

THE 1979 MIDYEAR REVIEW OF THE ECONOMY

HEARINGS
BEFORE THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
NINETY-SIXTH CONGRESS
FIRST SESSION

JUNE 27 AND 28 AND JULY 11 AND 13, 1979

Printed for the use of the Joint Economic Committee



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THE 1979 MIDYEAR REVIEW OF THE ECONOMY

WEDNESDAY, JUNE 27, 1979

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

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

Present: Senators Bentsen and Kennedy; and Representatives Hamilton, Mitchell, Brown, Heckler, and Wylie.

Also present: John M. Albertine, executive director; Charles H. Bradford, minority counsel; Kent H. Hughes, L. Douglas Lee, Paul B. Manchester, and George R. Tyler, professional staff members; Stephen J. Entin and Mark R. Policinski, minority professional staff members; and Mark Borchelt, administrative assistant.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. The committee will come to order.

Ladies and gentlemen, welcome to the opening hearing of the Joint Economic Committee's 1979 midyear review of the economy. This is the first in a series of hearings we will conduct focusing on the long-term outlook for our economy, with a special stress and focus on productivity.

Since World War II, our Nation has had an awful productivity record—one of the worst among the industrialized societies of the world.

It has hurt our balance of payments, employment, and especially our fight against inflation. Private economists have been telling us that the only way to fight inflation is with a recession. That means increased unemployment, and we are told if we increase unemployment, inflation will decline, even though we have not seen that in the 1973-74 recession.

Each time they have relied on that traditional approach, we have seen unemployment ratchet up, and we have seen inflation ratchet up, not down. I think that is the wrong approach. The economists are wrong.

You fight inflation with more production, with more goods and services that force prices down. You fight it with longer production lines, not longer welfare lines. That means we have to raise productivity in this country. It is the heart that enables our Nation to stay well, to grow stronger, to produce more goods and services for us all.

But equally important to our economic health is a reliable energy

supply. Whenever we talk about energy these days, people get a sense of frustration. There don't seem to be any simple answers. They seem to agree only on one thing, that Washington has made it worse.

In fact, back in Texas, there is a not-so-funny story about how the energy crisis will finally end: Skylab will fall, hitting a DC-10 which will strike a nuclear plant in Washington where the bureaucrats will all be stuck in gaslines.

People are very concerned about energy, about gasoline lines, and about soaring gas and heating oil prices. They have finally come to believe President Carter's admonition that the energy crisis is the moral equivalent of war. They just aren't sure who the enemy is.

They hear contradictory statements from the President and from the Energy Department. One day it is the Arabs; then it is the oil companies; then it is the farmers and fishermen; then it is themselves who are to blame. They sit in gas lines in Houston, Boston, Washington, or San Francisco and hear that no gas lines exist in rural areas. They hear that Federal regulations are responsible for the spot shortages and gasoline lines.

They hear about looming food shortages because trucks don't have diesel fuel while farmers who grew the food have all the fuel they want. They open their morning papers to read about another OPEC price jump and wonder what the Federal Government can do to put an end to rising energy costs. They sit in gas lines, wondering where it is all going to end. Do they face cold homes this winter or gas lines until Thanksgiving? Do they face food shortages or gasoline rising to \$1.50 a gallon? They want some answers, but they aren't getting them.

They should know that we can do an awful lot to deal with the energy shortages. We are the Saudi Arabia of the world when it comes to coal, for example, and can produce million of barrels of oil from coal.

There is a lot of oil and natural gas still to be discovered and used in this country, as well. The results of efforts to boost our energy productivity, to conserve energy, are just being realized now.

So we face a far from hopeless situation, and we hope to hear more about solutions today. The committee invited Energy Secretary Schlesinger to appear today. He is in Tokyo, however, with the President, so Deputy Secretary John O'Leary will appear in the Secretary's stead at 11:15.

Leading off today's hearing will be Prof. Thomas Schelling, director of the Committee on Economic Development's Design Committee on Long-Range Energy Policy.

Appearing with him will be Mr. Henry B. Schacht, chairman of Cummins Engine Corp. and chairman of that same CED committee.

Mr. Schelling has recently written a lucid examination of our energy situation, and we would like to hear from him after comments from my colleague, Congressman Hamilton.

Representative HAMILTON. Thank you very much, Senator.

I want to personally note that I am very pleased to welcome Mr. Schacht to the committee this morning. He is from my home town of Columbus, and one of the most outstanding business leaders of the Nation.

It is a special personal privilege for me to have him appear with Mr. Schelling.

We certainly welcome you both before the committee.
 Senator BENTSEN. Mr. Schelling, will you please proceed.

STATEMENT OF THOMAS C. SCHELLING, DIRECTOR, DESIGN COMMITTEE ON LONG-RANGE ENERGY POLICY, COMMITTEE ON ECONOMIC DEVELOPMENT, WASHINGTON, D.C., ACCOMPANIED BY HENRY B. SCHACHT, CHAIRMAN, DESIGN COMMITTEE ON LONG-RANGE ENERGY POLICY

Mr. SCHELLING. The study you referred to, Senator, was organized by Henry Schacht, on my left. We shall take a minute to have him explain how that study was done and why it was done.

Mr. SCHACHT. It might be helpful just to tell you that the study began in 1977 when the CED gathered together a design committee to try to figure out what new and useful might be said about energy.

It occurred to us that, given the period of policy issues, policy options available to this Nation to deal with this very difficult question, it might be more helpful, rather than going into specific policy options, to develop a conceptual framework against which policy options could be judged. That is the attempt of the red book you have before you.

Mr. Schelling was the author. It is his work. We find it compelling. We hope you will, too.

Senator BENTSEN. Mr. Schacht, let me say that we value the work of the CED. We know they do excellent work, and I speak with some bias because, when I was in the private sector, I was quite active in the CED.

Mr. SCHELLING. Thank you, Mr. Chairman.

We are dealing with the long-term energy problems, even though the figures suggest that we are going to hit the ceiling before the year is out. I want to address the long-range question.

Is there really a fuel shortage? What is the character of the fuel shortage? And how bad is the fuel shortage?

I don't mean the fuel shortage down at the corner where the gas lines are, but out there where it all comes from. The correct answer usually sounds like good news. There is more fuel than we will ever burn.

The bad news is that the reason we will never burn it all is that lots of it is going to be too expensive, even at the prices of the 21st century. Immediately more to the point, fuel is expensive and it is going to get more and more expensive. We have immense quantities of coal, but successive tens of billions of tons will be more expensive to mine and to burn and to clean up after.

There is lots of liquid fuel potentially available from tar sands, shale, even from coal itself, from abandoned mines, wells that can be further drilled, but it is going to get more and more expensive.

The problem is not an energy gap. It is not that there will be an overtaking of supply by demand. The image of the gap overlooks the fact that the amounts of fuel that can economically be extracted and consumed depend on the prices that people will pay for it, and more and more expensive supplies are going to have to be used.

The problem is not to try to keep the price of fuel from rising; it is to meet the genuine rising costs with policies that minimize the burdens, minimize the cost increases, and avoid major disruption to the economy.

If we formulate the problem as one of costs, the question arises, how big are those costs—how big are they going to be? A fair estimate is likely to be that the average cost of all our energy may double by the end of the century. Oil may more than double. Other fuels may less than double, but a good estimate may be about a doubling. Fuel is about 5 or 6 percent of our GNP at the present time. If the cost of that 5 or 6 percent of the GNP doubles by the end of the century, it will be equivalent to a 5- or 6-percent reduction in our productivity. This is to say, 5 or 6 percent of our GNP will go into the higher cost of producing fuel or the higher cost of trading exports for fuel.

By the time our GNP might have been double what it is today, it might be only 90 percent of what it is today. The difference is huge, measured in hundreds of billions of dollars. We have a huge economy. The energy problem for this country is very, very serious. It is not catastrophic. Our participation in an energy-short world makes us vulnerable to various types of disruption. The domestic problem is merely one of the very big economic problems we face.

A second problem is that we may aggravate that large one by policies that try to disguise the fact that costs are rising and to insulate us from those costs. If those costs are not paid, the energy will not be there when we need it. If the costs do not have to be paid by users of fuel, consumers need not care and cannot know what it is worth to save energy.

It is hard to estimate how much difference it might have made today if U.S. oil imports had been reduced even by 1 million barrels a day over the past few years. It seems very likely, reading this morning's newspaper, that we shall pay a permanent penalty in the higher price of OPEC oil for not having reduced consumption and increased domestic production.

Even a million barrels a day from world demand might make the difference between \$19 and \$21 or \$22 a barrel for oil. And that is all the oil that all of us, all importing countries, import from now on.

The stakes are indeed huge. We couldn't have asked for a more dramatic demonstration that when we postpone the price increases by subsidizing imports at the expense of crude oil producers, the price increases, when they ultimately come, come with a vengeance. That is what we are witnessing today.

It is barely 6 months since people were appalled at the thought of a 14.5-percent increase in the price of crude oil stretched over a 15-month period. We don't need any more evidence that a cheap fuel policy does not make fuel cheap.

By cheap fuel policy I mean the particular kind of crude oil regulation we have. There are two sides to it.

One is that domestic producers receive less for the oil they produce than what the oil sells for on world markets.

The second is that refineries have been paying, and mostly passing on to their customers, prices below the cost of imported oil.

An averaging process allows refineries and their customers to pay a price between the controlled, domestic price and the world price. The effect is the same as if domestic producers were taxed and the proceeds used to subsidize imports.

The system saves us consumers from paying the full replacement costs of the oil we get from domestic wells, but it makes us spend it on imported oil which looks cheaper than it is.

We have been using the proceeds of domestic controls to subsidize imports from OPEC. It is hard to imagine a more effective way to inflate the prices we pay to our foreign suppliers. Today's controls on domestic prices are like the fulcrum on which we lever upwards the price of OPEC oil tomorrow.

Deregulation will increase the prices we pay for crude oil and for gasoline, heating fuels, and anything else dependent upon petroleum.

The object is to reduce the upward tilt of energy prices in the future.

Getting all of us to behave in accordance with the true cost of oil today can lower the price we pay tomorrow. I have seen the estimates of how much less we might import by 1985 if we deregulate. The estimates were probably based on OPEC prices below those that are being speculated about in Geneva today. The estimates are rather modest—a million barrels a day or less as the sum of enhanced conservation and enhanced production by the year 1985. That sounds like a very modest difference, but even a million barrels a day, had we achieved it already, could make a striking difference to what the OPEC nations are doing in Geneva right now. And keep in mind that 1985 is the very, very near term where oil is concerned.

Nearly everything that is done to bring in new oil supplies, whether conventional oil or alternatives, synthetically produced fuels, and nearly everything that is done to conserve gasoline, jet fuel, home heating oil, or the industrial uses of petroleum, have a leadtime of at least 10 years. Today's problems are not really solvable today. We have to live with them.

The long-range problems, we can do something about today. Wishing that we had cut down oil imports in the past is useful only if it gives us the determination to take the steps now that will help us reduce imports in the future. We are already in the 1990's where today's decisions are concerned, not merely today's policy decisions here in the Congress and elsewhere, but the decisions we take in buying vehicles, constructing homes, or investing in synthetic oil.

It isn't going to help the poor in the long run to keep down the price of fuel today while worsening their heating oil problem 5 years, 10 years, or 15 years from now by not taking these steps that will protect their longer-run future.

The question arises even though consumers must pay more for refinery products, must we allow the proceeds to go to the lucky people who owned or had leases on or contracts for crude oil long before the prices reached today's level? It is tempting to discriminate, at least against old oil, by taxing away a part of the proceeds, letting the price go up as it must if we are to get the conservation we need and the enhanced production we need, but not letting the proceeds go directly from consumers to the owners of old oil.

The more serious question, I think, is whether we will have a permanent excise tax on future liquid fuel, the oil that has not been discovered yet, or the oil that, though discovered, is expensive to produce and bring to refineries. Indeed, it is difficult to assure anybody that

the same logic by which yesterday's oil and today's oil are subject to an excise tax or excess profits tax will not be the same appealing logic the next time the world price goes up.

It is hard to divide the market between present and future. The prices to which today's behavior is a response are the prices of 5, 10, or 20 years from now. And here we come to a remarkable asymmetry in the way profits and losses are treated. It is a captivating idea that we should tax away excess profits, leaving only reasonable profits to those who successfully find and develop new sources of oil. And there are indeed few lines of business in which people may strike it rich more dramatically than in prospecting for oil.

But prospecting for oil, like prospecting for any natural resource, is often a gamble. If you are lucky, you strike it rich. If you are not lucky, you lose a lot of money.

Any windfall tax that applies to future discoveries and future development of oil and other liquid fuel is like the Internal Revenue Service treatment of casino gains and losses. The Government proposes to capture only the excess profits of the lucky strikes that lead to profits in excess of costs. If you gamble in the casino and win, IRS will happily share your winnings. If you lose, you lose alone.

The scheme is asymmetrical, and it exists because people believe that this is the way to discourage gambling and other risky enterprises.

To apply it to natural resource development is, therefore, misguided. We want people to invest risk capital in the search for new petroleum, in the development of new technologies for liquid fuel, and in risky explorations of what kind of fuel developments the environment will allow us to produce. If we promise them that we will share their happy investments, taking a cut for the Treasury as windfall profits, but if they lose, they lose alone, we will merely be applying to liquid fuels the philosophy that has historically been found effective in discouraging risky enterprises.

I disagree with the President on this. As I understand his earlier proposals of 1977 and his proposals now, he would subject to special taxation new sources of crude oil brought in from now on. It will also be tempting to capture the windfall when OPEC prices go up, but as soon as that becomes anticipated, the effect will do more harm than good.

When old oil is not any longer oil identified by a historical date but is any oil, even in the future, that has already been found and developed, it will no longer be possible to surprise people who invested for profit and take it away from them.

I, therefore, support, Mr. Chairman, prompt deregulation with any windfall profits tax or any excess profits tax being applied only to some clearly defined category of old oil, historically defined so that consumers as well as producers will let themselves be guided by the real economic cost of liquid fuels.

Crude oil regulation does not reduce the cost of the fuels; it only disguises it so that we make the bad decisions that make the problem worse. It will not help the poor of 10 years from now to entice us today to overconsume and to underproduce and to subsidize imports

of oil from the part of the world where tankers go through a narrow passage that could be blockaded with primitive technology.

One final point, sir. I think it important to consider how to use any proceeds of a windfall tax, if there is one. I do not see any reason that mass transit or home solar heating or anything else have a special claim on a large amount of money that, by being especially allocated, would bypass the budget process. If the money is collected in a windfall tax to keep it from going from the consumers to the oil companies, then I would propose ways be found to get it back to the consumers.

Thank you.

[The prepared statement of Mr. Schelling follows:]

PREPARED STATEMENT OF THOMAS C. SCHELLING

Mr. Chairman, members of the committee: I am Thomas C. Schelling, Professor of Political Economy at the John F. Kennedy School of Government, Harvard University. I am a member of the study group on "Energy: The Next Twenty Years," organized by Resources for the Future, whose report on energy policy is nearing completion. Before that I was a member of the study group on Nuclear Energy Policy, organized by the Mitre Corporation, which published "Nuclear Power: Issues and Choices," in early 1977. Before that I was project director and author of the policy statement of the Committee on Economic Development on Nuclear Energy and National Security. And I am the author of a sixty-two page booklet, "Thinking Through the Energy Problem," published in March of this year by the Committee for Economic Development.

My statement today is based mainly on that most recent publication. It was difficult enough to cover the subject in sixty-two pages. This morning I must be even more brief. If the Committee will accept that longer published statement I shall be happy to submit it for the record to supplement the very brief outline to which I must restrict myself here.

I'd like to begin, Mr. Chairman, with the question, is there really an energy shortage? Are we running out of fossil fuel? How much fuel is there out there, and when will we run out?

The answer, Mr. Chairman, sounds like good news. But it is not. The answer is that there is more fuel than we shall ever burn. We'll never run out. Especially in the United States, the quantities of fossil fuel are huge. The bad news is that the cheapest fuels, the easiest fuels to extract and transport and refine and clean up after, are getting scarce. Successive tens of billions of tons of coal will be more expensive because of quality, depth and thickness, location, and, especially, the environmental effects of mining, transporting, and burning it. Oil can be had even from abandoned deposits at higher extraction costs. Deeper wells can be drilled; oil can be obtained from the ocean bed; it can be brought expensively by pipeline across the entire state of Alaska. Eventually shale and tar sands can yield immense quantities of liquid fuel but at costs that have not been, and still are not, competitive with the common fuels. Liquid fuels can eventually be obtained in large quantity from coal, but only at prices that, except possibly in the last few weeks, have never been paid for crude oil.

The problem is often described as the overtaking of supply by demand and the development of a gap. But the image of the "gap" neglects the fundamental economics of energy: the amounts of fuel that can be economically exploited depend on the prices that people will pay for them. More and more expensive sources of supply will have to be used. Rising demand will provide the market for them, but only at the higher prices that will cover their costs.

The energy problem is not to keep the price of fuel from rising. If fuel prices do not rise enough to cover the increasing costs of producing the fuels, the fuels will just not be available to buy. The problem is to meet the rising economic cost of fuel with policies that minimize the burdens, that allocate them equitably, that avoid disruptions in the economy, and that keep the costs from rising more than necessary.

Once the problem is formulated as a matter of cost, not of absolute gaps and shortfalls, we can try to measure the size of the problem. My estimate is that

the fuel portion of our GNP, roughly 5 or 6 percent of our GNP, may double in cost over the next couple of decades, so that while the GNP is doubling we shall lose about 5 or 6 percent of it in the higher cost of producing fuel and the higher cost of producing exports to pay for imported fuel. At some date around the end of the century when our GNP might otherwise have been double what it is today, it will be only 90 percent greater; to put it differently, it may take a couple of years longer for the GNP to double than it would if unlimited fuel were available at today's costs. In both its magnitude and its incidence on the rich and the poor, the result would be about as though a 5-6 percent sales tax were gradually but permanently imposed between now and the end of the century.

There is a complex of world energy problems, disruptive and frightening problems, that transcend the economics of cost increases. Many of those national security problems relate to the fact that half the world's petroleum reserves are located in countries that contain 1 percent of the world's population, countries with no modern tradition of government, located in an unstable part of the world. Twenty million barrels of oil per day go through the narrow Straits of Hormuz. Furthermore, most of our allies and many important underdeveloped countries are far more dependent on overseas supplies of fuel than we are. There is plenty of reason to think of the world energy problem as a crisis. But the U.S. energy problem, although vulnerable to shortrun import disruptions, is merely a serious problem, not the most serious domestic problem but one of them.

The danger is that we may attempt to insulate ourselves from the rising cost of energy by trying to hold prices down. We may deceive ourselves into believing that the costs do not have to be paid because we do not pay them openly and directly. But if they are not paid, the energy will not be there when we need it. If the costs do not have to be paid by users, consumers need not care and cannot know what it is worth to save energy. If we attempt to hold prices down while genuine costs are rising, there is a danger that our energy policy will aggravate the problem it attempts to solve. We shall simply waste energy resources in subsidized consumption, deny ourselves the enlarged supplies that could be available at higher prices, and delay the technological development needed to cope with rising costs.

I believe we may be witnessing dramatic evidence right now that we have been doing exactly that. Newspapers report that the spot price of crude oil—the price paid for crude oil not sold under long-term contracts—reached thirty dollars per barrel. Iranian production may still be down by a couple of million barrels per day below what it probably would have been if the Iranian revolution had not occurred. Saudi Arabian production may be up from what it would have been, but not by a full two million barrels per day. It is hard to guess how much of a ratchet effect this will have on the permanent OPEC price, and it is hard to estimate how much difference it might have made if U.S. oil imports could have been reduced by even one million barrels per day over the past few years, but it seems likely that we shall pay a permanent penalty—a sizeable penalty in the OPEC oil price—for having kept the price of oil in the United States artificially low during the past several years, stimulating consumption rather than conservation. I am afraid we could not have asked for a more dramatic demonstration, or a more discouraging one, that when we postpone the price increases by subsidizing the refineries at the expense of the crude oil producers, the price increases, when they ultimately come, come with a vengeance.

