr. Fitch and Professor Jacoby have addressed themselves to. People know, because it's in the papers daily, that business can make a profit of picking up the garbage at the doorstep of 29 percent of the pickup cost. Why don't we do it? Because we are frozen into arrangements that are more expensive. Nine people are employed by the municipality in place of the five employed by private business, and still the business is not only making a profit but they are paying taxes, also.

We haven't got the courage, those of us in politics. Let's face it.

I was on my borough council, and in my State legislature, too. We haven't got the courage to come out and do what needs to be done and this is what I think Proposition 13 is trying to tell us. Let's face up to the real issues.

MR. COOPER. And now with the lack of funds, for example, we just hired a private firm to administer our hospitals.

Representative REUSS. Cochairman Moorhead.

Representative MOORHEAD. Thank you, Mr. Chairman.

First, Mr. Jacoby, you proposed Federal spending limits and ultimately cuts in spending. One of the things that the committee is looking into is intergovernmental relationships. Would you recommend cutting such transfer payments from the Federal Government to the State and local governments as revenue sharing, CETA, and similar programs?

MR. JACOBY. Yes; I don't think any item of the Federal budget should be exempt from an effort to find opportunities for saving. I think that there is a lot of water in these Federal grants. In fact, I saw a study recently by an academic economist, I have not looked at it, but I merely cite it. I am not sure how solidly it is based, but his contention is that nearly one-half of the people holding CETA jobs are not qualified for them under the Federal standard. That is being misused and abused by many local governments; it has not been adequately audited by the Federal Government, and apparently a great deal of waste is occurring in this one program, which you mentioned.

You can go down the whole list of Federal grants. I am sure you will find equal opportunities for either doing them more efficiently or perhaps where the output doesn't justify the input, for eliminating them.

Representative MOORHEAD. So general revenue sharing where there is no auditing, that would be a prime candidate for reduction in Federal expenditures?

MR. JACOBY. Yes, I would think so, sir.

Representative MOORHEAD. Just to get the panel working here, Mr. Bryce, in your testimony you said that small cities have become more dependent on the Federal Government in recent years. Do you share Mr. Jacoby's feeling that we can cut back on Federal transfers to smaller cities?

Mr. BRYCE. I think we can cut back almost anything that we choose to cut back. And, having said that, I really do intend to emphasize what I think is a far easier statement to make than to implement. As I listened to individuals comment about the inefficiency of government, and compare that with businesses, a number of things go through my mind.

First of all, I do agree there is inefficiency in government. But there is also inefficiency in business.

Businesses also have losses; so I don't know why we must malign those governments in particular for having that problem.

Most of the businesses which are in some of these cities are reasonably small in comparison with the local government. Many of them do not produce products which are as complex or as difficult to assess, or as difficult to provide to their consumers.

So, whereas I might conclude that there is some amount of inefficiency, I think it's an oversimplification to assume that simply because some businesses work well, and many of them I want to say, simply do not work all that well, that we ought to expect the same thing of local governments.

I would like to use your question to make one other statement, and that is I would like to go back to your earlier question to me about capital spending, and I would like to make two other points.

As I listened to Mr. Peterson make his reply, two things went through my mind. One is that it is true that, as he pointed out, that there has been a general trend in the aggregate spending of State and local governments with respect to capital programs. I was not referring to the aggregate spending; I was referring particularly to small cities.

The second thing, as he does suggest, there has been a question of difficulty of acquiring capital in the capital markets for some of these localities.

I would like to underscore one point, and that is that one of the significant differences between financing capital programs in large cities and financing capital programs in small cities is that many small cities do not rely as much on the capital markets as the larger cities do. It is a very common thing to find in many smaller cities that although they do have the authority to borrow, they finance capital programs either through reserves, as was implied earlier by one of the panelists, or they do it through grants or through other means.

Representative MOORHEAD. Mr. Peterson, can large cities get along with reduced Federal transfer payments?

Mr. PETERSON. I would like to answer that question in two steps.

First, I think that in designing Federal programs that we are beyond the stage where we need the temporary programs or urban assistance designed to relieve financial strain. Both the CETA legislation and the antirecession fiscal assistance legislation are scheduled for expiration September 30, and the local public works portion of the public works bill has expired. I think this is a good opportunity to

turn one's attention from short term fiscal sustenance to the design of more permanent programs by beginning to phaseout some of those temporary ones.

Second, I believe that in any discussion of the cost implications of Federal grant programs that more attention has to be given to the structure of aid programs and their implications for local public sector prices. In a sense it is quite deceptive to speak of inflation at the State and local level as if prices were beyond Government control.

A good deal of the increase in State and local costs has been increasing in relative prices—public sector wages, for example—and capital costs that have increased beyond the national inflation rate. Federal grant-in-aid programs have contributed to that price inflation by lowering the cost to local governments of acquiring certain kinds of services. I think there has been a direct linkage between State and local wage levels and the prices paid for goods and services, and the design of aid programs. Until very recently Federal aid programs were designed to stimulate spending and often had the effect of raising prices, as well.

The original purpose of general revenue sharing, in fact, was to stimulate State and local spending to make sure that State and local spending increased as a portion of gross national product.

We have come a long way in the last decade in our perception of that issue. We now want to restrain State-local spending, where possible. It is therefore important to design Federal grant programs, not to deliberately stimulate spending, but to be sure the expenditure impacts are not captured simply in price increases.

Representative MOORHEAD. I wonder if Mr. Gramlich would care to comment.

I think it is a very significant statement made that we should be changing our emphasis from fiscal relief measures to more targeted economic development measures if we stay in the business of assisting localities at all.

Mr. GRAMLICH. I agree with that. I don't have too much to add, except for one other point. That is that a lot of the temporary measures that Mr. Peterson was referring to were things passed as part of the economic stimulus package of 1976. Measures expressly designed to stimulate the economy by changing the spending of local governments. And I think that the people who have looked at the success of that effort—including others, as well as myself—have found in general that there wasn't that much spending that was stimulative.

I think that one can conclude that, if you are interested in stimulating the economy—which you have to be from time to time—that the best way to do that is by direct income tax cuts and increases, and not by grants through local governments. That is not an effective way to alter the national economy.

Representative MOORHEAD. Thank you, Mr. Chairman.

Representative REUSS. Thank you, Congressman Moorhead.

The one overriding conclusion I draw from this enormously interesting discussion is that, while the immediate bolt of lightning from Proposition 13 fell on the heads of local government, there is enough sin to go around at the State and Federal level, too, and that the problems we are talking about are really the problems of our Federal

structure, and thus an approach like that taken by the Joint Economic Committee and the Subcommittee on the City, which doesn't try to distinguish too much between levels of government, but tries to look at the total of what has been done, seems to me to be the direction in which we have to go, and I congratulate each one of you for pursuing the problems before us in that light.

It's been an extremely helpful session. We could go on for a long time, but we have been working hard for more than 3 hours.

I want to thank you and thank Congressman Moorhead for his generosity in agreeing to cochair this joint session.

The Subcommittee on the City will convene here at 9:30 a.m. tomorrow morning for a continuation of these hearings.

[Whereupon, at 12:43 p.m., the joint hearing adjourned, subject to the call of the Chair.]