It is barely six months since people were appalled at the thought of a 14.5 percent oil price increase over a fifteen month period; we do not need any more evidence that a "cheap fuel" policy does not make fuel cheap. Let me explain what I mean by a "cheap fuel" policy. We have been regulating the price of domestic fuel oil. There are two sides to the regulation. One is that the producers of crude oil receive substantially less for the oil they produce than what oil is worth on world markets. The second is that refineries have been paying and mostly passing on to their customers prices substantially below the cost of imported oil and below the cost of new domestic oil. There has been an averaging process that allows refineries and their customers to pay a price between the controlled domestic prices and the world price level. The effect is the same as if domestic producers were taxed, and the proceeds were used to subsidize imports. The system not only saves the American consumer from paying the full "replacement costs" of the oil he obtains from old domestic wells; the system makes him spend it on high-cost im-

ported oil that looks cheaper than it is. We have been using the proceeds of domestic price control to subsidize imports from OPEC. It is hard to imagine a more wonderfully effective way to inflate the prices we pay. Today's controls on domestic prices are the fulcrum on which we lever upwards the price of OPEC oil tomorrow.

It is worse than that. By stimulating the use of liquid fuels, and hence stimulating imports, we not only bid up the price we pay for the petroleum that OPEC sells, we make ourselves even more vulnerable to shortrun disruption by increasing the fraction of our liquid fuel that we depend on from interruptible overseas sources. And we aggravate our balance of payment problem, the declining value of the dollar, and the resulting inflationary potential, not to mention the lost confidence of other countries in the ability of the United States to maintain the dollar as a world standard currency.

Deregulation of crude oil prices in the United States will immediately increase the price of crude oil and increase the price of refinery products, and the prices we pay for gasoline, heating fuels, and anything else dependent on the industrial use of petroleum. That rise in the price of the things we buy that are made from crude oil is deplorable, but it is the purpose of deregulation. The object is to affect the tilt of the trajectory of energy prices. Raising the prices we pay for energy will begin to inhibit our demand; higher prices will promise to cover the costs of enlarged future supplies; and new technologies that conserve fuel, not economical at today's energy prices, will be introduced to save fuel because they save money. The trade-off is between today's prices and future prices; getting all of us to behave in accordance with the true cost of fuel today may lower the prices we pay the day after tomorrow.

I have been reading estimates from many different sources about the amounts of liquid fuel that may be conserved or produced by 1985 with the elimination of crude oil price regulation. The amounts look rather modest, about a million barrels a day roughly of reduced consumption and enhanced supply. That makes it look as though we don't get much resolution of the problem, while we get some enhanced burden on the particular people who consume more fuel than the average. And in particular, the poor are thought of as being especially hard hit by rising prices of heating oil and gasoline. May I suggest, Mr. Chairman, that 1985 is the very near future, and if we focus on that date we'll always be blinded to the long-term problem and tempted to go on subsidizing the importation of OPEC oil. Energy saving and energy producing are long-leadtime activities.

Home heating depends on the technology of housing construction, furnaces, insulation, storm doors and windows, the improvements that will result from responses to higher fuel prices cumulate over the years, and 1985 is barely the day after tomorrow. Even the gasoline mileage of automobiles and light trucks and vans involve time periods of a decade or more; with today's known technology we can improve mileage by 1985, but with cars and trucks and vans lasting ten years or so, it will be the 1990's before we have flushed out yesterday's models, and new technologies will take a few years to develop and another decade to work into the fleet. On the supply side, bringing in oil from shale or liquid fuel from coal, or even conventional oil from depth and distances (like the north slope of Alaska) where costs are high, involves typically a decade or more planning and financing and physical activity. 1985 is barely tomorrow. We are already in the 1990's, where results are concerned, in the crucial decisions made today and tomorrow in response fuel prices.

I would like to state emphatically that I believe consumers are done a disservice by offering the option of deceptively cheap petroleum products, when their response to those cheap products will simply make them more expensive in the future. I believe the poor people in this country will suffer even more from high energy prices ten years from now if we do not soon stop stimulating and subsidizing fuel consumption through a price-control system that is popular only because its long-term effects are not visible. We can postpone the problem, we cannot keep it buried forever.

But a legitimate question does arise, can we save ourselves from paying to those lucky people who owned oil wells half a dozen years ago the world price of a product that they are able to sell because of decisions they took when the price of oil was a small fraction of what it is today? Can we, in other words, continue to control the price of "old oil"? And should we plan to capture the excess profits of new oil that is brought in in the future?

Mr. Chairman, if we could separate the present from the future and simply deny the people who had profitable oil wells some years ago, the appreciation

of their properties that go along with the rise in the price of petroleum, I'd go along with the idea that we should do so. Discriminating in favor of "new oil" and against "old oil" would appear to capture the "undeserved gains" of people who luckily invested in oil wells before 1973 without inhibiting new exploration and development. But old oil was once new oil. Today's new oil may be declared old tomorrow, and tomorrow's new oil declared old the day after. The same logic by which this year's "windfall gains" can be taxed away while letting consumer prices go to a market level may be just as appealing when oil and gas prices have increased another 20 or 50 percent.

The market cannot be divided convincingly between "present" and "future." Its time dimension is continuous. The prices to which today's behavior is a response—the prices that provide the incentives for current decisions on future supply and new investment—are the expected prices for five, ten, or even twenty years from now. Even consumer decisions on heating systems, insulation, or gasoline mileage depend on the prices anticipated for five years from now. Development now of new fuel sources that may begin to come on the market ten years from now will be a response to the prices expected in the second decade hence. It is predicted prices, not current prices, that determine investment decisions.

And here we come to a fundamental asymmetry in the way profits and losses are treated. Whether we are thinking of potential price regulations or potential excess profits or windfall profits taxes, there is a tendency for the federal government to depress the incentives for exploration and the development of new supplies of energy, whether conventional petroleum or synthetic liquid fuels from shale or coal, or whatever it may be.

It is a rather captivating idea that we should tax away the "excess profits" of those who strike it lucky in their petroleum development, or their development of synthetic liquid fuels, and that we allow "normal" profits but no more. There are few lines of business in which people strike it rich more dramatically than in prospecting for oil. Reasonable profits may appear to be a necessary incentive to exploration and development, but "unreasonable profits" can clearly be captured for the benefit of us consumers.

But prospecting for oil, like prospecting for any natural resource, is usually a gamble. If you are lucky you strike it very rich, and if you're not lucky you lose a lot of money. The prospects for losing a lot of money are balanced by the possibilities of striking it rich. If the government skims away the occasionally lucky strike, it may seem to be taking only the "excessive profits" of the exceedingly fortunate, but it can't help but effect the average prospective return.

Any windfall profits tax, or excess profits tax, that applies to future discoveries and developments of fuel, is very much like the IRS treatment of casino gains and losses. The government proposes to capture only the "excessive profits" of the lucky strikes that lead to profits in excess of cost. If you gamble in the casino, or on the horses, and win handsomely, the IRS will share your winnings with you, and indeed the bigger you win, the higher the share the IRS takes. If you lose, you lose alone; the IRS neither commiserates nor shares in your loss. The scheme is asymmetrical; it exists largely because people believe that this is a way to discourage gambling.

This is a sure way to discourage risky enterprises. It is built into our income tax policy because it does.

To apply it to natural resource development is therefore misguided. We want people to invest risk capital in the search for new petroleum, and in the development of new technologies for liquid fuel. If we promise them that we'll share their happy investments, taking a cut for the Treasury as windfall profits, but if they lose alone, we are simply applying to liquid fuels development the philosophy that has historically been found attractive and effective in discouraging risky enterprise.

I wish it were possible to tax away today's and yesterday's windfall profits without causing any anticipation that we may do the same thing next year, and the year after, and ten years from now. But you cannot forever treat by-gones as by-gones without people anticipating that you'll do it again. That is why I would propose that the price of crude oil be deregulated and that any windfall profits taxes be emphatically and definitely applied to sources of crude oil currently regulated and not to new sources.

I believe I disagree with the President on this. As I understand his proposals, both his crude oil pricing proposals of the National Energy Plan of 1977 and his

more recent proposals for deregulation and windfall taxes, he would subject to special taxation new sources of crude oil brought in from now on as well as applying the tax to price increases in the future beyond those required to bring domestic prices up to the world price level. I believe it is crucially important to establish a cutoff. I go along with the idea that "old oil" can be subject to a kind of confiscatory taxation. I don't like the principle, but the consequences make it attractive. But people have memories, and this is something you cannot do repeatedly. If people think that new oil will be declared oil after it is discovered, you cannot effectively distinguish old from new. It makes sense to deregulate future oil completely, and not attempt to drag out price controls into the future. It will always be tempting to capture the "windfall" when the OPEC price goes up; but as soon as that becomes anticipated, the effect will do more harm than good. When "old oil" is not any longer oil identified by a fixed historical date, but is any oil that has already been developed, it will no longer be possible to surprise people who invested in hopes of profit and discover that their profits would be taken away.

I therefore support, Mr. Chairman, prompt deregulation, with any windfall profits or excess profits tax being applied only to some clearly defined category of "old oil" so that consumers as well as producers will let themselves be guided by the real economic cost of liquid fuels. Crude oil price regulation does not reduce the cost of fuel, it only disguises it so that we make bad decisions that aggravate our problems. It will not help the poor of ten years from now to entice us today to overconsume and to underproduce and to subsidize imports of oil from a part of the world where tankers go through a narrow passage that could be blockaded with primitive technology.

One final point. I think it important to consider how to use any proceeds of a "windfall" tax. I do not see any reason to let mass transit or home solar heating or anything else have a special claim on a large amount of money that is collected primarily to keep what consumers spend from going to the oil producers.

The money indirectly comes from consumers in a manner that raises the cost of living index. I would like to see it go back to consumers in a manner that reduces the official consumer price index.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Schelling. You talked about the development of synthetic fuels. The House, I believe, passed a major bill last night in that regard. And I will shortly introduce some legislation on the Senate side. How would you structure such a synthetic fuels program in view of the question of market price uncertainty? The technology seems to be pretty well developed.

Mr. SCHELLING. That's correct, the technology is developing. There is very little experience with what the synthetics are likely to cost, especially with the environmental problems they will run up against and what the costs will be of abandoning some kinds of development and eliminating the environmental threat from others.

My proposal would be to estimate the likely worth of liquid fuel in the 1990's, where the worth is essentially the worth to us of doing without some OPEC oil. That would be something on the up side of the expected OPEC price of oil.

Having done so, I would be prepared to contract for a significant amount of liquid fuel for delivery from, say, 1985 on to the 1990's. I would do it by letting competitive contracts. I would not select favored technologies but contract for some amount.

I would go up to 1 million or 2 million barrels a day for delivery by 1990 under competitive bid where the United States stands ready to lose the difference between the price at which it contracts and what it gets for by putting it through regular distribution. My understanding is that the bill that was passed last night roughly is along these lines, but I haven't examined it in detail.

Senator BENTSEN. Thank you. I will withhold the rest of my questions because we have a limitation on time here. I would ask my colleagues, if they will, to hold their questions to 5 minutes because we have additional witnesses.

Representative HAMILTON. Thank you very much, Senator Bentsen.

Mr. Schelling, I find persuasive your argument that a windfall profits tax ought not to be applied to those areas where you have a high risk involved in exploring for oil. Is there a distinction, however, between the oil we get as a result of risky exploration where we want to reward investors, and the oil that comes to us from OPEC, for example, where we really don't have that kind of a risk. Also, you draw a distinction in your suggestion between the old oil where you accept a windfall profits tax, and new oil where you would not accept a windfall profits tax. What if that new oil comes to OPEC where there really is not, it seems to me, the ordinary risk involved? Is that a distinction that has any validity to it?

Mr. SCHELLING. If we could subject the OPEC countries to windfall tax and get the proceeds, I would be happy. I don't know any way to do that. All we can tax is domestic production. And there, what I want to tax is only the production for which decisions were already made in the past, not the production for which decisions have still to be made in the future.

I don't want a situation where anyone who can bring in liquid fuel cheaper than OPEC oil can't afford to because of an excise tax.

Representative HAMILTON. How would you deal with the OPEC nations in the cartel?

Mr. SCHELLING. I would deal with them precisely by having an energy policy that in the longrun will reduce consumption by making the price of refinery products reflect their cost and by promising producers of new liquid fuels of any kind from any source that they will not be penalized in competing with OPEC in the future.

We are stuck with OPEC right now. And I don't know what diplomatic measures may be taken to keep Saudi Arabia and some other countries properly interested in the world economy rather than in their own short-run profits.

But what we might have done about what OPEC is doing today, it is too late to do. The important thing to keep in mind is that what we can influence is the OPEC market another 5 years from now and on to the 1990's. That, I believe, is what this committee can properly keep reminding people of.

Representative HAMILTON. Thank you, Mr. Chairman.

Senator BENTSEN. Congressman Mitchell.

Representative MITCHELL. Thank you, Mr. Chairman.

Mr. Schelling, you indicated that deregulation is going to have a negative impact on the poor and the working poor in terms of price increases. But you also argue that over the long run, it would be better to go through that suffering now rather than experiencing major shortages 10 years from now.

My concern is that the poor and the working poor are in a unique situation in this country, particularly those who live in our inner cities who are poor.

In the last 10 years, we witnessed an exodus of industries from cities to suburbia. This means that the working poor who are city dwellers

are not able to find jobs. Traditionally these jobs are the lowest paying jobs.

In addition, we have a situation in which our national policy is directed to increase unemployment. That is anticipated in the budget presented by the Congress and also anticipated in the budget presented by the President. An increase in unemployment, in my opinion, will fall disproportionately on the poor and the working poor.

It seems to me, based on those factors and a constellation of a whole host of other factors, that some preferential treatment ought to be given right now. Some method ought to be devised right now which would reduce the exacerbating impact of deregulation on the poor.

Do you have any thoughts on this issue?

Mr. SCHELLING. Yes; I do, sir. Holding down the price of gasoline, or holding down the price of heating oil, or holding down the price of any of the household energy-intensive commodities, is not very much focused on the poor. It is a very inefficient way of doing something for the poor.

Most of the price increases will be paid by the nonpoor. The poor pay somewhat more disproportionately for energy than the rest of us, but most of what you save people, if you try to hold down those prices, you save at all levels of income.

If we want to help the poor, there are many more direct ways that help the poor other than helping everybody and hoping the poor benefit, too.

Representative MITCHELL. That is what I want to find out, some of the direct ways that might be applied immediately to ease the awful crunch that is going to fall on those persons. What are some of those methods?

Mr. SCHELLING. The awful crunch that is going to fall on the poor is not primarily from energy. There are many ways an awful crunch is going to fall on the poor. It is the rising cost of health care for those who do not have adequate insurance, the rising cost of foods, the rising cost of housing. Energy is only part of it. And to try to help the poor by going after each commodity separately is a way of diverting attention from the fact that there are more direct ways of helping the poor, primarily through the tax system and other programs that are oriented toward benefiting the poor.

Keep in mind that many of the poor are not affected by gasoline prices because they are too poor to drive or they are too old to drive.

Representative MITCHELL. I must express dissatisfaction with your answer. It is a real, real problem, and I want your answers to be responsive, to focus on energy solutions for those people rather than a broad kind of answer that you have given referencing taxes.

I don't think I received an answer, Mr. Chairman.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

Before I pick up again on the points raised by Congressman Mitchell, let me suggest that if we had been having this meeting 100 or so years ago, the room probably would have been lit by whale oil lamps. I guess there came a day when those fishermen went out of Marblehead and came back and said: "We can't find any whales," not unlike the people now who are suggesting we are not finding oil.

Senator KENNEDY. They went out of Boston.

Representative BROWN. Marblehead seems more colorful, Senator.

But in any event, the question is, Should we have taxed the whales at that time? We now seem to be in the process of taxing the oil; a tax which seems to me doesn't necessarily help the situation.

What saved us then was that about that time, somebody found this black stuff oozing out of the ground in Pennsylvania and decided that maybe it would substitute for the whale oil. And, in fact, as the price went up, it was a suitable substitute for whale oil, as we well know.

Now, what is our prospect, first, for the need for an additional tax on oil, and second, on the question of whether or not we can find legitimate substitutes that will be economically viable for increasingly expensive petroleum products.

Mr. SCHELLING. There are lots of increasingly expensive substitutes. There are huge amounts of oil that can be obtained from shale, tar sand, even coal. All of them are going to be expensive.

If you wanted to compete with OPEC oil, both to save us money and to make us less vulnerable, it will be important not to tax the substitutes, or else the substitute fuel can't compete even at the OPEC price.

It is always attractive and sometimes wise to tax away past gains. It is always attractive to control the prices of things that appear to be fixed in supply and can't go away. I think rent control is popular because in the short run, the houses can't go away. There are easy targets.

Oil has appeared to be an easy target. Oil that has already been found may indeed be an easy target, and it is not going to become unbound, if it is taxed.

But the oil that hasn't been brought in yet is dependent on being able to obtain a price at which it can compete with OPEC. And what I am afraid of is that if we proceed with taxing future oil, we are simply denying ourselves the opportunity to compete with OPEC and, therefore, increasing our vulnerability to imported oil.

Representative BROWN. You really haven't addressed the possibility of synthetic fuels. And I may come back to that, but to get back to the question addressed by my colleague, Congressman Mitchell, we have rising food prices, and yet we do not tax the farmers specifically in order to take care of the rising food prices. We have rising housing prices, and we have to take care of the poor in that regard. But we don't necessarily tax the builders.

It seems to me that it would be unwise for us then to tax the oil producers in order to help the poor pay for rising heating costs.

Poverty programs are handled through the general fund when we want to offer relief for the poor. And it seems logical to me to continue that policy with reference to rising heating costs.

If we could provide jobs and some assistance with eyorbitant increases in the heating costs for the poor through the general fund, would that be better than to tax oil producers specifically in order to assist in trying to hold down heating costs for certain classes of society?

Mr. SCHELLING. I think the argument for taxing oil producers is that it looks like easy money. And it is easy money, if it doesn't affect

future production. But it is easy money, and all it is money. And it is worth a few billion dollars annually for the next several years. Tax it or not, what you get is money.

With respect to the problem of the poor, I'm sorry I wasn't responsive to Congressman Mitchell. My fundamental argument is, don't try to help the poor with every different kind of policy like energy policy. Help the poor with programs that are designed to help the poor, to identify who the poor are, where they are, what they need, and what kinds of tax relief they can use, what kind of other benefits, whether it is food stamps, paying for medical care, or something that is particularly related to the poor.

Energy is not particularly related to the poor. It is a shotgun technique that tries to solve what ought to be a focussed problem in a manner that confuses the energy program with the problem of the poor.

Representative BROWN. My time is up.

Representative MITCHELL. I wish I had more time, but I don't.

Senator BENTSEN. This is a very critical and important subject. I am sure we all have a lot more questions.

Congresswoman Heckler.

Representative HECKLER. Thank you, Mr. Chairman.

Mr. Schelling, on the same subject, as you know, I come from Massachusetts. And I think you are aware of the predictions by the home heating oil industry that we will be paying 80 to 90 cents a gallon or \$1 a gallon or more for home heating oil in the Northeast. And we have a question on supply.

Now, this will certainly make many low- or middle-income citizens in Framingham, Mass., poor. They are not poor necessarily today by our current yardstick. But when the convergence of crises impacts on their lives in the very near future, as we are told, they will become poor. And part of the problem will be the energy policies.

Now, I can see your points. And in fact, you are speaking to an amendment that we are going to have on the House floor today on the windfall profit tax. And I must say you are persuasive.

What relief can you offer to the consumers in various regions, for example, the Northeast where cold winters are commonplace and skyrocketing costs are going to become astronomical for heating oil?

Now, this situation is an impact of energy policies. Aren't there some funds from this windfall profit tax that can be diverted as a rebate or in some form of relief to these low-income families?

Mr. SCHELLING. Yes; Congresswoman Heckler. But first, let me say the more deadly serious problem for the poor is the next 10 years, 15 years, 20 years. The long-range problem of seeing that the energy situation grows worse slowly rather than rapidly, and gets less severe than it might over the next 15 or 20 years, is something in which the poor have an enormous stake.

They are rightfully concerned whether or not heating oil is going to go above 99 cents a gallon in New England. But what we should be especially concerned with is whether heating oil is going to go above \$1.99, 5 years later.

Right now, what you could do with the windfall tax would be worth a few billion dollars. That is not huge, but it is also not peanuts.

If you want to help the poor, I would say help the poor, but don't help only those who are poor because of heating oil or poor because

of gasoline. There are lots of poor who need help even more than those whose fuel bill is going to go up \$250.

But I would again argue that if the main purpose of a windfall tax is to redress the harm that is done to the poor by letting the price go up, don't divert it away into things that look like attractive energy programs, long-range solar development, and so forth, but find ways to get it back to the poor.

I would propose giving the tax funds back to them, if possible. That method reduces the official Consumer Price Index and focus on the poor and not merely those whose poverty happens to have been aggravated by price increases.

Representative HECKLER. Mr. Schacht, would you like to make a comment?

Mr. SCHACHT. This is a subject that our design subcommittee wrestled with on this issue. This problem got the most heated debate at our meeting.

Congressman Mitchell, your concern about the poor, we spent hours on this. One of the things the book is designed to do is help focus on whether a windfall profits tax or any kind of tax could divert the rising price to offset those who really are going to be affected. That is the key question.

If you buy the framework that prices are part of the solution, as unpleasant as they are, if you buy the analogy that it is better to take a little unpleasant medicine now than to face a potentially terminal disease later, if you buy that analogy at all, then the criteria to judge the price mechanism is twofold: One, will it produce conservation; and two, will it bring on the alternate energy sources we ultimately need to free our economic dependence and political dependence on the Middle East?

The point Congressman Brown makes and the point we found compelling was that if you put windfall profits tax on, you negate one of the two actual reasons for allowing the price mechanism to work.

One is conservation. Clearly, rising prices are important. If you aren't very careful with a windfall profits tax, you, in fact, negate what I believe is the more important goal. And that is the freeing up of the alternate sources.

This in no way deals with the very real issue we are all concerned about, the very societal issue, of what do you do with large segments of the population who no longer can afford even minimal standards of living, and the windfall profit tax exacerbates their problem?

What we are trying to say is not to ignore that argument but to say that the answer to that is not found in the windfall profits tax, because it will negate the alternate sources of energy. The answer to that question is found in our general revenue system which says these are very real human beings whose human needs have to be met. It just says that the windfall profits tax is going to make their problem worse long term, because we won't have alternate energy sources.

What we have to deal with then is the unpleasant problem of revenue and the tax system and social security system. And we will have to relieve these people from some other obligation that they now have, whether it be social security or minimum income tax or some other general rebate.

And if we say it is politically necessary to put windfall profits on old oil, let's put that in the general revenue and let's have an offset that goes to poor people to help them offset their general rising cost of everything they do.

These are real human beings, and we have to worry about the society. We have a narrow point, and that is to be careful of windfall profits. That's all.

Representative HECKLER. I don't think there is that much difference of opinion. I personally would agree with you. We have to develop our own sources of oil and of energy. That is primary, in my judgment. That is a primary goal.

And a second would be conservation. But there has to be some relief for those that are severely impacted. And I think you can achieve all three perhaps in one, if it is a careful devised plan.

But you would suggest that the question of the impact of higher fuel costs on the low-income family be handled through the general tax policy rather than through this windfall tax?

Mr. SCHACHT. That would be our recommendation.

Senator BENTSEN. Thank you, Congresswoman.

Senator Kennedy.

Senator KENNEDY. I'm sorry I missed the earlier testimony, Mr. Schelling. I would like to welcome you here.

Your response to Congresswoman Heckler was positive, as I understand. Did you say yes in answer to her question?

Mr. SCHELLING. About windfall?

Senator KENNEDY. Yes. That it should be, or that the response of the need to the equity issue ought to be responded to in terms of tax policy rather than related to it.

I was interested in reaching the issue of general cost. As you know, very clearly we have certain parts of the country which are particularly vulnerable to escalating petroleum costs. That is, through either the accidents or benefits of geography and because of the industrial development trends of past history.

As we have shaped any national policy in areas of concern for this country, we have tried to balance those burdens and those benefits off. We shape national defense policy to meet the challenges from our adversaries. That burden is borne pretty equitably across the society.

I think there has been a very important element in fashioning energy policy that the American people are going to be convinced that the burden is fair and that it is equitable and that the American people are prepared to respond to what they are asked of and from their leadership. But I think it is extremely difficult.

You are both distinguished political scientists and people who have studied the process of politics for many years to think that you are not going to have enormous kinds of pulling and hauling and tugging and perhaps inadequate and incomplete and wholly nonresponsible responsible responses to national public policy unless there is a clear perception that the belt-tightening is done fairly and equitably.

We have the action of history that says that there are many sections of the country, whether it is home heating oil in my part of the country or diesel oil in the agricultural part of the country, the middle distillates in other parts of the country, the southern parts of the Nation

where elderly people have to be cool because of the nature of their burden. It seems in fractions, and developing and shaping an energy policy, I am very interested in your analysis that we have to really just sort of target and take a very narrow segment in terms of responding to this issue and problem.

I myself think that the American people would be more responsive and perhaps be treated more fairly and equitably if we had sort of a cost-benefit evaluation of these alternative energy systems. What does it mean in terms of cost to the average family, or the needy family, or the consuming family, for the development of synthetic fuels versus the issues of energy productivity?

What is it going to mean in terms of heat conversion, in terms of their energy bills, if we develop one type of alternative energy versus whether we develop another type of alternative energy? What are going to be the real kinds of social impacts?

What are going to be the equitable tradeoffs on it? Are we going to see, on the one hand, if we say we are not going to put any kinds of taxes on what you call the genuine costs arising, which are interpreted by many people in our own State as being general costs, being what OPEC leaders are costs as they are sitting around a restaurant in Geneva, and completely unrelated to real costs, versus what the real costs would be in terms of energy productivity, synthetic fuels, solar energy, the technology problems that are connected with it?

Is it going to be jobs to these people that are going to be living in these crowded urban areas? Is there some sign of hope for them in the future?

And I am just asking if you could review with me, at least, in the development of your own thinking about how you place these alternative energy options, how you traded them off. What kind of value did you give the issues of equity and give to the needs of the people which pay the highest percentage of their income for energy and recognize that their lives and the lives of their families are going to be dramatically impacted? Because the political fact of the matter is that those for the most part are not the ones that have the high-priced lobbyists and have the high-priced spokespeople down here. They are the ones in the political spectrum that are left behind time and time again.

And there is very, very little, I think, indication, as much as we are able to analyze, as you have, in a very eloquent way about how we ought to proceed. There are many of us who are going to see that train pulling out of the station and those senior citizens and those elderly people left behind, gazing.

I know what you are trying to do is give the best-case scenario, but I would hope maybe you could help us, as I know from both of your works, know personally your concern and your compassion about these particular groups.

Now, just review for us—and I know I have taken up half of my time in terms of laying out the premise, but I think it is in terms of these alternative energy sources—how you reviewed those, how you compared them, how you factored in the social and equitable issues. And in looking at this problem, which is national, also, how did you look at it from a regional point of view?

Senator BENTSEN. If I may interrupt just a moment, Senator Kennedy, the House Members have had to go vote. I have another meeting, but will be back shortly.

Why don't you go ahead and continue this hearing, Senator Kennedy. Then would you please recess the hearing until 11:15, after you complete your questions.

Senator KENNEDY [presiding]. Thank you, Mr. Chairman.

Mr. SCHELLING. First, Senator Kennedy, what we have to pay OPEC is a real cost. It costs real money that has to be earned by real people. From our point of view, it is a real cost.

I can deplore the fact that in wage costs, and drilling costs, and drilling costs, the OPEC price bear no relation to what the oil is worth. But when we get \$20 oil or whatever it is going to be, we are getting oil that is worth \$20 to somebody else. And it is oil that we have to pay \$20 for.

So it is just as real to those who pay it as if we had to dig it out of the ground at \$20 a barrel.

Senator KENNEDY. That's right. I will agree, in terms of the points of departure. But I think it is important that the American people don't understand that that is an administered cost. It is quite different from the real costs that we have in terms of airlines' flying or truck travel, roads, or widgets, or cornflakes, or Wheaties, in terms of a competitive. But it is a real cost, as you define it.

Mr. SCHELLING. And it is clearly administered, because anybody could read in his newspaper today that the price decisions are being made by people in Geneva right now, and they are not discussing wage levels in Iran. They are discussing what the market will bear.

Senator KENNEDY. But that is unrelated to what it is here in the United States in terms of oil sold.

Mr. SCHELLING. But the cost to us of doing without the OPEC oil is whatever it costs us either to use something other than fuel or to get more fuel. So in terms of what we want to do to encourage more fuel production or encourage more fuel conservation and how we think about what it is worth to save some fuel, it is going to be OPEC's \$21 or whatever the price turns out to be.

Now, with respect to allocating the burdens, I would be very reluctant to think that we can do everything we want with respect to regional equity, equity by income level, equity by occupational group, through manipulating energy policy. It is going to be exceedingly difficult to have an energy policy that makes the energy problem less severe 10 years from now rather than more severe.

And by trying through allocation to take care of every group that deserves governmental attention will put, unfortunately, more burdens on people like John O'Leary, who is going to succeed us here this morning, than they can possibly imagine. Right now, I believe that we are discovering that the worst thing that may happen, even to the poor, may not be that the price goes up but that an allocation system that can't work may create enormous uncertainty about whether they can drive to work tomorrow, whether they can take their elderly parents to the doctor and dentist the day after.

It is remarkable that there is hardly anything in the newspapers or on television complaining about the price of gasoline. It is the

extraordinary uncertainty about supply and the awkward way that we pay for gasoline, by losing an hour or more of time when we could be working.

That is why I am skeptical that handling all of the problems regionally between city and rural areas, between tourist areas and non-tourist areas, will ever be managed by allocation. Allocation often converts a serious price problem into a more serious problem of absolute shortages and uncertainties.

For this reason, I feel that energy policies should primarily focus on the long run. What can we do to see that the poor and everybody else are less jeopardized by fuel prices from 1985 or 1990 on, rather than simply this coming winter.

And I would try very hard to take care of the genuine problems of the poor by genuine programs for the poor. I am not even sure there is good reason why people in the rest of the country should help me pay for my heating oil in New England merely because oil prices are conspicuous and people can have pity on me, while other people in other parts of the country suffer other price increases that simply don't get the attention.

I would be more willing to take my chances on higher fuel prices in New England, not just myself, but for the poor, if the alternative is an attempt by allocation mechanisms to convert a price problem into a gap problem. The worst thing that can happen to the poor is to have an allocation system that allows their month's fuel supply to run out 3 days before the month is over and the pipes freeze. They are far worse off than simply paying the higher price.

If they paid higher prices, I would say focus on the problem of their poverty and don't try to solve that problem by fine tuning an energy policy.

Senator KENNEDY. Well, that is about the same answer I heard in the earlier questions. What I am interested in is your balancing the alternative energy resources and what kind of consideration you give, if any, to the social and equitable issues which are involved in them on synthetic fuels versus energy productivity, solar, on oil shale, tar sands, all of the —

Mr. SCHELLING. We are now talking about fuel supply in the 1990's. I don't think we can afford to do anything but develop the most economical fuel supplies.

Senator KENNEDY. What is that

Mr. SCHELLING. We don't know. And therefore we shouldn't make the decision here. We should indicate what the price of fuel is likely to be, if necessary, and be prepared to offer a price and let people develop what fuels they can to meet those prices, whether it is going to be shale, coal, or tar sands. But to decide now and stick with the program would be a mistake. I think it is important to make sure that the price at which those fuels can be sold is a price that competes with the future OPEC price, so that people who are willing to risk investment in developing some of these which will be losers and some of which will be winners will know at least when they win, they can compete with the OPEC price.

Senator KENNEDY. Well, are you coming down, then, in favor of a synthetic fuel as a development program?

Mr. SCHELLING. I would favor particular kinds of synthetic fuels development. I answered the question earlier, sir, before you arrived.

I believe that offering to contract for some limited amount of synthetic fuel for delivery beginning in the late 1980's and allowing competitive bids to be submitted within an announced ceiling, a ceiling that would have an escalator clause of the cost-of-living index for inflation, would be sensible. And I would think that up to a few million barrels a day of such contracts might well be a good insurance policy.

And it seems to me that even as insurance, it may turn out not to cost money to the Government.

Senator KENNEDY. And that would be pegged to the OPEC price. Would it be above the OPEC price?

Mr. SCHELLING. I would peg it to what we think the OPEC price is likely to be in the 1990's. If, therefore, it can be produced without the subsidy, it will make it. If some subsidy is required, the subsidy ought to take the form of a price contract.

Senator KENNEDY. What do our studies show on that? What sort of subsidy would be necessary?

Mr. SCHELLING. The subsidies could be anywhere on the order of \$3 to \$10 a barrel.

There are two reasons we don't know. One is that most of these processes have not been undertaken on a commercial scale. And the extent to which present cost estimates will prove wrong can't be known. Second, nobody can predict what additional cost environmental protection will require or what environmental protection regime will be in effect.

For that reason, on these costs, about all one can say is, well, within twice the 1978 price of OPEC oil, we can probably begin to have very large quantities of liquid fuel, starting in 1990.

Senator KENNEDY. You don't think that is just going to be an invitation for OPEC to raise their prices up to that level?

Of course it is. Of course it is. Is there any question in your mind?

Mr. SCHELLING. OPEC doesn't need an invitation to raise its price.

The Saudis are telling us to take steps to enhance our own supply and to reduce our consumption, because they claim to have an interest in world economic stability and indicate that in addition to their own increasing supply, they want to see us and other consuming countries take more steps to conserve oil and to produce more of our own.

They are asking for a response from the United States about what we are going to do. At least by 1990 there are things we can do, and we can make them understand that.

Senator KENNEDY. Well, in this additional \$3 to \$10 a barrel subsidy for the synthetics, in your own study did you review the different alternatives of synthetic fuels? Did you come out in support or in favor of any particular types of synthetic fuels? Or did you discount any as being economically unrealistic?

Mr. SCHELLING. We didn't pick a favorite, and we think it would be unwise policy for the Government to pick a favorite.

Senator KENNEDY. What should we do? Should we just go along with all of them, then?

Mr. SCHELLING. We let them compete with each other.

Senator KENNEDY. Each with \$3 to \$10 a barrel, in shale oil, tar sands, and other types?

Mr. SCHELLING. That's right. If tar sand development can compete with oil at \$25 a barrel and shale at \$28 a barrel, I will take the tar sand. If it is the other way around, I will take the shale. If coal can do it for \$24, I will take the coal.

What I want is the liquid fuel the cheapest way possible, whatever it comes from.

Senator KENNEDY. And what about energy productivity, if you recall the mandating of various requirements and the savings that can be achieved from that? Did this figure into your program as well, energy efficiency?

Mr. SCHELLING. Yes. We know that energy efficiency is already improving quite strikingly in industry. It is already improving quite strikingly in the automobile fleet, although in all of these cases it takes 10 years to have a major effect, because you have to flush it through a durable fleet.

There are improvements in productivity in home heating. And generally these improvements will be induced by the rising cost of fuels.

On the other hand, there are many ways people can be assisted in alerting themselves to opportunities for savings. And in a few cases, people can be induced to do what they ought to do for themselves anyway.

So there is at least an important limited scope for mandated standards and even things like mandatory labeling. But I think the primary response will be that people will save energy when it saves them money.

Senator KENNEDY. Well, did your program support the subsidy for energy productivity and efficiency as well in the substitute fuels?

Mr. SCHELLING. We did not go into particular programs for particular kinds of productivity.

Senator KENNEDY. Why not?

Mr. SCHELLING. Because we were developing a framework for thinking about energy policy and thinking about the role of the price system, thinking about the role of environmental protection.

Senator KENNEDY. Well, environmental protection, aren't you from an environmental protection if you are getting energy efficiency? Isn't that the most environmental concern, rather than the issues of shale oil or tar sands or burning more carbon dioxides over the period of the next 100 years?

Mr. SCHELLING. The techniques that are most efficient in terms of fuel use are not necessarily the techniques that are most benign for the environment. We could provide electricity with a lot less fuel if we didn't mind sulfur. We could probably get better gasoline mileage if we didn't mind lead.

There is a very serious trade-off between energy conservation and environmental conservation.

Senator KENNEDY. But can you review why, in terms of trying to meet a national energy policy, you are prepared to see the kinds of heavy subsidies in these synthetic fuels and not the kinds of subsidies in terms of the energy productivity or energy efficiency and encouraging that factor?

You indicate pricing to be a factor. The fact of the matter is, this gets back to an equity issue. The poor people don't have the front-end money that rich people do to insulate their homes. They don't have the money to go out and get the windows in order to do it. They don't have the front-end money in order to take it as a tax credit.

And I am just wondering, in shaping of an energy policy, if we are so willing to use the taxpayers' funds on the one end of the system in terms of increasing the energy alternatives from a synthetic point of view, and I think there has to be some resources that are going to be allocated for that. I do myself think what we ought to do is be able to break that down in some more meaningful way, rather than attempting just to throw money at a problem in terms of a variety of different synthetic fuels.

But it just boggles me that those that come before our committee are so interested in spending billions and billions of dollars in terms of increasing synthetic fuels, and yet when we ask in terms of energy efficiency and mandated programs, whether in energy productivity, we talk about, you know, the cost mechanism and the reluctance to have that kind of commitment in terms of funding.

And I don't understand whether it is from an economic point of view or from an energy point of view.

MR. SCHELLING. Sir, you gave several examples of why, in general, we do not believe in subsidies. Most subsidies are poorly targeted. They become built in and outlast their original purposes.

Senator KENNEDY. Are you talking about tax credits now?

MR. SCHELLING. I quite agree with you, tax credits for home insulation don't necessarily reach the groups that equity would lead us to want to reach. They don't necessarily greatly increase home insulation. They give credits to those who were going to insulate anyway. They may raise the prices of insulation.

And it is beyond the power of the Department of Energy to look at every such small subsidy and see whether it is working or whether it has outlived its usefulness.

Senator KENNEDY. Are you aware of the insulation program in Canada?

MR. SCHELLING. No, sir.

Senator KENNEDY. Do you know that within about the next 3 years, they will have about 90 percent of their homes completely insulated?

MR. SCHELLING. I don't, but I hope that it is worth it in terms of the money it saves. If it is not, it is a poor program.

Senator KENNEDY. That's what I am asking in terms of the developing of an energy policy. Evidently, you felt that it had advantages.

MR. SCHELLING. In this country, the Congressional Budget Office has submitted the effect of income tax credits for home insulation and has found that it cost the taxpayer an enormous amount of tax expenditure to get a little more home insulation with a very small energy saving.

The only reason that we are considering subsidies to synthetic fuels is that liquid fuel in the country is so enormously important.

Senator KENNEDY. You will provide that to me, that CBO reference, in terms of what it is for the energy savings in the energy insulation?

Mr. SCHELLING. Yes; it is in my office. I will get it to you.

Senator KENNEDY. Are you talking about tax credit or insulation generally?

Mr. SCHELLING. This was the income tax credit.

Senator KENNEDY. I think that that is very much an open question in my own mind as someone who has serious concerns about using tax policy in that way myself.

But the question in terms of insulation about how you are going to do it and what it means in terms of the savings of energy, what it means in savings of energy, I think there is a different conclusion.

You might say how we are going to do it, whether we are going to provide direct kinds of allocation of funding for it, or whether we are going to provide some other kind of mix.

I mean the Canadian has a certain mandate program in terms of the transfer of housing. You have to have it insulated. They have other kinds of techniques and devices which have been successful and which they believe from an energy point of view have been far, far more efficient than the purchasing of a new barrel of oil.

What I am trying to sort of get at is whether in that aspect of that side of the problem, whether in your own study you have given that much attention as you have in terms of the other producer side to reach conclusions.

Mr. SCHELLING. We were primarily concerned that people will, indeed, respond to the need for insulation once they understand that the cost of heating oil is high, is not going to go down, and is likely to rise.

Senator KENNEDY. That is not true about elderly people. That is not true about poor people. That statement just isn't accurate on it.

It is not true in Massachusetts, and it is not true in most of the industrial areas of the country.

They just cannot afford the front-end funding, which is necessary for them to get the insulation.

And I will challenge you to produce the figures that would indicate to be so. It is just not so. It is just not so.

And there may be those that have more resources and income that can understand it and put on a cost ratio over a period of time that would be willing to spend that.

But it is not true in terms of the needy people in our society. I just don't believe it.

Mr. SCHELLING. I thought we were discussing energy and not how to take care of the needy.

Senator KENNEDY. We are talking about insulation and your statement that the economics of it are sufficient to persuade them to go ahead and insulate their house.

And my point was senior citizens, elderly people, don't have the \$1,000 that is necessary to insulate the house.

That is what we are talking about.

Mr. SCHELLING. I agree. But to the extent that we are concerned about conserving energy in total to make ourselves less dependent on OPEC, less susceptible to supply interruptions, to keep the price of oil down in the future, we are interested not in who is interested, but how much fuel is saved.

The problem of those who cannot pay the front-end cost of insulation is the same as the problem of those who cannot afford the front-end cost of any home repair.

It is the problem of the poor and not the problem of saving energy.

Senator KENNEDY. I am long beyond my time, but let me ask one final question.

You are prepared to give a direct funding for the development of synthetic fuels. Are you equally prepared to give direct funding for the conservation of energy if they are able from a cost-benefit ratio to show that they are going to be able to save or provide cheaper energy?

Mr. SCHELLING. Only if I can find comparatively straightforward, nonadministrative competitive ways to do it.

The only reason that I consider any such things with respect to synthetic fuel is the possibility of allowing competitive bids for a product that the Government can buy to have for people in the future to keep down the price of fuel.

Senator KENNEDY. Well, is that such a problem from an economist's point of view of getting utilities to compete about whether they will be able to insulate homes and give them the direct payments that they can do it?

If you have got A, B, C, D, all competing for X's home, they will be able to do it at cheaper prices.

Can't we do that? Can't we treat those people on the area of the saving of energy productivity and efficiency the same way we are going to treat them on the other? Or do you object to that?

Mr. SCHELLING. I object to using electric utilities as the preferred instrument for financing conservation, sir.

Senator KENNEDY. If you have got other devices, I am just trying to understand the way. Are there other devices to do it? Or do you object in principle or do you accept in principle? But you don't like the devices of the mechanisms. You haven't found a mechanism.

Mr. SCHELLING. I accept in principle the notion that the best way to conserve energy is to let people save money by insulating. The best way to help the poor is not through insulation policy.

Senator KENNEDY. My time is up. Congresswoman Heckler.

Representative BROWN. Senator, are you presiding now, or am I? Or how are we doing it?

Senator KENNEDY. Senator Bentsen told me I was presiding and I will yield to Congresswoman Heckler.

Representative HECKLER. Mr. Schelling, I think that in view of the fact that we are experiencing a small windfall of time, I can't resist going into a subject that isn't covered in your statement, which is dealing with your expertise in the field of nuclear energy.

You authored two publications on nuclear energy and conducted numerous in-depth studies in that area. I wonder if you could discuss that subject in some general terms or specific terms in view of the revelations and problems that we have had with Three-Mile Island.

What would you say about nuclear power now?

Mr. SCHELLING. Before Three-Mile Island, my view was that, nuclear power being good during this century only for electricity, the essential question was nuclear power, coal fired power, or less power,

and that we had to keep a healthy nuclear power industry because it may turn out that burning coal is sufficiently hazardous to our health that we will wish to do it with nuclear, which, when it works well, tends to be more benign.

People are concerned about nuclear power when it doesn't work well. People are worried about coal if and when it burns as promised because there are enormous uncertainties about the public health hazards in burning large amounts of coal.

It seems to me important not to commit ourselves to coal-fired electricity if it is possible to keep nuclear power going, at least for another decade.

Now, one of the difficulties with nuclear power is that it was already becoming unpopular in this country and elsewhere before Three-Mile Island. Not many electric utilities are adventurous, high technology corporations. Many of them realize that if they cut costs immensely and make high profits, the public utility commissions will regulate them down to normal profits.

But if they get involved in something that imposes an extraordinary loss such as Three-Mile Island, the utility commissions will not necessarily permit them to recapture the investment.

Electric utilities, therefore, tend to be very conservative. Predictable high costs don't bother them that much as long as these costs will be taken into account in the rate price.

Therefore, there has been a sort of disinfatuation about utilities with electric power. It was already happening. There were very few new orders for reactors, some being canceled, some being deferred.

I don't think that we know yet whether the nuclear energy industry in this country is going to survive this latest blow.

My personal belief is that we are undoubtedly going to be far more careful with nuclear than we were before Three-Mile Island. I conjecture that the grounding of the DC-10's was largely due to Three-Mile Island and the recognition by regulatory agencies that it is no longer true that you get in trouble only for grounding airplanes. You can also get in trouble for not grounding them.

And with respect to nuclear power, I think it will never again be true that ordinary casual business as usual is the order of the day at power reactors.

Representative HECKLER. One of the problems that I find Members of Congress mentioning in terms of nuclear power is the fact that for all these years that we have discussed this subject, the nagging and unanswerable question really was the question of the disposition of the waste. That question plagued us and created a continuing tension and still has not been resolved.

But after thousands of hours of testimony, the difficulties that were most recently experienced at Three-Mile Island had never been discussed. The kinds of failures or problems had not been raised as serious weaknesses.

We questioned how many other such weaknesses there are or might be.

Now, I wonder if you could address this question of the disposition of the waste. We still have not resolved that central floor issue. Why is it that with our technological skills in America, certainly, we should be able to resolve this. But we haven't.

What is the answer and what do you propose to Congress?

Mr. SCHELLING. The most serious problem about disposing of the waste is that people want something that will dispose of the wastes for 10 years, 100 years, 1,000 years, 25,000 years.

The wastes can be safely disposed of at present. They do not take up much space. They can be put in remote places and appropriately guarded places and otherwise.

What cannot be done yet is to find a way to put them irretrievably some place forever where nothing can ever happen and nobody will ever need to go back and do anything new with it.

My personal belief is that any disposal should be retrievable; that we should not commit ourselves to anything that is supposed to last 25,000 years.

If we can commit ourselves to something that is good for 10 years, after 10 years, do it again if it works.

For this reason, we would not be searching for the ideal, permanent, total, irretrievable disposal system. I would rather recognize that there were many, many ways to take care of it indefinitely, if not permanently, and then come around to what is really a very serious problem that the public has, which is the desire that the wastes, even if they are not a huge problem, nevertheless, being a problem, can be taken care of in somebody else's backyard.

The difficulties of having nuclear wastes travel through your town by truck or railroad, the difficulty of just knowing that your State has been selected for the booby prize, seems to be something that most localities and most States can't get used to.

It is partly because this enormous mystery surrounds waste. Not only are they nuclear wastes, but when people explain in thousands of years how long the poison may last, it sounds longer than if they had simply said "forever."

Representative HECKLER. I am afraid that I will have to go and vote. And unfortunately, I would like to proceed on this, but I will take advantage of your proximity in Boston to further search out your responses to these issues.

Since none of us will be available and our next witness is not currently present, I would like to recess the hearing until 11:15, when Mr. O'Leary does appear.

And I would like to thank both witnesses for their participation this morning and for the insights they provided for the committee.

[A brief recess was taken.]

Senator BENTSEN [presiding]. The committee will come to order.

Since we are running behind schedule, and I know, Mr. O'Leary, you have a statement to give, would you mind not reading your prepared statement. We will put it in the record in its entirety. If you would go ahead and summarize it, we will go directly to questions.

STATEMENT OF JOHN F. O'LEARY, DEPUTY SECRETARY, DEPARTMENT OF ENERGY, ACCOMPANIED BY LYNN R. COLEMAN, GENERAL COUNSEL

Mr. O'LEARY. Thank you very much, Mr. Chairman. I will take advantage of your invitation and insert the prepared statement into the record.

I would like to introduce Lynn Coleman, the general counsel of the Department, who is with me, who knows all about the subject matter that we are covering.

Mr. Chairman, I would like to briefly summarize the situation as I see it on a global basis. I think that what we are seeing now is a switch in the terms of trade on petroleum that will be of fundamental importance to this economy for the next 10 years, anyway, and probably for the next generation.

Now, the background of that, Mr. Chairman, is this: Ever since the end of World War II, essentially since mid-1947 or 1948, up until last January except for a very brief period of time during the embargo, the world oil market was characterized by surpluses. Even as recently as last fall and before Iran had its revolution and began to fall back on production, there was a substantial surplus in world producing capacity—at that time 4 to 4.5 million barrels a day.

Indeed, if that substantial surplus producing capacity had not existed, today's critical situations would by now have true crisis proportions. We would have had a global catastrophe if Iran had disappeared as a producer without replacement capacities elsewhere.

We are now at the point, Mr. Chairman, where we see the world in these terms: The world as a whole is producing about 60 million barrels a day, a little bit more. The Soviet bloc produces and consumes about 10 million—I am rounding now; it is actually about 11 million, but 10 million is close enough for our purposes. We produce and consume about 10 of our own, importing, of course, almost another 10. Starting with 60 million barrels per day, the Soviets out leaves 50, the United States out leaves 40, and the rest of the world, the non-OPEC world, produces another 10 million barrels a day. That would be Australia, Mexico, Canada, and a few other producers. That leaves, then, about 30 million barrels a day or half of the world's supply internationally traded and supplied by OPEC.

As we look forward as to what is going to happen to that, I think the likelihood is that we will not find an expansion in OPEC's supply over time. And the reason for that, Mr. Chairman, is fundamentally because of the division between the so-called have-nots, those that do not have large reserves in OPEC, and the so-called haves.

As it turned out, the have-nots, those that do not have large reserves, have large populations and expansion programs and would produce more oil than they could. The haves, those with very large reserves, relative to their present producing potential—that would be Saudi Arabia, Kuwait, United Arab Emirates, and Iraq—those countries have small populations and are not under any particular pressure to raise their levels of production.

Indeed, it has been pointed out on numerous occasions that Saudi Arabia alone, by simply opening its production back to the levels attained a year ago, could alleviate all of the strain and pain in the world supply system. Because of their internal requirements and because of the political setting in which they exist, and in large part because of the lesson to all of the developing world that was served by the Iranian revolution, there is little likelihood they will in fact produce to our convenience. They rather will continue to produce to meet their convenience. That is also true of Kuwait and the other have nations.

So while it is fair to say there is plenty of oil to go around, at least for the short run, the likelihood is, because of the distribution of oil among the international traders—that is to say, among the group of nations that make up OPEC—they will not in fact provide plenty of oil to go around.

Let's turn to the U.S. situation briefly, Mr. Chairman, because it bears very heavily on this. We have an awful lot of charges and countercharges as to why we are in trouble here, why there are lines now in 20 States around the Nation. I would like to give you my best judgment as to why that situation exists.

First of all, there have been charges that the oil companies have been withholding; that they are holding high stocks of crude and keeping their refinery runs down in order to facilitate price increases. Let me comment on that, Mr. Chairman.

Current fuel stock levels are in the range of 328 million barrels. In our judgment, those stocks could be reduced to perhaps 305, perhaps 310 million barrels.

Let's say there is 20 million barrels that, in our judgment, the judgment of the officers of the Department of Energy, the refiners could run that they are not running now. They could over the next 3 months, let's say, reduce their stock level by 20 million barrels without jeopardizing the continuity of their operations. What would that do for them? Mr. Chairman, it would provide another 200,000 barrels a day of total product, perhaps 300,000, depending on the rate of drawdown. And that would provide 100,000 barrels to 150,000 barrels a day of gasoline, assuming they were able to run that gasoline at the ratios that now prevail across the industry.

That is against the shortage of around 800,000 barrels a day. So if they were to do it, we would still have a certain shortage in this country.

It would also permit the production of 50,000 or 75,000 barrels a day of middle distillate. And the stock requirement of middle distillate through the remainder of the summer is something like 800,000 barrels a day. So it would be only a token contributory to solving our heating oil problems this winter.

So I think that is the true perspective of the outside dimensions of the charges of withholding. I don't think it would make a significant difference with regard to fuel oil. And it certainly wouldn't make the difference between shortage and adequacy of supply with regard to gasoline. If that were done, we would still have a very, very tight situation on gasoline supply.

Now, the viewpoint of the companies, Mr. Chairman, is this: All during that period that I alluded to earlier of world surpluses, if something happened to their supply system—that is to say, if a ship didn't come in on time or a pipeline shipment was missed—because of the surpluses that I alluded to earlier, the companies could always pick that up and recoup the loss of that ship not coming in or the pipeline missing a beat without interruption to their refining operations. That surplus cushion has gone now, Mr. Chairman.

Consequently, I think we will see a tendency on the part of refiners to maintain stocks at somewhat higher levels than was the case during the long period of surplus.

I just give you that as an observation.

Second, we are treated everyday to authoritative articles with regard to the State, with regard to rest or unrest in the Middle East, particularly in Iran. The companies see this, and they have their own intelligence, and I think what they are saying to themselves is:

We don't want to get into a position where we are living from hand to mouth on crude oil stocks in the event there is another interruption or partial interruption of supply. We then get to a point, instead of having the moderate to severe shortages that we are encountering in the United States, that is of disaster proportions.

I think, Mr. Chairman, I would like to see the companies run a little more. I think they are conservative in their inventory management, but the thing I have to tell you, if they did this, it would not solve today's problems with regard to supply. It could possibly put them in a situation where they would be unable to maintain their refining operations should there be an interruption of the supply. It would precipitate a potentially more serious situation than the one we have now.

Mr. Chairman, let me finally say where this takes us. Over the short run, there is a very little to do about this. It is indeed the frustration of my professional career. And Congressman Brown now has heard this on numerous occasions, I am sure, that despite the fact that this country has the technology and has had the technology for anywhere from dozens to 100 years to produce the fuels that we need from the resources that we have, we haven't taken those steps, haven't taken those actions that are necessary to get us started down the path of developing the synthetic fuel industry.

In consequence, what we are going to have to do in the short run is find ways in which we save oil. Right now we are using a million barrels a day less than we were or better than a million barrels a day than we were at this time last year. That isn't from what we would like to be using. That is from the actual consumption in June a year ago. We are down 7-, 8-percent gasoline, 4- to 5-percent middle distillate, and 4- to 5-percent on residual fuel oil, June to June, a very substantial reduction.

And we are doing that from a combination of enforced measures. The gasoline allocation is, of course, the factor behind the 7-percent saving in gasoline and other measures that the Department is administering.

I note here primarily the program that we have run now for the last 3 months of replacing oil with natural gas under boilers. That is about a 300,000 barrels a day saving.

And there is a substantial program we have of wheeling power from coal-based generation plants into areas that normally would use oil for generation of electric power and from nuclear plants into areas that would normally use oil, maximizing the coal as energy and minimizing the drain on oil. Those three elements are accounting for the bulk of those savings.

As time goes on, the emergency plan that was passed by the Congress that empowered the President to establish mandatory thermostat settings on office buildings and other nonresidential structures will have an additional impact on saving petroleum. But I don't think they are experiencing very much of that yet.

So, Mr. Chairman, I think in the short run we are going have to intensify these measures. Over the long run, we are going to have to go to the development of alternative fuels.

I was extremely pleased last night to see the Moorhead bill which amends the Defense Production Act clear the House with strengthening amendments. I would hope for speedy action in the Senate so that we can begin the long delayed, frankly long delayed, job of getting started on the development of the synthetic fuels industry.

Now, with regard to that, Mr. Chairman, let me say a word on the costs that are associated with that program. I have hypothesized the maximum potential, or what I regard as the maximum potential for the United States to produce synthetic fuel at the rate of expansion of about 1 million barrels a day of production annually.

Senator BENTSEN. When could we achieve that rate of production?

Mr. O'LEARY. We could begin that as early as 1985, 1986, and add to it in the indefinite future a million barrels of new capacity each year thereafter.

With that hypothesis, I have asked myself what would it cost? I only use this as an example of impact on consumers of doing it and not doing it. If we were to begin a program analogous to the highway trust fund, we would require a price increase on gasoline of about the dimensions of the price runup of the last 2½ months, that is to say, 10 cents. A 10-cent tax would cover all the costs that are associated with all of the synthetic fuels that this country could possibly need—10 cents per gallon.

Senator BENTSEN. That would be more than \$10 billion a year.

Mr. O'LEARY. That would generate \$11 billion a year. And that would be enough to provide and more than enough to provide the subsidy required to bring on 1 billion barrels a day as far ahead as we care to go, Mr. Chairman.

I think that although it is unlikely, we will go that course, using that for funding. It does put in perspective the price to the American people that would be required in order to start this program.

Now, \$11 billion is a lot of money, but we have already had a price runup, this year of almost double that. We get nothing for that. The next time we have a crisis, we will have another runup, and we will get nothing for it. The next time and the next and the next time. Because we are at the point in our history now, Mr. Chairman, where any little interruption—I am not talking about ill will—any little interruption in that skintight price system that we depend upon will cause the sort of disruptions to this economy that we are experiencing today. The loss of one single producing company as a result of internal difficulties, the loss of a critical loading facility because of a fire, the loss of an important transfer point on a pipeline because of a fire, not hostile acts at all, but just the normal things that can occur in a tailor-tight system could bring the sorts of disruptions and inevitably the sorts of price increases time and time again from experience in the past.

And I think, Mr. Chairman, it is time that we recognize that and began to tailor our national policy to the absolute realities of the world oil situation.

Thank you, Mr. Chairman, for this opportunity to discuss this matter with you this morning.

Senator BENTSEN. Thank you, Mr. O'Leary.

[The prepared statement of Mr. O'Leary follows:]

PREPARED STATEMENT OF JOHN F. O'LEARY

Mr. Chairman and Members of the Committee, I appreciate the opportunity to be here today to discuss with you a broad range of energy and economic issues.

At the present time, we anticipate that world oil markets will remain tight at least through the fall. Regardless of this week's OPEC price actions, there will still be a significant shortage of distillate fuel worldwide. World oil production is well below what would be required to meet unconstrained demand and to rebuild stocks, and U.S. refiners must compete with other users for available supply.

We are hopeful that net crude imports could average at least 6.2 MMBD for the remainder of the summer. The API estimates of crude imports in the last two weeks have shown net imports of about 6.2 MMBD, which represent an increase of about 400,000 barrels per day from the levels in May. If net crude imports average 6.2 MMBD, if domestic crude oil production averages about 8.6 MMBD and if refiners draw down available crude stocks to the very minimum operating levels, gasoline supplies for the remainder of the summer could average about 95 percent of 1978 supplies at the best. This would be 8 to 9 percent below projected demand for this summer. Reported domestic production in recent weeks has been nearly 200,000 barrels per day below the 8.6 MMBD projections.

The above estimates assume that U.S. refiners could produce enough distillate to rebuild their stocks to between 230-240 MMB by October 1, while supplying distillate this summer at slightly below the 1978 level. Building distillate stocks to these levels by next fall will require shifting refinery production to increase distillate output. This may require additional Federal actions to assure adequate heating oil stocks for next winter.

There have been widespread charges of withholding as the major cause of the current gasoline and distillate fuel shortages in the United States. In our view, refiners have been very conservative in crude and gasoline stock withdrawals. Refiners could be drawing down stocks by an additional 200,000-250,000 barrels per day without reaching minimum operating levels. Such draw-downs could translate into an additional 100,000-125,000 barrels per day of gasoline and could provide 50,000-60,000 barrels per day for distillate fuel stocks.

The fundamental problem is that the U.S. economy needs about 1 MMBD of crude oil more than is currently available. There is adequate refinery capacity, both here in the United States and in the Caribbean, to handle higher import levels. For the American consumer, the basic explanation for the gasoline lines this summer is our patent inability to import enough crude oil for domestic use.

These present difficulties are only the symptoms of the underlying world energy problem. It is becoming clear that higher world oil prices will not necessarily bring on greater OPEC supplies—contrary to conventional market behavior. In the short run, we must rely on sharply lower oil demand growth, or possibly an absolute reduction in current oil consumption, to help restore equilibrium in world oil markets. The 5 percent demand restraint goal adopted by the IEA last March and the discussions in Tokyo now being held by the United States and its allies to limit overall oil imports indicate how narrow the immediate options are.

The world energy problem is fairly clear in its main outline. First, the supply of oil available to the United States and other consuming nations is limited fundamentally by the production decisions of a few OPEC countries. Second, these long-term production restraints greatly increase the risk and potential damage of temporary supply interruptions and instabilities within any of these countries.

In the past few years, projections of OPEC supplies have had to be revised downward again and again, as a few producer nations have demonstrated great reluctance to invest in capacity expansion. While OPEC production in 1985 was once projected to be 40 MMBD, we now expect OPEC's total production to be substantially below that level.

In other words, if we are lucky and escape another supply interruption, OPEC supplies next year and for years thereafter will be close to what they are now.

After 1973-74, due to slack production capacity in world oil market prices actually fell in real terms. But the Iranian crisis, cutbacks in key exporting countries and the continued growth in world oil demand have resulted in recent severe price pressures. If OPEC continues to restrict supplies to current levels, world oil prices could continue to rise in the 1980's.

Some immediate increases in non-OPEC production will occur by the end of next year. Production from the North Sea should rise by 400,000 barrels per day by the end of 1980. For Mexico, average production in 1980 should reach 1.9 MMBD, or about 300,000 barrels per day above this year's current average. However, to restore equilibrium, sharp curbs on world oil demand will be critical, and over time we will have to find ways to add to supplies. The latest OPEC price increases will certainly encourage further conservation and slower economic growth that will help brake oil consumption next year. These price shocks in the first 5 months of this year are already about half the magnitude of those in 1973-74. The absolute dollar increase for the first price rise was \$9. In the first 5 months of this year, the absolute dollar increase has been over \$4. And in 1979, compared with 1973-74, the U.S. depends more heavily on foreign oil, so that the total increase in the U.S. import bill will be considerably greater. Based on price increases in the first 5 months of this year, the U.S. import bill will reach over \$50 billion in 1979—equivalent to an increase of \$8 billion in 1 year.

Our immediate problem is to cut back demand and wipe out the current world oil shortfall as soon as possible to prevent a further explosion in OPEC price levels. The long-term, more difficult challenge is to develop new oil sources or oil substitutes that can meet the growth—albeit the slackened growth—in world oil demand.

In the past few years, there has been considerable discussion about the oil "glut," or the excess OPEC production capacity which recently existed in world oil markets. That situation was not a unique one. In fact, from 1948 to 1978, with the exception of the embargo period, there have been surpluses in the world oil markets. The entire market structure for oil that came into being during this period reflected generation-long experience with oil surpluses. In 1979, however, the surpluses disappeared—at least temporarily but perhaps permanently.

Several new factors explain why these surpluses are unlikely to occur. The OPEC nations with the greatest oil resources happen to be those with the most revenue and least need to expand their capacity. On the other hand, those countries with the greatest desire to expand their capacity and increase their revenue flows also happen to be those with the fewest oil resources.

It is also clear that any equilibrium achieved today can be wiped out overnight by turmoil in one or more of the producer nations. For example, political stability in Iran, with its export production back up to 2.5 to 3.3 MMBD, is more critical than ever to the world's economic security. Unrest here and in other OPEC countries could lead to new and greater shortfalls almost immediately.

Nor can we expect that non-OPEC oil supplies will be able to meet the entire long-run growth in world oil demand. Total non-OPEC production, currently at 20 MMBD, could rise to around 24 MMBD by 1985. Though welcome, non-OPEC supply increases in the next few years will be relatively limited.

The Mexican government reports proved oil and gas reserves to be over 40 billion barrels. Probable and potential reserves could be two to four times higher. But regardless of the size of these reserves, the outlook for Mexican production, at least through 1985, is limited. Mexico plans to increase total production from 1.5 MMBD currently to only about 2.2 MMBD by the end of 1980 and 2.4 MMBD by the end of 1982.

Meanwhile, in other non-OPEC LDC's, there have been no giant or super-giant oil fields discovered in the last decade. While potential world oil resources are large, the future discoveries of large oilfields—especially the "super-giant" fields that have in the past yielded most of the world's oil supply—are likely to decline sharply. More and more oil will have to be found from smaller than average finds. The discovery and development of large new fields (if they are to be found) will probably take at least a decade.

Nonetheless, many non-OPEC LDC's have a significant undeveloped oil potential. The World Bank, for example, has begun a major program to encourage investment in new oil exploration, and has listed Argentina, Brazil, Chile, Colombia, India, Peru, Chad, the Philippines, Thailand, Vietnam, and Niger as countries with high oil potential. Even modest additions to the world oil export

trade or reductions in OPEC exports to these countries could reduce the stringency in world oil markets. The World Bank has already approved 5 projects under this program, which total over \$260 million, in India, Pakistan, Turkey, Thailand and Egypt. Some 25 additional projects are under active consideration in West Africa, Asia, Latin America, and the Mediterranean. Fifteen of these projects average about \$50 million each, while 10 projects fall in the \$5-\$10 million range.

It should be abundantly clear the United States will have to develop its own insurance against the massive uncertainties in the world oil future. If nothing else, the Iranian crisis has led to growing recognition in the Congress that strong and positive actions will be necessary. The President's decontrol decision, should stimulate greater development of the Nation's oil and other energy resources. The President is also committed to the development of a synthetic fuels program.

In particular, the Administration has supported the Moorhead bill, with some changes, has proposed initiatives to encourage the development and production of synthetic fuels. At this time, the most promising world-wide unconventional energy sources appear to be the heavy oils, tar sands, and to a lesser extent oil shale. But the greatest known resources of heavy oils and tar sands are located outside the United States, and U.S. oil shale production may be limited by environmental constraints. Synthetic liquids and gases from coal could prove extremely valuable oil substitutes for the United States, with its large coal reserves, especially if production costs prove to be at the lower end of the estimates and world oil prices rise as expected.

Most obviously, synthetic fuels can substitute for conventional oil supplies, as these supplies dwindle at home and become scarcer and more expensive world-wide over the long term. In addition, a synthetic fuels program may have a deterrent effect on OPEC pricing behavior well before the U.S. substantially relies on these fuels for domestic consumption. If the costs of synthetic fuels are firmly established through early commercial production, even though such production may at first be in small amounts relative to total U.S. needs, OPEC producer nations would hesitate to raise world oil prices above the levels at which these fuels become competitive.

By the end of the century, the benefits of accelerated synthetic fuel production now could be substantial; and the longer we delay getting started, the more perilous and improbable will be a smooth transition to new forms of energy supplies. The United States has perhaps only 15-20 years to manage the transition away from traditional oil and gas supplies. It will be an extraordinary test of leadership whether the Nation has the foresight to launch programs that will have their greatest tangible benefits 10 or 20 years from today. With the long lead times needed to develop a major new energy industry, action must be taken now to achieve even modest production levels in the 1990's.

There should be no illusion that it will be easy or inexpensive to reduce U.S. oil imports with unconventional technologies. But at the prices of \$25 to \$30 per barrel in the 1980's, imported oil itself will no longer be a cheap fuel of last resort. Nor are the capital costs required to build a synthetic fuels industry beyond the Nation's means.

Some have noted that building 500,000 barrels per day of synthetic fuels capacity might run \$10 to \$15 billion, even perhaps as much as \$18 to \$20 billion, depending on the technologies developed. But that cost is not really so high when compared to the cost per gallon of fuel ultimately produced.

Most synthetic fuels plants are highly capital-intensive, with capital charges amounting typically to one-half to two-thirds the total cost of the product. In this era of inflation, synthetic fuels plants built in the early 1980's should be more and more economically attractive in the 1990's, because so much of the product cost is fixed cost. Put in these terms, I think most Americans would find insurance not only affordable but attractive.

It should be noted that programs to encourage synthetic fuels from coal are not in conflict or competition with efforts to encourage more direct coal use. First, the coal industry has the basic productive capacity to meet both types of demand. Second, the strategies for synthetic fuels and direct coal use address different sets of energy problems and needs. Through the Power Plant and Industrial Fuel Use Act of 1978 and improvements in emission control technologies, the United States is seeking to remove environmental and other non-market barriers to efficient investments in coal. Below a certain size, however, industrial boilers and

facilities cannot economically convert to coal; and apart from these utility and industrial facilities, coal cannot meet a variety of liquid fuel needs.

Since they can directly substitute for liquid fuels, synthetic fuels are far more versatile, and provide much greater insurance against world oil uncertainties. Put another way, greater direct coal use in industrial and utility facilities will be critical to prevent absolute increases in U.S. oil import levels as the economy continues to grow. Synthetic fuel production, on the other hand, can create a deterrent against future OPEC price increases, and can reduce the insecurities created by the high import levels we already sustain.

During the coming transition from cheap oil and gas supplies, the United States cannot rely blindly on any technology or set of technologies. Indeed, even synthetic fuels rely on depletable, finite fossil resources. Significant new supplies of inexhaustible energy will be required to meet the long-term energy needs of the United States and the rest of the world.

In the message sent to the Congress last week, the President outlined a national strategy for accelerating the use of solar and renewable resource technologies. The President set a national goal of deriving a substantial portion of the Nation's energy needs from the sun by the year 2000. The Solar DPR makes clear that solar energy should not be regarded as a remote major supply option.

The DPR concluded that solar energy offers important advantages over many competing energy technologies. It is clean and pollution-free. Accelerated solar energy development can reduce the risks of extremely rapid oil price rises, and provide insurance against unusual constraints on domestic energy supplies like coal and nuclear power.

The key elements of the President's program are:

Creation of a new national Solar Bank, funded in 1981 at an initial level of \$100 million from the Energy Security Trust Fund. The Bank would provide interest subsidies for owners and builders of residences and commercial structures who install solar equipment.

An exemption for gasoline/alcohol mixtures from the current 4 cents Federal gasoline excise tax to encourage the use of gasohol.

A 20 percent tax credit, up to a total of \$2,000 per home, for new homes built using passive solar designs and applications. This and the following tax credits will be funded from the Energy Security Trust Fund, as announced in the April 5, 1979 Energy Message.

An additional investment tax credit of 15 percent (for a total of 25 percent) to encourage the use of solar technologies to provide process heat for use in industry and agriculture.

A new 15 percent tax credit for the purchase and installation of airtight woodburning stoves in principal residences.

The DPR made clear that acceleration of solar energy requires a wide variety of policy initiatives. Solar technologies face various specific problems and barriers that impede commercial development in particular markets. The same technology may be economic in one type of market, but need further development before it is ready for use in another.

I would like to give particular mention to gasohol in this context. Over the past six months, small but growing regional markets have developed. Indeed, the demand for gasohol has increased dramatically, revealing a strong consumer interest in a gasoline derived from renewable sources as well as a strong consumer interest in a higher octane unleaded fuel.

For most of the 1980's, production capacity for converting raw materials to ethanol will limit the production and use of gasohol. More feed stocks will be available than will be able to be converted to produce ethanol. Present incentives appear likely to increase ethanol fuel production from a current level of approximately 4,000 barrels per day to a level of approximately 20,000 barrels per day by 1982, with gasohol use thus reaching 200,000 barrels per day or 3 percent of present gasoline consumption. This production capacity will come from use of present unused distillery capacity and expansion of present facilities.

A permanent extension of the \$0.04 per gallon Federal motor fuel excise tax exemption for all fuel containing at least 10-percent biomass alcohol (as the President has proposed) would encourage investors to build new alcohol fuel facilities. This exemption yields an effective subsidy of \$16.80 for each barrel of alcohol fuels blended with gasoline to produce "gasohol."

The solar energy program generally is not like the man-on-the-Moon goal; the Federal Government alone cannot do the job. The success of this national

solar strategy relies not only on the Federal Government, but on State and local governments, the private entrepreneurs, inventors, and ultimately, on the strength of the American people's commitment to finding and using substitutes for our diminishing supplies of traditional fossil fuels.

Finally, I would like to comment on the progress in filling the SPR during the last few months. The SPR now contains about 85 million barrels, and could be drawn down at a rate of 125,000 barrels per day. The drawdown capability will increase to about 1 MMBD by October.

There have been no new purchases of crude oil for the SPR since the Iranian revolution last fall, but deliveries of oil already under contract have continued. Small amounts are still being delivered, with the final deliveries expected this August. It is not clear yet when we will be able to resume oil purchases for the SPR, but it does not look too hopeful for this year.

In conclusion, I would note that the current shortfall and recent OPEC price increases have brought the Nation to a critical juncture. In the past two years, our difficulty has been to develop a sense of urgency among the American people.

Democracies do not like to hear bad news, or mobilize for invisible crises. But the price shocks this year have come more frequently and rudely than ever, and it appears the Nation's past willingness to drift into catastrophe may have declined sharply. I now believe this country is ready to take up the unfinished business of implementing an effective energy policy.

That concludes my prepared statement, Mr. Chairman, and I would be pleased to address any questions that you may have.

Senator BENTSEN. Mr. O'Leary, we had a good attendance this morning, but our ranks have been decimated by rollcalls.

You paint a very sobering picture. It shows how important it is that both the Congress and the administration make substantive moves. I was looking at some figures earlier. They show the price of oil in 1970 was \$1.80 per barrel.

Today OPEC ministers are meeting in Geneva to set a new price that will approach and may even exceed \$20 per barrel.

Do we see an end to this spiraling OPEC price increase? Do you expect next September or October another ratcheting up the price beyond whatever they set today? Do you think we are looking at another \$5 or \$6 per barrel jump in September or October?

Mr. O'LEARY. I wouldn't speculate on the price increases, but I think in the market I have described to you, Mr. Chairman, of real price increases, substantial price increases will be the annual or semiannual feature of our oil market from here on out.

Senator BENTSEN. I, too, am delighted that the House passed the synthetic fuel bill last night. I successfully sponsored such an amendment in the Senate during 1975. We are a little late bringing it about.

Mr. O'LEARY. Mr. Chairman, I might comment in that connection that had we taken the action in 1973 that the House took last night, by this year, late this year, we could have the first fruits of that action in the form of actual production of synthetic fuels and actual physical relief for the tight crude situation in this country.

Senator BENTSEN. We have got the problem, and you have stated it well, of balancing off gasoline now and heating oil this winter. We saw a Wall Street Journal report yesterday that gasoline supplies will be even lower next month than they were in June. Phillips Petroleum, for example, will be delivering 19 percent less gas in July than last year for the same month.

In those cases, if you add your military and agriculture set-asides, their actual shortage appears to be closer to 40 percent, or about double what the average motorist experienced this month.

Is the gas shortage going to be twice as bad in July?

Mr. O'LEARY. No, I don't think so. What you have here is a company that has historically bought a lot of its products, its gasoline, on the spot market. And the spot market is dried up. At least economically the spot-market gasoline has dried up. So you are seeing your reflection in those numbers of Phillips Petroleum position.

I think more representative numbers would come from discussions I have had, for example, with Exxon who hopes to be able to hold about the same supply next month that they had this month within a narrow range of percentages. In most of the discussions I have had with producers over the last 2 weeks, that seems to be the case. They hope to be very, very close to their June levels in July.

I don't think we will have a massive shortfall in comparison to the June number.

Senator BENTSEN. What do you think we will have in the way of continuing gaslines? How long do you think we are going to be faced with them?

Mr. O'LEARY. Well, the gas lines are in part a result of the absolute shortage, in part a result of panic, psychological reaction on the part of consumers. And I am sorry to say, it is in part the result of our inexperience in running—the Department of Energy's inexperience in running—a large allocation system.

We find, for example, one company takes very close to 100 percent of last year's allocations supply fraction. That in fact is only because of the operations of our system, getting 70, 71, 72 percent of the gasoline to an individual of the portion that a service station had last year to that service station. The rest of it is going into special circumstances.

Let me tread upon a tender toe now. A part of that may be agricultural certifications. A part of that is undoubtedly some errors in our allocation system that permits a class of new service stations to enter into business with a real bang.

That is to say, if you build a gas-and-go station, we don't contrast that to the stations in the neighborhood. We contrast that to other gas-and-go stations that are very hard-bargain operations. We might start someone, a brand new entry into a neighborhood, with 200,000 gallons a month where his competition is going along on 40,000 or even 30,000 gallons a month.

This is an error in our rules that Lynn Coleman and his associates are now in the process of rectifying.

So I think if we take a careful look at our rules, we have exacerbated at least moderately a bad situation by the sheer difficulty of running an allocation system that is tantamount, as I said to my colleagues from time to time, of running the economic activities of the fourth, fifth, sixth, and seventh largest nations of the world.

Senator BENTSEN. We hear so many contradictory reports that I think the public ought to hear from an authority what the situation is regarding heating oil supplies. We have a lot of people talking about having a real shortage of heating oils this winter, where people might have to move out of their homes into public buildings, into school buildings.

Do you think we are going to face that kind of a heating oil shortage this winter?

Mr. O'LEARY. Mr. Chairman, I think there is only a slight possibility of that, and that would be associated with another massive supply

interruption. If supply of crude remains anything approaching its present levels, we have the tools, the time, the will, and the direction from the President to assure that there is an adequate supply of heating oil this winter.

I have heard those charges. I regard them as irresponsible, to frighten people. Unless there is a generalized shortage that comes from some now-unanticipated event among the supplying nations, there is no possibility, Mr. Chairman, that we will have a shortage of the dimensions that will force people to be herded into school buildings and that sort of thing.

We can ground planes and divert jet fuel into that use. If need be, we can put severe restrictions on use of diesel fuel oil.

The President's instruction to us is to be sure that householders have sufficient fuel oil. That is the first priority in all the programs that we are now working with in this oil problem of ours. We have, as I said, the tools and the time. And it will be done, Mr. Chairman.

Senator BENTSEN. Good. I think that helps put some of those fears to rest.

I noticed in this morning's paper that French President Giscard d'Estaing was saying that the United States had done nothing to cut back on the use of energy. I was very pleased to see you say that we have in fact cut back on gasoline usage by some 7 to 8 percent, and on middle distillate some 4 to 5 percent. Is that correct?

Mr. O'LEARY. And residual in the same range. Altogether, we are 1 million barrels and more below where we were 1 year ago. May I say in that context that I was with the Minister of Industry of France 1 week to 10 days ago, and I went over this ground with him in some detail. So the French Government knows precisely the numbers that I have just given you, Mr. Chairman.

Senator BENTSEN. I want to ask you about a railroad coal rate case involving San Antonio, Tex. They converted a local powerplant to coal to try to help trim oil and natural gas use. Yet, they have now seen their railroad rates on the hauling of that coal go up from \$12.42 to \$18.18. I understand the problems of the transportation system of this country and particularly, the railroads. But in fact, San Antonio sits in a monopolistic position with the railroads in transporting their coal.

We are using far less coal today than we were projected 3 years ago to use.

Now, one of the reasons, one of the many reasons, appears to be increased rates for hauling coal. It seems that we should set some priorities in rates for coal shipments to encourage rather than discourage the utilization of coal. We seem to be receiving conflicting directions between the Department of Transportation and between your department.

Would you care to respond to that?

Mr. COLEMAN. Yes, sir, Mr. Chairman. Our view is largely in agreement with yours. You have a basic conflict of policy among the people who are concerned about the economic health of the railroads, and that is a serious problem. It affects energy as well, because we obviously have to have adequate rail transportation capacity in order to move the coal.

However, we think that decisions affecting setting the price at which coal would be transported by rail must take into account energy considerations, must take into account the policy that the Government, as directed by the Congress in the last term, that we switch massively to coal, principally for the purpose of generating electricity.

In the San Antonio case, the Department of Energy intervened at the ICC to make this point of view known. We have intervened also in the ICC's generic western coal rate proceeding and in the Louisville-Nashville case. Our authority is, of course, a completely limited kind of situation, to being an advocate for a point of view.

It is one of the more troublesome questions that confronts the administration, one that needs to be resolved.

Senator BENTSEN. Mr. O'Leary, we are hearing a lot about the truckers' problems; we hear reports that they are being resolved. Yet, every morning we read reports of food rotting either in the warehouses or in the fields, and stories of highway violence. We have even heard that New York's meat supply might be cut in half next week.

Are we facing a major trucking shutdown?

Mr. O'LEARY. We are having right now a major shutdown by truckers, Mr. Chairman. I had a report this morning.

Senator BENTSEN. Let me ask you, what percentage of diesel fuel do they get? Are they being curtailed any more than other forms of transportation, such as the airlines? Are major trucking firms receiving more than the independents?

Mr. O'LEARY. They are not being discriminated against in any sense of the word, Mr. Chairman.

The point that I was about to make, that there are 20 States this morning that are having problems with gasoline lines and what have you. Of those 20, 11 attribute their problems to bulk terminal or refinery blockades by truckers.

I think what we have here is an extremely serious situation, Mr. Chairman, one in which we have a national strike, incipient national strike on the part of truckers. We also have the same sort of thing with regard to gasoline operators. They have a long series of grievances.

The truckers will tell you, for example, that the treatment that they have had from the ICC has been, for one reason or another, unfair or parochial, that they don't like the differing weight and size limitations that States have imposed.

They refer to the "Iron Curtain" that comes down along the Mississippi that prevents large vehicles with heavy loads moving across the country. They resent the slowness of the ICC in the passthrough. They resent bitterly the farmers having precedence for diesel during the planting season, up until we rescinded that order last week.

I think what you see here and in the service station category—and I think we are going to face about the same sort of situation there—a whole series of grievances that have come to a head because of the fact that there isn't enough oil to go around. I think, Mr. Chairman, if this gets progressively worse, which could occur—that is to say, if we do have further supply interruptions and things get tighter—we will see other national strains of this sort.

I understand them. I understand what the truckers are about and what the service station dealers are talking about. But I think it is at a time when we ought to be able to handle those national problems better than in an emergency setting, with, in effect, a gun at our heads.

So I as an American citizen I deplore what I am seeing happening here. The situation, I think, however, goes back to its root cause, and that is our oil policies have been unwise in the extreme. We have kept controls on for too long.

For example, many of our difficulties on gasoline distribution now are because we have an impossible control system to administer. So long as we are forced to administer it, it will be bumping and lumping and ill serve the people. Further, I think that our crude oil price controls were on too long. We were overutilizing and underproducing crude as a result of those controls.

As I mentioned earlier the unwillingness of this country to see the real villains, and that is the cartel of oil producers, but rather, to point at various other would-be villains, and therefore our unwillingness to embark upon the hard course of developing the alternatives that will make it possible to live in the world of the future is a major problem we face.

So I think that, although we are going to see signs of national unrest during the remainder of this summer, and it is possible with increasing severity, the root cause to this is. Mr. Chairman, weak policies, ill-advised policies in the petroleum and general energy sector.

Senator BENTSEN. Mr. O'Leary, my time has expired. And I remember again you told me you had a prepared statement, so we will move along.

Congresswoman Heckler, if you will proceed, please.

Representative HECKLER. Mr. O'Leary, in February and March you ordered the oil companies not to buy oil on the spot market, even though inventories were declining and a gasoline shortage was developing. The companies called it the O'Leary rule.

You said also in your testimony today that any small disruption can cause a major problem.

Weren't you responsible for a very major disruption in inventories by making that decision? And do you say now that the decision was a mistake?

Mr. O'LEARY. Congresswoman Heckler, I have to correct you on one or two grounds. We did not order anyone. If we had—

Representative HECKLER. Advised.

Mr. O'LEARY. That's right. We advised. Many companies did not abide by that advice. I advised them in the same way we are now advising them to increase runs and tilt middle distillate. We are seeing nothing in increased runs for middle distillates.

Sometimes I think we are shouting at the wall, Congresswoman Heckler.

Representative HECKLER. You did advise them not to buy oil in the spot market, isn't that correct?

Mr. O'LEARY. For the brief period of time Iran was settling its price, we counseled our people, in their dealings there, to not be the price leaders. That probably has saved and will continue to save us

a great deal of money over time. I would do that again, Congresswoman Heckler.

Representative HECKLER. What has it done in supply in terms of our shortage?

Mr. O'LEARY. It had very, very little impact on supply. If you note, our supply has been running in an almost constant 36 percent of the supply available to the international energy agreement or to the States as a whole, almost constant. I think it had zero effect on our supply.

Representative HECKLER. Let me say, yesterday this very committee had as a witness Mr. Barry Bosworth, who maybe is, fortunately from your point of view, leaving the administration, because he cited in his litany of how the current crisis occurred the very fact that the Department of Energy advised the oil companies not to make those spot purchases. That was one of the factors he considered as contributing to the major shortage we have today.

Mr. O'LEARY. Well, I am pleased to hear that Mr. Bosworth knows the sources with that degree of particularity. And I will certainly consult with him, Congresswoman Heckler, the next time we make that sort of decision.

Representative HECKLER. You can call him from retirement, I suppose.

I would like to ask about the nature of the shortage in terms of gasoline. What is the percentage of shortage in unleaded gasoline as opposed to leaded?

Mr. O'LEARY. The shortage in unleaded is probably 2 to 3 percentage points more acute than the situation with regard to leaded.

Representative HECKLER. Isn't it true that, since we know that 2 or 3 percentage points—even Mr. Commoner, who disagreed with the Department, has testified to that as well—we know that the unleaded lines are greater and the unleaded gasoline product is in greater short supply—at the same time, gasohol, which combines gasoline and alcohol, reaches the quality of unleaded gas and provides a high octane content and has been used for 50 years in Brazil and is a technology that is on board in one major industrialized country.

And yet, your Department has dragged its feet in funding and developing of the gasohol alternative, which is a grassroots movement in America.

Mr. O'LEARY. Congresswoman Heckler, there is really a contradiction in the terms of your question. It is, as you point out, a well-developed technology. Indeed, we are now selling gasohol in at least 10 States, more likely 15 States.

The action of your Government in this area has been to provide a subsidy of about \$17 per barrel for the people who produce this material. The subsidy comes about by a tax forgiveness on the entire gallon, not just on the 10 percent of the gallon that is represented by the alcohol. That is in effect a subsidy equivalent to the price of crude. It simply wipes out the price of crude so far as the operator is concerned.

It would be impossible, I believe, to have any use today of gasohol without that subsidy.

The reason that gasohol is being marketed is because of the presence of that subsidy. I think, in addition to that, it is fair to point out

that this administration took a zero program in gasohol and has built it up to the point it is a special program, with the charge of \$10 to \$15 million, and it will grow much larger as we begin to know what to do.

Indeed, in my view, the most important short-term result of the Moorhead bill that the House passed last night, if the bill goes through both Houses, will be to produce alcohol as a blending agent for fuel. I think that is probably what will occur predominantly in the first 4 to 5 years of that program.

So you find, first of all, that the administration and the Congress have taken steps that permit gasohol to now make a small but growing contribution. And we are in the process of taking further steps that will permit it to potentially make a massive contribution.

We are very strong supporters in this area, Congresswoman Heckler.

Representative HECKLER. I feel that you have made your support of gasohol extremely obscure; that a contribution of \$10 to \$15 million is infinitesimal in terms of the funding of the Department. And as a matter of fact, as I understand it, the Brazilian experiment, which has been an experiment in effect for 50 years, has proven the stability of gasohol—and in fact, there are other raw materials other than the sugar cane which is the basic source there.

Municipal waste can be converted into ethanol. Yet, the Department of Energy has not funded the development of that process.

In terms of the issue of gasohol, it seems you are still studying the problem. And as I understand it, you have an alcohol fuels report that you haven't released. Is that true? Is there such a report?

Mr. O'LEARY. We have a draft report, and I would be pleased to share that draft with you. But the final report hasn't been completed as yet. It is not a matter of our sitting on a report that is completed, Congresswoman Heckler. It is a matter of having a draft that is in final. I would be glad to ship you up a copy of the draft this afternoon, if you would like that. We have done it for other Members.

Representative HECKLER. I would appreciate it. But I would also appreciate an acceleration of efforts, because the long lines at the gas stations today for unleaded gas, which is where the shortage is, are increasingly a source of unnecessary rage and inconvenience to the public.

I think the gasohol process has not been funded and that your study of a study, in the light of the experience of the Brazilians, is indefensible in today's market.

Mr. O'LEARY. Well, Congresswoman Heckler, I really can't agree with you there. We have to have a program for national policy in this area. And it is customary to do a good piece of analytical work to find out what you can.

Incidentally, a finding in that report suggests that, despite the frustration and long lines, you cannot expect in the short term, even at maximum rates of utilization, a strategic contribution from this source. About the best we can expect by, say, 1985, is 40,000 barrels a day of gasohol based upon ethanol processes.

I think for methanol, there could be a substantial runup above that. Again, in light of the subsidy and in light of the fact that we have

encouraged this and in light of the fact that the technology exists—and this is a matter of businessmen going out and investing in a proven technology, in a proven market, with a very large subsidy—that the sorts of things the Department of Energy is supposed to do I believe really have been done, in fairness, not badly.

I think that it is coming along. It is making a contribution. And we are, as I say, mighty pleased to see them.

Representative HECKLER. My time has expired, thank you.

Senator KENNEDY [presiding]. Mr. O'Leary, it is nice to see you and greet you.

Mr. O'LEARY. It is good to see you again, Senator.

Senator KENNEDY. Just in the time that we do have—I don't know, Chairman Bentsen said you have to—we tried to divide up the time between now and 12:30, if we could—

Mr. O'LEARY. 12:30 is fine with me.

Representative BROWN. How will we divide it up, Senator?

Senator KENNEDY. Let's try and do it mathematically, if that can be done.

Representative BROWN. Fifty percent for the Senate and 50 percent for the House? Some of us have not had a question opportunity yet, Senator.

Senator KENNEDY. That includes myself, Congressman.

Representative BROWN. You were asking questions when I came in the last time.

Senator KENNEDY. That was the last series of witnesses.

Representative BROWN. I think Congressman Wylie has not had a question opportunity either.

Senator KENNEDY. I haven't had a question for Mr. O'Leary, either. But as the chairman, I intend to inquire, and will yield accordingly.

Representative BROWN. Thank you.

Senator KENNEDY. In the May internal White House memorandum which was prepared June 6—and I have a copy of it here, which is from the Office of Fuel Regulation to Jack Watson—it effectively said that it would be necessary to have—the memo's words—"low inventories could lead to major shortages of home heating oil next winter if existing supply and demand trends continue and serious hardship"—they mention for farmers in that instance.

I think we could say, though, for that, for heating their homes with heating oil in the New England area. They were putting the estimates at that time as a minimum revised target as being 231 middle distillate stock projection barrels. The May trend is 194. The June trend is 156.

If this trend continues—and there is certainly no indication to the contrary—and given the authority which you have, which you indicated yourself that you have, about the issue of refinery yield orders, we would like to know whether you are going to exercise that authority to try and make sure that people are going to be able to heat their homes next winter.

Mr. O'LEARY. Senator, I pointed out to Senator Bentsen, in response to a question from him, that we had both the tools and the time and the Presidential direction to assure that we have an adequate level of middle distillate stocks by this fall.

Now, if you had refined your trends just a little bit further, for example, in the first week in June, what could have been the first

week of June, you would have found the projection would have taken you to 100 million barrels.

I only cite that, Senator Kennedy, because if you want to—
 Senator KENNEDY. We took through the 15th of June.

Mr. O'LEARY. I see what you are talking about. I just say if you do that, if you chose a week or a short period of time, that you get into an absolutely misleading sequence. What we are going to see as we get the driving season behind us is a very, very sharp upturn, well above the trend line that is shown in either the May trend or June trend here.

These things don't move smoothly. They will find there will be quite low production and consequently quite low buildup in middle distillate stocks all through the remainder of May and of June. And I expect there will be significant buildup beginning in July and running on through August and September.

Senator KENNEDY. If you don't see that, what kind of assurances can you give us today, in terms of exercising—

Mr. O'LEARY. The direction, to us, Senator, is that we get to an adequate stock level. I would like to speak to the 230, 240 thing, so I can put it in perspective: 240 million barrels a day is not enough to insure comfort if you have the worst winter in history, or a severe supply interruption on into the winter. It is not enough; 210 is enough if you are importing enough crude, if you are able to hold your stock levels high, or if you have a normal winter and normal commercial activity, or even a downturn in commercial activity.

So I think the point to note there, there is a wide range in which you can brand the stocks adequate. We have chosen the number 230 to 240 to represent to us a sort of median point. We will look at it very carefully as we go along.

I don't say, in any sense of the word, we are not striving for the 230-to-240 range. But to put it in context, it is not a magic number, is all I want to say.

Now, with regard to what we are prepared to do, we are going to watch this situation in the context of the imports bulletin, and project it with regard to economic activity. If it becomes evident to us, as we get into July, that the refiners are not making adequate provision for the winter we have under preparation the necessary orders to force them to increase their runs, and to increase their residual fuel oil production.

Senator KENNEDY. And you give us the assurance you will exercise that authority?

Mr. O'LEARY. Yes. If that becomes necessary, the President has said we must have that stock buildup. That is the first priority of the party.

Senator KENNEDY. We are really talking now in 2 weeks, 3 weeks down the line, in terms of when this authority—because we are close to the first of July now.

What can you tell us, in terms of what is going to be the—

Mr. O'LEARY. Senator, we are not 2, 3 weeks away. I say, if you get into July—

Senator KENNEDY. That is less than 2 weeks.

Mr. O'LEARY [continuing]. And begin to see that we have been manicuring this on a weekly basis, and begin to see refiners are not

getting their targets, and have inquiry with them, and find out—you know, we are involved in a constant cycle of discussion of this with the major contributors to that—they are not going to do it voluntarily, we are quite prepared to order them.

I am not going to tell you, Senator Kennedy, we are going to do that on July 1, or July 15. If necessary, we will do it.

Senator KENNEDY. I understand what you are saying, but we would also like to have some measuring stick so that we know what we can expect, and when we can expect some kind of action; rather than what we are talking about is 2 to 3 weeks. And when these decisions are going to be made.

How bad does it have to go? What is your sense of expectation as a weekly by weekly progress? What is your sense of expectation? How bad does it have to get before you are going to exercise that?

Because, as you point out, you are getting weekly reports.

Mr. O'LEARY. I think that is a fair question, Senator, and one that does have the variables that I have indicated to you. It is based not only on progress toward the goals, but the entire situation. What does it look like, primarily with regard to runs?

That depends upon import levels. If we find, for example, there is every expectation after this OPEC situation is straightened out, we will be able to have sustained high level of imports, that puts less urgency on it.

If, on the other hand, the world markets for crude remain very tight, and it appears to us we will be down in the 6-million-barrel-a-day level, it says we will have to work somewhat earlier toward the mandating, if it comes to that, than we would.

So I am afraid, Senator, that we are not in the position where I can give you a formal answer—not now, or indeed ever. But I can tell you this: the President has told us that his first priority in energy for the fall, domestic supplies of energy for the fall, is to build some heating oil stocks to an adequate level. That is a charge on the Department.

Senator KENNEDY. What do you consider now, the adequate level?

Mr. O'LEARY. What we know about it today, is 230, 240 million barrel range. And we can do it. We have the time and the tools. And we will do it.

Senator KENNEDY. And if you are going to get, say, a 500 thousand barrel transfer, in terms of the storage; now, say, by the 2d or 10th of July, are you going to exercise this authority?

Mr. O'LEARY. I am again going to tell you, I am not going to commit here to a formal approach to this; a date upon which we will exercise authority. We are going to apply the best judgment that we have. The thing I will promise you—

Senator KENNEDY. You promise you will come back to the committee and tell us about it then?

Mr. O'LEARY. I will tell you that we will have the stocks up to adequate levels by the fall. We have the time and the tools.

Senator KENNEDY. Can I ask you just another subject matter?

In the development of the energy policy, have you done a cost-benefit sort of risk evaluation of the alternative synthetic fuels, energy productivity, energy efficiency? Shouldn't that be really done either by the Congress or by the Executive, in time to fashion coming to grips with this?

Mr. O'LEARY. Yes. There are numerous studies that bear upon that. The trouble with that is that they depend upon hypotheses with regard to price.

If we say that we are going to limit a \$15 world, ad infinitum, synthetics, and there is plenty of availability; or a \$20 world, ad infinitum, synthetics; \$25 or \$22—

Senator KENNEDY. They have always been \$4 or \$5 above the oil price, for the last 25 years.

Mr. O'LEARY. No; they have been generally \$1 above.

Senator KENNEDY. That was in noninflation dollars.

Mr. O'LEARY. That was in old dollars.

Let me give you a follow on to that. We have thought about this in terms of economics, and let me give you just one little insight into it that I had in a discussion with a group from Congress the other day.

We said that there is a possibility that the oil situation will precipitate purely economic impacts, along the line of reducing gross domestic product for the industrialized nations by, let's say, 1 percentage point. That is not unreasonable in light of the 1972-74 experience.

The cost of that to the industrialized nations is, by the year 1990, \$2 trillion. We bear a third of that, roughly, because of the share that we have in the world stock.

When you begin to add to that, we can debate that. Is it bad? Is it more? Is it less?

When you begin to add to that, Congressman Rinaldo's statement to me yesterday; he was in his district office, and a man came in and said, "Congressman, I am so mad at the world I am going to get a gun and go out and shoot people."

If we put into the context of what happened is happening to the truckers now, what is happening to the threatened gasoline dealers strike, and the sheer aggression that is going to come out of that, the frustration and anger and disruption to the economy, I think it adds a perspective that we don't often realize in the assertion of pure economic benefit cost.

What is it worth to me this morning, 40 miles away from here, having to come into this hearing without any gas, getting up a 6 in the morning and hoping they are not out by the time I get there? What is it worth to me, over today's price of gas, to know I am going to get gasoline?

Before you came in, Senator, I testified that a dime tax on gasoline, one-half the runup of the last 4 or 5 months, if we chose to do it that way, would pay for all the synthetic fuels we would ever need; pay for 1 million barrels a day annual increments, as long as we care to have it.

In the meantime, we should conserve. We should build smaller cars. But the fact is, we have run the cost up permanently by 20 cents a gallon in the last 4 or 5 months because of our misapprehension, our mishandling, our sheer abuse of this oil policy over the last generation.

I think, when you begin to talk about the fine points of the benefit-cost ratio, my appreciation of them is they are useful policy guides. But when you really get down to measuring them—how well do they tell you what to do?—they are not very constructive.

So certainly in answer to your question, we should do that. And certainly we are doing that. But there are a lot of things that I don't measure by a cold calculation. And the cold calculation itself, is not an objective indicator of policy, because it has the subjective biases of the analyst built right into it.

Senator KENNEDY. Let me ask you, Mr. O'Leary, you—as I understand—will probably be, at least as mentioned in the newspaper, leaving the Department.

Mr. O'LEARY. I haven't submitted a resignation yet, Senator.

Senator KENNEDY. Well, it was reported in the Times.

Mr. O'LEARY. That makes it true. I had no idea, Senator.

Senator KENNEDY. Somebody knows something you don't know, or whether you know—

Mr. O'LEARY. Senator, I will immediately, upon returning to my office, submit the resignation and make the Times article—

Senator KENNEDY. You are not anticipating?

Mr. O'LEARY. Senator, I, like everyone else, anticipate leaving the Department. But I haven't resigned, as yet.

Senator KENNEDY. At this time.

Mr. O'LEARY. If that is helpful.

Senator KENNEDY. What is your advice, though for the future DOE employees?

My time is up. OK.

Thank you, Mr. O'Leary.

I just say, I don't know, but you have always been enormously responsive. I have difficulties, obviously, with Mr. Schlesinger. I have always found your response to our particular problems to be constructive. I am glad to see you here today.

Congressman Brown.

Representative BROWN. Senator, with all due respect, I think Congressman Wylie came in before I did. So I will have to miss my opportunity for questions, because I have a speech that I have to give. And I regret that, I really do. I think it is fair for him to have the opportunity.

Representative WYLIE. Thank you very much.

Mr. O'Leary, refinery officials have been telling me that they have essential refinery capacity. And I have been trying to get a handle on this. I have talked to Secretary Schlesinger about it. I talked with Mr. Bosworth about it yesterday.

Refinery officials say also that they have pipeline capacity to bring crude from California, Alaskan crude from California into Ohio.

And I just would like to know: What about those factors? Are those facts; and if so, what can be done about it? What can we do about it?

Mr. O'LEARY. Well, they are facts. We have excess refinery capacity in this country. We are running about 84, 85 percent refinery utilization. You can say 100 percent is 92 percent, if you want to juggle numbers.

In other words, we have a cushion now of something approaching 7 or 8 percent refinery capacity.

In addition to that, Congressman Wylie, we have a lot of capacity outside the United States. There is a refinery in Canada, and the Caribbean has a lot of excess capacity. There is no problem with that.

With regard to pipeline capacity, quite obviously you can get

Alaskan crude to the gulf, because 300,000 barrels a day is getting there. And there is a pipeline at work that can take crude oil to Ohio. So there is no problem there, at all.

The problem here is not refinery capacity, at the moment. It is a crude shortage. We are about 1 million barrels a day short, in what we would like to have in crude—crude runs in this country.

It is directly attributable to, first, the Iranian revolution and the loss of Iran as a producer; and second, the unwillingness of those nations that do have capacity—that would be the ones that I went through earlier—to expand that capacity.

May I take an opportunity to speak of one other aspect of this problem?

You mentioned Alaskan crude?

Representative WYLIE. Yes, sir.

Mr. O'LEARY. Now, Alaska crude approximates 1.2 million barrels a day; 850,000 barrels a day of that, is finding a home on the west coast in the Puget Sound area, and down in California; and 350,000 barrels a day is coming around in a very expensive anchor movement, down the coast in VLCC's to Panama, or floated through smaller vessels through the canal, and back up into the gulf coast in ports, and into the pipeline system, and finally back into the refinery. This is very cumbersome and very expensive.

That is all right, except the net impact of that is to reduce the receipts of the producer up on the North Slope to about \$7.50 a barrel. That producer has the opportunity for expanding his production. The quickest expansion of production that we could get in the country is in Alaska. We could expand that by about 500,000 barrels a day.

The 500,000 barrels a day is about the degree of today's—well, it is 80 percent of the shortfall in gasoline supplies today. If it could all suddenly merge and miraculously become gasoline, it could make a material difference; that is, a major contribution to helping our problems.

Those producers have plenty of money; don't misunderstand me. They are British Petroleum Co., Exxon, Arco, and Sohio, and they have plenty of money.

But when they see \$7.50 there, and higher returns elsewhere in the United States; and in different lines of work, for example, investing in real estate, or what have you, they choose not to invest in Alaska.

You people have tied the President's hands, with regard to permitting the swap of that oil to Japan, in return for a like amount of crude here.

Now, what could happen if we were to permit those swaps, is the producers would get a higher net back—\$2 or \$3 more. That would be enough, our analysts tell us, to prompt the investment both in line capacity and producing wells up in Alaska. That isn't going to happen otherwise. We can't order them to do it. You understand, these are private firms. They would then increase their productions by 500,000 barrels a day.

That 500,000 barrels a day, under the swap proceedings, would go to Japan. Japan, in turn, would take 500,000 barrels a day of the oil it now gets from the Middle East, and send it to us. We would have a net increase of 500,000 barrels a day, although it would be in the form of some imports and some exports.

I think that is, personally, a reasonable proposition for us to be able to entertain. But the way the law is now situated, the President cannot make the findings that would permit him to permit that kind of a possibility.

Representative WYLIE. The law was enacted as a knee-jerk reaction to an article in the Reader's Digest, and other publications, that said that Alaskan crude was going to Japan; and we had a shortage of crude in the United States. So we said that Japan isn't going to get any Alaskan crude.

So, if you take that as shortsighted, we were shortsighted in some sort of swap arrangement.

Mr. O'LEARY. I think it is an example of the Nation taking an action that seems, on the surface to be sound; but when you look a little more deeply into it, it is one that hurts us, and can be demonstrated to hurt us immeasurably.

I would say, Congressman Wylie, that I would not, myself, recommend to the President that he permit any portion of the current level of production be exported. We have got a home for that stuff. But the question is: Do you produce another 500,000 barrels a day, or do you not?

Then, I would say let's do those things; at least give them a 3-year license to produce and export.

Representative WYLIE. Are you saying there is no real shortage of crude, but it is a matter of distribution?

Mr. O'LEARY. No. I am saying that, on a global basis, there is plenty of crude production capacity; but it is in the wrong hands.

Representative WYLIE. Well, speaking of oil being in the wrong hands, I noticed the oil minister from Saudi Arabia this morning indicated that they probably will raise their prices again to the industrialized nations. The Saudis will raise prices to reduce the consumption of oil.

Mr. O'LEARY. I think that every time I have talked to the fellow who is the milkman, the butcher, it is really not for his good; it is for my good he is raising his prices.

Representative WYLIE. Sharply raising domestic prices for gasoline and other petroleum fuels to reduce consumption of oil enough to stop OPEC from raising their prices?

Mr. O'LEARY. No; I don't really think so. I think this is a very convenient argument now, for the producing nations to make. But at bottom, they like to sell, like many producers of raw materials, for just as much as they can get for it.

Representative WYLIE. Well, you indicated a little while earlier, people are frustrated or angry, and very aggressive. And I get that in my mail and conversation with them about gasoline shortages. And they are going to be more angry, frustrated, more aggressive, if there is a heating oil shortage. How much do we need to reduce gasoline production to assure that we do not have a heating fuel shortage?

Mr. O'LEARY. I don't think we are going to have to cut deeply into gasoline production to do that. I think we can do it by action short of that.

And, as I indicated in response to Senator Kennedy, we will do whatever is necessary to get the heating oil supplies up to an adequate level.

I don't think it need be enormously disruptive to gasoline use—that is, pull it significantly below current levels.

It may be that I am wrong.

Representative WYLIE. I hope you are right.

Mr. O'LEARY. I hope I am right.

As we look at it, that will be one of the weighing factors. But again, as I indicated, we will do whatever is necessary to be sure we do have sufficient supplies of heating oil. That is the first energy priority.

Representative WYLIE. Have you done any research, or are you doing any research, on the alcohol engine automobile, which can run in a 500-mile race?

Mr. O'LEARY. Yes; we do.

Representative WYLIE. So it can be done.

Mr. O'LEARY. Congresswoman Heckler was pointing out to us, the Brazilians have been doing this for years. We produce a lot of alcohol in this country, I am told by friends, and we know how to produce it. It is an old, established technology.

It is quite true that you can use alcohol, in blends up to 10 percent, with existing engines without changing them; even get material improvement in performance, in some instances. And we are actively encouraging that now, both through research programs and through a congressionally enacted tax credit, which gives the subsidy equivalent of about \$17 per barrel for gasohol.

Representative WYLIE. I have always been told by scientists in my district we are producing ethanol, which could be used in an internal combustion engine, from garbage.

Mr. O'LEARY. That is quite true. And it is the same process that is now being used for gassy and sugar. It would go through a fermentation process. And this is no mystery about it, you can do it.

Representative WYLIE. That would solve two problems in the development there—get rid of our garbage and also we could run our automobiles.

Mr. O'LEARY. It solves a problem, but I want to point out again the number I gave to Congresswoman Heckler and its limitations, our estimate is on forced draft conditions. You couldn't have more than 40 million gallons a day from those sources by 1985. So you have to look upon this as a very good, a very interesting thing, but not as something that will change our strategy significantly, our dependence upon imports in and of itself.

Representative WYLIE. Worthwhile enough to do some—

Mr. O'LEARY. Very, very worthwhile.

Representative WYLIE [continuing]. Additional research?

I have been given a note my time is up.

Representative HECKLER. I would like to, if I might, point out to Mr. O'Leary that I have found him more responsive than other spokespersons for the Department, and I do appreciate that. But I have to say that there has been little Department support for gasohol and for the development of the conversion of urban waste. Disposal of waste costs the United States \$4 billion annually, and the problem of locating landfill sites across the country is one of the greatest public policy questions in America today, and a growing one. The most detailed, advanced research is being done at the Natick Army Labora-

tories in New England and was cited by the National Academy of Sciences and your Department. The National Academy of Sciences in February published a document saying this was a most advanced research on the use of urban waste, the conversion of garbage into ethanol which can be blended with gasoline to produce gasohol, which I am using in my congressional van with great success.

Nonetheless, despite the great results of their earlier work and the fact that the scientific team was cited by experts all over the world and the fact that they had exceeded their capacity in the current laboratory situation and requested further funding from the Department of Energy, that that funding has not been forthcoming since last August. And month after month has gone by, exacerbating our problems in terms of unleaded gas, the shortage of unleaded gas.

And the Department of Energy, in its wisdom or lack of it, when funding the development of a conversion process for cellulose waste gave a contract to Georgia Tech.

Now, one agency, the National Academy of Sciences, cited Natick Laboratories as being the foremost expert in the world today. And they use those terms. And despite this, the DOE did not see fit, and has not yet continued, to fund this hopeful experiment with urban waste conversion.

And, frankly, if you are thinking of leaving, which I would be sorry to see, I would hope that you can deal with this before that departure.

Mr. O'LEARY. Congresswoman Heckler, I want to tell you that Georgia Tech, too, has a tremendous capacity for research. And you may quote me.

And further, I want to say that I will talk to that great U.S. citizen and that great citizen of the Commonwealth of Massachusetts, and that great scientist, John Deutch, and find out what he is doing about this, because it is on his head, not mine.

Representative HECKLER. Let me just say Georgia Tech may have its research capacity and, indeed, it does, but when the National Academy of Sciences in Washington, D.C., representing the whole country, cites one laboratory as being foremost in the development of this expertise, it is hard to understand how a research facility without that practical experience could be more practical and suitable for the continuation of research.

Mr. O'LEARY. Congresswoman Heckler, I agree with you entirely. And I will have a session with John Deutch personally this afternoon to find out why he did this thing.

Representative HECKLER. I would certainly like to have the decisions implemented by a new decision which will at least give equal opportunity to what is, I think, the development of a very important process.

Representative WYLIE. Senator Kennedy, could I ask one more question?

Senator KENNEDY. Sure.

Representative WYLIE. Mr. O'Leary, I have been told that the oil companies and the automobile manufacturers are resisting the development of a gasohol engine.

Mr. O'LEARY. You don't require a gasohol engine. You can use, as I indicated earlier, right now, far, far more than we will see of

alcohol in conventional engines without a single bit of adjustment. When you get into methanol, you get into a problem in this event primarily in seals. You will find that it will chew out the rubber. We are going to have to make minor modifications in seals and that sort of thing, some of the components. It will chew out nylon, as well.

But at the moment, we don't have any significant amount of methanol coming into the system. You can stand up to 3 or 4 percent of methanol without having those deleterious effects. The ethanol is coming in 10 percent and is perfectly compatible with today's Detroit engines.

Representative WYLIE. Is there a problem in refinery capacity then, too?

Mr. O'LEARY. No. You don't run it through a refinery. It is a blending. It is a blending agent. You would add it. In many cases, the stuff that is being used now is blended postrefinery.

Representative WYLIE. But the present engines can only use up to approximately 10 percent.

Mr. O'LEARY. But we are so far away from being at 1 percent. That means we have several years' cushion in order to adopt both the engine and refineries to higher levels of use of this material.

Representative WYLIE. Could we stretch out the use of gasoline if we could increase refinery or increase the capacity to produce ethanol?

Mr. O'LEARY. We can, indeed.

Representative WYLIE. That's what we need to be working on then.

Mr. O'LEARY. Well, as I indicated, I think we are working on it. There is a substantial interest in it now. Many people around the country are reopening stills for the production of this material. And it is being sold in a dozen or so States.

So, I think it is going ahead. It is making more of a contribution than any of the other so-called synthetics at the moment.

Representative WYLIE. Kentucky moonshine boys might welcome that. I heard you use the word still.

Mr. O'LEARY. It is run through a distillery.

Senator KENNEDY. With all respect to Mr. John Deutch, who is going to have a lot to do, I don't think he was aboard the Department when that decision was made, in any event.

Mr. O'LEARY. Well, he has been around that Department—

Senator KENNEDY. I think we just had his confirmation hearings here this week.

Mr. O'LEARY. No, no. He has been in the Department now since the date, or very close to the date, of its information. He is one of what we would call the old pioneers now.

Senator KENNEDY. Could I, just in the final minutes, Mr. O'Leary, trace back a bit in terms of the time when we knew there was going to be a shortage, and you know the actions that were taken by the Department of Energy. I got the earlier explanations that you gave; you were talking about a lot of the administrative and regulative inefficiencies and requirements which contributed significantly to the shortages and the misplacements of energy products.

Mr. O'LEARY. Not for the shortages, but rather the balance.

Senator KENNEDY. When did you really become conscious there was going to be a shortage?

Mr. O'LEARY. Our first organized effort of this, according to a chronology I have prepared—and I would be pleased to submit for the record—was, as I recall it, in mid-January. We then put together a group in the Department that I chaired, at least nominally, and we began to look at the sort of response that would be required if Iran were out for a long time.

You may recall that Iran had just had its ultimate revolution at that point, was just getting started on that quarter of downtown. And we began within a couple of weeks or within a week of the time of the revolution, per se, to begin to plan for our response.

That resulted in a number of tentative and finally final judgments that went into a document dated in middle to late March that we have entitled the "Iranian Response Plan." And it cataloged the sorts of things we would do.

In the meantime, we were preparing the standby orders, the emergency orders, of one sort or another, necessary to get us to the point where, for example, we have the allocation in place we have today.

Senator KENNEDY. Yes, if you would submit the plan.

Mr. O'LEARY. When we began planning.

Senator KENNEDY. Began planning and when did the shortage actually start.

Mr. O'LEARY. We began to feel the shortage actually in the form of long gasoline lines in the first or second week of May.

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



U.S. Department of Energy

**RESPONSE PLAN:
REDUCING U.S IMPACT
ON THE WORLD OIL MARKET**

April 1979

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SUMMARY OF RESPONSE PLAN:
REDUCING U.S. IMPACT ON THE WORLD OIL MARKET

The Need to Reduce U.S. Petroleum Use

The U.S. has entered into a commitment with the International Energy Agency (IEA) to reduce petroleum consumption by up to 5 percent as its contribution to offset the world's shortfall brought about by reduced oil production in Iran. The 20 member countries of the IEA entered into this joint agreement to prevent shortfalls and to stabilize the world oil market and reduce pressures for premium oil prices. The U.S. obligation under this agreement is to reduce demand for oil imports by up to 1 million barrels per day (MMB/D) by the end of 1979. The President set forth the specific measures to meet that commitment in his speech of April 5, 1979.

Since December, world oil reductions from the termination of Iranian exports have resulted in a total shortfall of about 200 million barrels (MMB). Although Iran has now resumed oil exports at less than 2.5 MMB/D, its foreign sales are more than 2.5 MMB/D below its export level in 1978. Conditions in Iran remain uncertain, and it would not be prudent to depend heavily on continued exports from Iran at even the current low level.

As Iran's oil exports ended last December, other major exporting countries increased production to offset about 3 MMB/D of the 5 MMB/D shortfall. Continuation of this higher level of production cannot be relied upon. Saudi Arabia and other Arab producers, which contributed most of the surge production, have indicated an intent to cut back production as Iranian exports resume, and Saudi Arabia is in the process of cutting back production by about 1 MMB/D. Reduced production will keep supplies tight and support the higher price levels announced by OPEC on March 27, particularly high premiums for light crudes.

The IEA commitment will ease the interim oil supply problem faced by the U.S. as a result of the reduced oil production by Iran. Imports to the U.S. in the first quarter were about 700,000 barrels per day (B/D) less than needed to maintain stocks at desired levels. The loss of crude oil imports resulted in reduced refinery output; refinery utilization rates have dropped from 91 percent last December to 88 percent in January, 84.5 percent in February, and 83.5 percent in March. The shortfalls in refinery output and imports have required excess use of petroleum stocks to meet demand. As a result, industry oil stocks are about 70 million barrels (MMB) below projected normal levels.

Distillate fuel oil stocks are at an unacceptably low level, and it is critical that these stocks be rebuilt to safe levels before the next heating season. Gasoline stocks also have been drawn down faster than desired and are now below projected normal levels going into the summer peak demand period. Unless petroleum demand is restrained, heating oil stocks would not be built to safe levels by next fall. If distillate fuel oil demand is not reduced, fuel oil stocks for next winter must be built by reducing gasoline production. If demand for gasoline stays at current high levels (4.5 percent above the 1978 demand) there would be substantial shortfalls before the summer is over. The shortfall of gasoline would be due to the reduced stocks and the reduced refinery throughput, as well as the heavier crude oil substituted for Iranian oil, which reduces gasoline production capability.

In addition to the IEA goal to reduce U.S. oil demand, two oil supply shortfall scenarios were considered in developing the U.S. Response Plan. The Base Case scenario assumes a world supply shortfall of about 1 MMB/D due to the need to rebuild inventories, difficulties in sustaining production in Iran, and/or reductions of supply by other producers. The More Severe scenario assumes a return to the more serious 2 MMB/D world oil shortfall experienced earlier this year. Under the Base Case, oil shortfalls in the United States would be about 700,000 barrels per day between now and October, reflecting the high demand to rebuild stocks and the limited level of imports. Shortfalls beyond October would be about 500,000 barrels per day. If the world oil shortfall increases to 2 MMB/D, the shortfalls in the United States could increase to about 1.1 MMB/D in the third quarter, reflecting the high demand for stock rebuilding, and to about 900,000 barrels per day in the fourth quarter of 1979 and the first quarter of 1980.

Chart A shows the estimated oil shortfalls under the two scenarios. Charts B and C show the impact of these shortfalls on U.S. supplies of gasoline and distillate fuel oil if consumption is not reduced.

Potential Oil Shortfalls

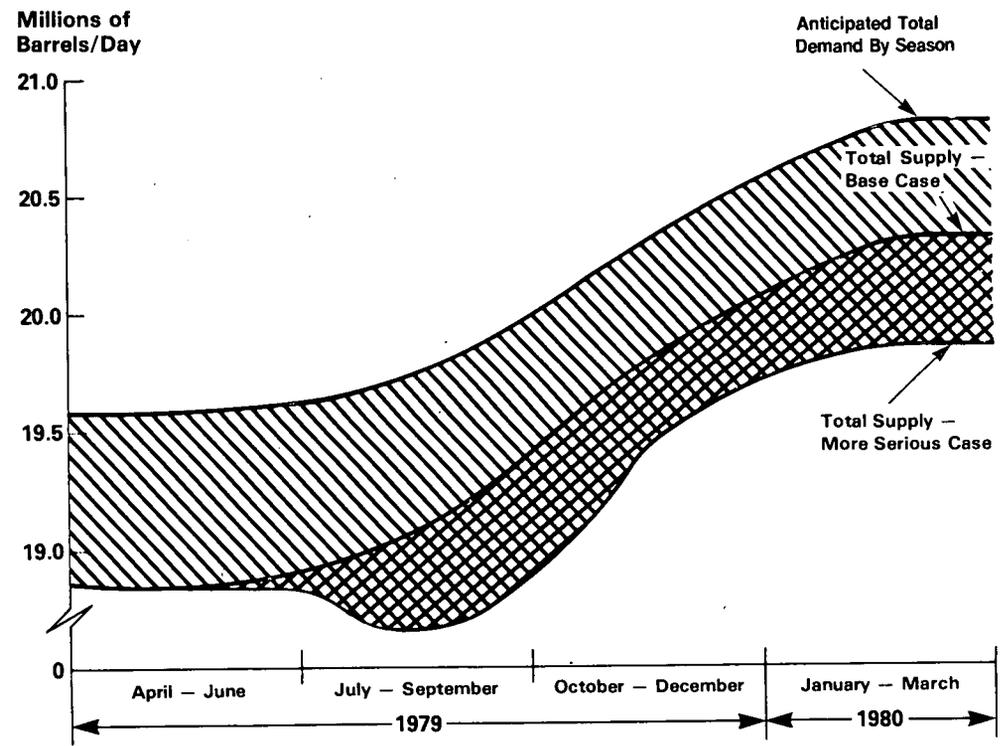


CHART A

Gasoline Stocks at Primary Level (Millions of Barrels)

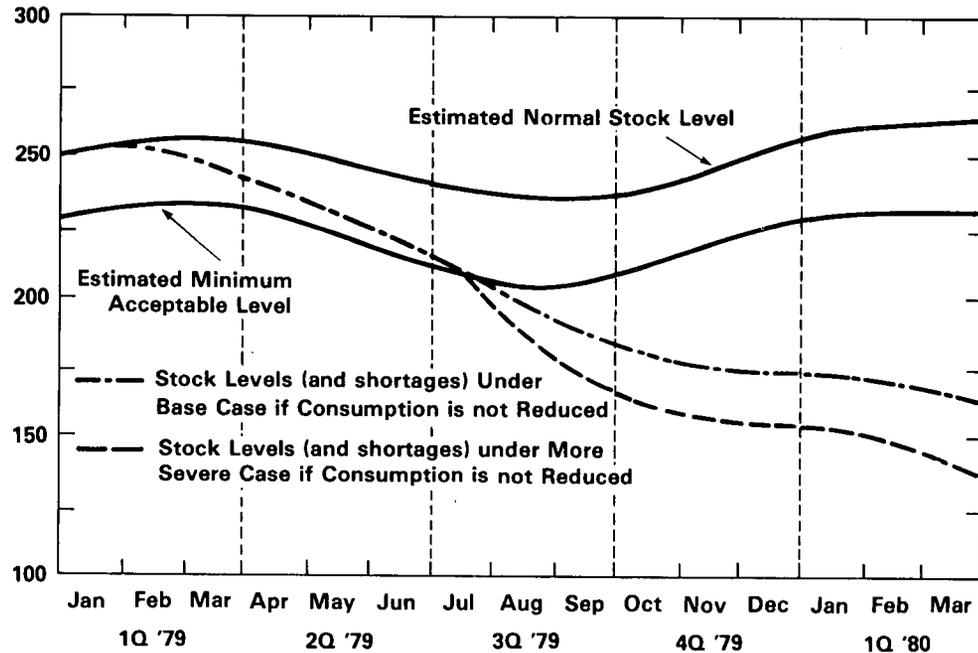


CHART B

The stock levels below the Estimated Minimum Acceptable Level are hypothetical since stocks would actually be maintained at minimum levels through curtailments in supply.

Distillate Stocks at Primary Level (Millions of Barrels)

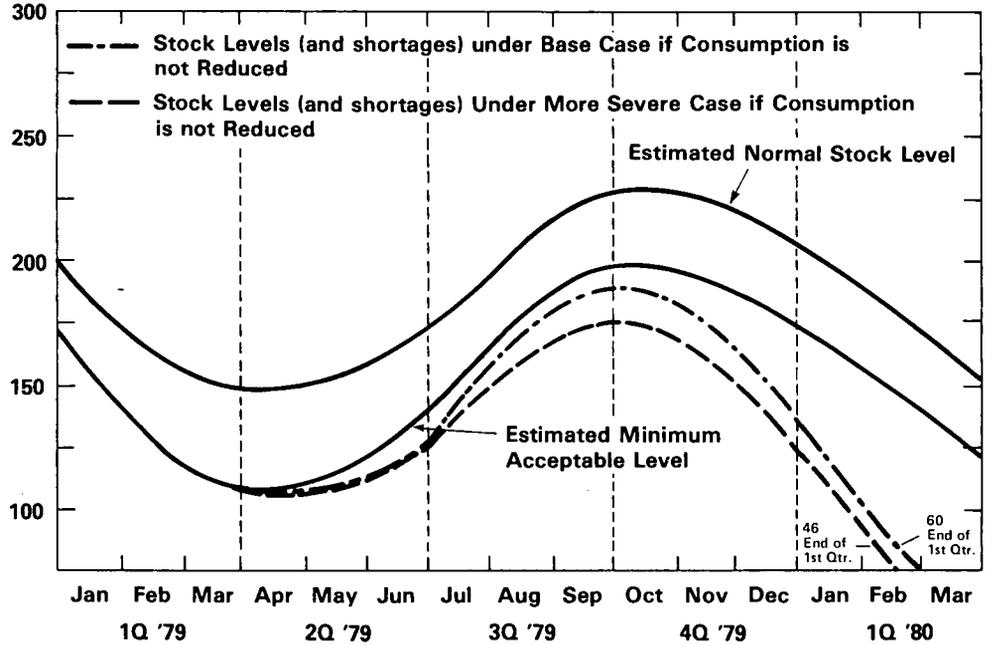


CHART C

The stock levels below the Estimated Minimum Acceptable Level are hypothetical since stocks would actually be maintained at minimum levels through curtailments in supply.

A failure to reduce world oil consumption will result in further increases in foreign oil prices as refiners bid for the limited supplies. "Premium" prices for foreign oil may be bid significantly above the new high base price established by OPEC. Effective action by the IEA member countries to reduce consumption will help to stabilize market conditions and discourage further price increases.

Proposed Response Plan

The Response Plan is designed to meet the IEA commitment to reduce oil demand, to minimize pressures on world prices and avoid oil supply problems later in the year.

The Response Plan contains a graduated set of measures to be implemented as necessary to meet the IEA commitment and to deal with potentially more severe shortfalls. The plan provides for:

- o Early implementation of a number of measures to reduce consumption, increase domestic production, assure equitable distribution of available crude oil and provide for rebuilding distillate fuel oil stocks to safe levels. The measures selected for immediate implementation are those which will have little or no adverse economic impacts.
- o If the initial actions are not sufficient, more severe measures would be introduced to reduce consumption further, to require the build up of distillate stocks to acceptable levels, and to distribute available oil supplies equitably.

The Response Plan is designed to rebuild winter fuel oil stocks to safe levels by next October. Petroleum stocks have already been reduced by about 70 million barrels below normal by the end of March. It will be necessary to rebuild distillate stocks to safe levels by October to assure adequate heating oil supplies for the winter heating season.

Refiners will be requested to take action to build distillate stocks to target levels by October, so that total U.S. distillate stocks reach at least 240 MMB. If necessary, regulatory actions will be used to assure safe distillate fuel oil stock levels.

A wide range of crude and product allocation procedures are available to help resolve any severe distribution problems that may occur. Some allocation of crude oil will be necessary to provide equitable allocation of the reduced crude supply among refiners. It also may be necessary to establish an allocation fraction to allocate gasoline and possibly other products among users. Allocation may be on a voluntary industry-wide basis, with standby mandatory allocation to be used if necessary.

Specific Response Measures

Table A summarizes the response measures and reduction targets needed to meet the IEA goal.

The immediate response measures include the following:

- o Each State has been urged by the President to implement plans to reduce gasoline consumption. The President will set targets for reductions in gasoline use. If successful, this effort will avoid the need for mandatory Federal plans to inhibit gasoline demand.
- o State governments also have been requested by the President to reduce their direct use of gasoline, and to control government building temperatures, similar to the requirements placed on Federal agencies.
- o All Americans have been requested to reduce their total oil consumption by actions such as reducing discretionary driving, use of carpooling and mass transit, obeying speed limits, and setting their home and office thermostats at 65 degrees in the heating season and 80 degrees in the cooling season. All drivers have been requested by the President to reduce driving by 15 miles per week.

- o In the Federal sector, the President has directed Federal agencies to take immediate steps to reduce energy use by at least 5 percent. As part of this reduction, all agencies are being required to reduce use of gasoline for government vehicles by 10 percent, and control building temperatures at no warmer than 65 degrees in the winter and no cooler than 80 degrees in the summer. To encourage Federal employees to use carpools or mass transit, Federal employees will be required to pay full commercial rates for parking spaces provided by the agencies in urban areas. The full rates will be phased in starting in October.
- o The effort started in January to switch large utility, industrial and commercial users from oil to natural gas is continuing. There is a large potential for switching from oil to natural gas, particularly in the summer of 1979, which could offset a substantial portion of the shortfall. Oil savings from this effort had reached over 200,000 B/D by early April.
- o Electric utilities are being encouraged to transfer excess electricity from coal and hydro power plants to utility systems which rely on oil fired plants to reduce the need to use oil.
- o Mandatory building temperature controls will be implemented upon approval of the plan by Congress. The plan would require thermostats to be set at no warmer than 65° in the winter and no cooler than 80° in the summer in public, commercial and industrial buildings.
- o To increase gasoline supplies, and reduce fuel used for oil refining, EPA is modifying its current requirements for the phasedown of lead in gasoline.
- o The President will consider State requests for waivers of State standards under the Clean Air Act if this is found to be appropriate due to shortages of low sulfur fuel oil. The Administrator of EPA will consider unusually large increases in

the price differential between complying and non-complying fuels as a basis for recommending approval of State requests.

- o Refiners will be requested to establish targets to rebuild distillate fuel oil stocks to acceptable levels by next October. DOE will be prepared to implement additional measures, including voluntary or mandatory gasoline allocation fractions, if the voluntary stock building effort is insufficient.
- o The shortages of crude oil may require allocation of crude among refiners to avoid severe inequities. As smaller refiners have serious crude shortages, DOE will continue to direct larger refiners to sell crude oil to the small refiners under the current Buy/Sell program. If serious inequities develop for larger refiners, a range of actions can be taken, including using the current Buy/Sell program, establishing a separate Buy/Sell program for larger refiners, or implementing the full crude oil allocation program to allocate oil to all refiners based on a fraction of pre-interruption oil supplies.

In addition to the above demand reduction measures, the following actions are now underway to increase domestic oil production and restrain oil demand to help reduce the oil shortage by late 1979 and early 1980:

- o The planned decontrol of crude oil prices will reduce demand for oil and stimulate greater domestic oil production.
- o Crude oil production will be increased at the Naval Petroleum Reserve at Elk Hills, California.
- o The Alaskan crude oil pipeline is being modified to increase the throughput capability of the line and permit an expansion in Alaskan North Slope production by the end of 1979.

If the above actions are insufficient, the following additional actions would be taken as necessary:

- Utilities may be mandated to transfer base load power from coal, nuclear and hydro facilities to replace electrical generation from oil-fired facilities.
- Mandatory actions may be taken to require major utility and industrial users to switch from oil to natural gas if voluntary switching is insufficient.
- Gasoline sales may be restricted for part or all of weekends if voluntary reductions in gasoline use are insufficient. States are encouraged to develop alternative mandatory plans to save similar amounts of gasoline.
- A full crude oil allocation system may be required to distribute available crude oil on an equitable basis among all refiners.
- Mandatory refinery yield orders and product allocation fractions may be necessary to assure safe stock levels for next winter.

If the shortfall becomes even more severe:

- Additional mandatory measures to reduce gasoline consumption may be proposed.
- The Strategic Petroleum Reserve may be used if necessary to avoid disruptive shortage conditions.

The actions outlined in this Plan, if implemented early and effectively, should be sufficient to meet the U.S. commitment to the IEA and permit the United States to withstand the current world oil shortage without serious disruptions. Table A shows that the shortage can be eliminated if Americans reduce oil use as requested, including switching to alternative fuels, controlling building temperatures and reducing gasoline use. If other major consuming nations cooperate in taking similar reductions in consumption, the pressures to permanently increase world oil prices will be minimized.

TABLE A

ESTIMATED SAVINGS FROM RESPONSE MEASURES
(Thousands of Barrels Per Day)

	<u>1979</u>			<u>1980</u>
	<u>Apr-Jun</u>	<u>July-Sept</u>	<u>Oct-Dec</u>	<u>Jan-Mar</u>
<u>Increased Domestic Production/ Reduced Consumption</u>				
. Decontrol of Crude Oil Prices	-	-	60-80	100-120
. Increased Elk Hills Production	5	10	20	20
. Increased Alaskan Production	-	-	0-150	0-150
<u>Immediate Demand Reduction Actions</u>				
. State, Local, Private Initiatives to Save Gasoline	200-250	200-250	200-250	200-250
. Switch to Natural Gas	250-400	250-400	250-400	250-400
. Electricity Transfers	100-200	100-175	100-200	100-200
. Building Temperature Controls	55-110	175-350	195-390	180-375
. Reductions in Federal Use	12	16	19	29
Subtotal	<u>622-977</u>	<u>751-1201</u>	<u>844-1509</u>	<u>879-1544</u>
<u>Additional Action if Necessary</u>				
. Mandatory Weekend Gasoline Sales Restrictions or Alternative State Plans	-	135-270	120-235	110-220

DETAILS OF THE U.S. RESPONSE PLAN

I. U.S. Obligation to Reduce Oil Imports

At the March 1-2 International Energy Agency Governing Board Meeting, member countries decided to implement measures to help stabilize the world oil market and prices by reducing their demand for oil in world markets. Each government agreed to take measures, voluntary to the extent possible and mandatory to the extent necessary, to achieve a reduction of up to 5 percent in oil use. The measures to be implemented include both voluntary and mandatory conservation to reduce consumption, fuel switching, inventory management procedures, and increases in domestic production. The U.S. share of the reduction target would be nearly 1 MMB/D. The agreement provides for a reexamination of the level of savings required as the world oil supply conditions evolve.

II. Potential Stringency in World Oil Production

In addition to the reduction targets under the IEA commitment, two oil supply scenarios have been used in developing this response plan. These are not necessarily projections of what will occur, but rather provide a range of estimates of what could occur, to which the U.S. should be prepared to respond.

A. Base Case: This case assumes oil exports from Iran and other producers that result in a net supply shortfall of about 1 MMB/D through the first quarter of 1980. The need to rebuild inventories, the difficulties of sustaining production and exports in Iran, and reductions of supply by other producers combine to limit supply below projected world oil demand. Allocation of oil among nations is assumed to be on the basis of total oil consumption. Even if crude oil production is at a level adequate to meet normal demand, the current low level of petroleum stocks would result in a need to constrain demand.

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B. More Severe Case: This case assumes a world oil shortfall of about 2 MMB/D starting in the third quarter of 1979 and continuing through the first quarter of 1980. This could result from more serious problems in Iran which prevent continued exports, or by further reductions in incremental surge production by other OPEC members.

Attachment 1 discusses the world oil supply picture.

III. Estimated Shortfalls in the U.S.

The estimated U.S. shortfalls below needed supply levels for the two scenarios are as follows:

	Base Case (in millions of barrels/day)			
	1979			1980
	<u>2nd Qtr</u>	<u>3rd Qtr</u>	<u>4th Qtr</u>	<u>1st Qtr</u>
U.S. Demand	18.8	18.7	20.3	20.8
U.S. Production	10.8	10.8	10.7	10.7
U.S. Imports	<u>8.1</u>	<u>8.2</u>	<u>8.8</u>	<u>8.9</u>
Total U.S. Supply	18.9	19.0	19.5	19.6
Normal Stock Changes	+ .4	+ .6	- .3	- .7
Shortfall from Constrained Imports	.3	.3	.5	.5
Shortfall Due to Low Stocks	<u>.4</u>	<u>.4</u>	<u>-</u>	<u>-</u>
Total Shortfall	.7	.7	.5	.5

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More Severe Case
(in millions of barrels/day)

	1979			1980
	2nd Qtr	3rd Qtr	4th Qtr	1st Qtr
U.S. Demand	18.8	18.7	20.3	20.8
U.S. Production	10.8	10.8	10.7	10.7
U.S. Imports	<u>8.1</u>	<u>7.8</u>	<u>8.4</u>	<u>8.5</u>
Total U.S. Supply	18.9	18.6	19.1	19.2
Normal Stock Changes	<u>+ .4</u>	<u>+ .6</u>	<u>- .3</u>	<u>- .7</u>
Shortfall from Constrained Imports	.3	.7	.9	.9
Shortfall Due to Low Stocks	<u>.4</u>	<u>.4</u>	<u>-</u>	<u>-</u>
Total Shortfall	.7	1.1	.9	.9

The impacts in the next six months of the world oil stringency on the U.S. market under the Base Case would be a shortfall of approximately 700,000 B/D. This includes a shortfall of about 300,000 to 360,000 B/D as the U.S. share of the 1 MMB/D world shortfall, and a shortfall of 360,000 to 390,000 B/D as a result of the need to rebuild low U.S. stocks.

The U.S. shortfall would decline to about 500,000 B/D by the fourth quarter of 1979 and the first quarter of 1980 (under the Base Case supply scenario), when U.S. stocks have been rebuilt.

Under the More Severe Case scenario, in which Iran or other producers cut back their production from their current levels, the U.S. shortfall could rise as high as 1.1 MMB/D in the third quarter, including the shortfall caused by the need to build stocks for the winter.

These estimates of the potential shortfalls to the United States assume the mid-range estimate of demand growth developed by the Energy Information Administra-

tion (EIA). The demand estimates assume normal oil supply conditions, prior to any conservation or fuel switching efforts as a result of the current oil shortfall and prior to any impacts of the March OPEC price increases. The EIA mid-range estimate is somewhat higher than other current estimates of demand. If the lower estimates were used, the estimated shortfalls in the last quarter of 1979 and first quarter of 1980 could be reduced by up to 250,000 B/D.

The impact on the U.S. of the reductions in Iranian oil exports, and estimates of potential shortfalls to the U.S. in the next year, are discussed in detail in Attachment 2.

IV. Ability to Use Industry Stocks

Industry petroleum stocks at the end of 1978 were generally at an acceptable level, but they had been reduced to abnormally low levels by the latter part of March. By the end of March, total petroleum stocks were estimated at about 70 MMB below estimated normal levels for this time of the year.

Total U. S. crude and product stocks at the primary level have been reduced by about 125 million barrels from the beginning of the year through the end of March. Industry stocks could not be reduced much further without causing operational problems or creating shortages in essential seasonal stocks. There are significant uncertainties about the ability to reduce stocks, and the reduction of safety stocks reduces industry's ability to respond to a further sudden reduction in supply or to a colder than normal winter. Therefore, the plan assumes no further reduction in total industry stocks after the first quarter of 1979.

Gasoline stocks will continue to be drawn down through September to meet increasing summer demand, but increases in distillate stocks for next winter need to more than offset the drawdown of gasoline stocks.

The drawdown of stocks has resulted in the use of much of the "safety stocks" normally maintained by industry to protect against supply and demand contingencies. The use of the safety stocks increases the risk of spot shortages of supplies.

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Attachment 2 shows projected normal U.S. stock levels and estimated minimum acceptable stock levels for 1979, for total petroleum, gasoline and distillate. It also shows the preliminary actual stock levels through March 30.

V. Response Strategy

The primary objectives of the Response Plan are to:

- o Meet the U.S. commitment to IEA to reduce petroleum consumption. Reducing demand for petroleum will remove market pressures to increase oil prices. Demand for oil which exceeds the feasible or desired production levels of exporting countries will encourage "premiums" above base prices. If demand can be reduced below desired production levels, there will be economic pressure to reduce or remove the premiums and to avoid or minimize future increases in base prices.
- o Avoid any serious shortfalls of petroleum. The most critical times will be mid-to-late summer as gasoline use peaks, and in mid-to-late winter as distillate demand peaks and stocks are being drawn down rapidly.
- o Rebuild industry safety stocks to provide greater protection against future supply or demand problems, such as unusually cold weather or future disruptions of imports.
- o Avoid any unnecessary adverse impacts on the U.S. economy. A primary purpose of Government action is to help avoid or reduce the economic costs which might result if responses are based solely on the interests of each business and individual consumer.
- o Help avoid major inequities among sectors of the economy or regions of the country.
- o Be prepared to respond to more severe shortfalls. The Response Plan is intended to establish the framework for quick response by the Federal and State governments in the event foreign oil production is reduced substantially below current levels. Because of the very tenuous nature of current world oil production levels, the United States must be

prepared to respond quickly to changing conditions. Accordingly, this Plan includes plans for responding to a range of oil supply conditions during the coming year.

VI. Longer-Term Actions to Increase Petroleum Production and Decrease Demand

High priority is being given to increasing domestic crude oil production to reduce our dependence on unreliable foreign oil supplies. There is relatively little that can be done to increase U.S. production within the next 6 months, but it is critical that these efforts begin now if we are to reduce our vulnerability to the inevitable disruptions of foreign supplies in the future. It also is essential that prices of petroleum to U.S. consumers reflect its real value, to discourage the less efficient uses of petroleum.

Three specific actions are summarized below which will increase U.S. crude oil production. These actions also will have important longer-term benefits.

A. Phased Decontrol of Crude Oil Prices

The President's plan for phased decontrol of crude oil prices through 1981 is expected to result in increased crude oil production starting in 1979. It also is expected to reduce oil demand due to the effects of the higher prices to consumers. These combined effects could result in savings of about 60,000 to 80,000 B/D in the fourth quarter of 1979 and 100,000 to 120,000 B/D in the first quarter of 1980. See Attachment 3 for further information.

B. Increased Production From the Naval Petroleum Reserve at Elk Hills

DOE is accelerating efforts to increase production at the Elk Hills reserve by 20,000 barrels per day by the end of 1979, and by another 25,000 barrels per day by October 1980. This requires development of a water injection system at the reserve.

DOE also is working to resolve litigation with Chevron which is preventing production of 30,000 barrels per day at Elk Hills. This increase would

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be achieved within 90 days of a settlement of the case. See Attachment 4.

C. Increased Production from Alaska North Slope

Current crude oil production from the North Slope is approximately 1.2 million barrels per day. The amount of production is constrained by the throughput capability of the Alaska pipeline. Actions are now being taken by the Alyeska pipeline company to increase the pipeline capability and to expand production to 1.35-1.4 million barrels per day by the end of 1979. This requires installation of additional pumping capability on the pipeline.

These actions could increase domestic oil production by 150,000 to 200,000 barrels per day above previous projections.

VII. Proposed Demand Reductions and Other Response Measures

A. Immediate Actions

The following actions either have been implemented or are to be implemented as soon as possible, to constrain demand in the second quarter. These are actions which are expected to have little or no adverse economic impacts.

1. State, Local and Private Initiatives

- o Each State has been urged by the President to implement a plan of its choice to reduce gasoline consumption, to meet specific savings targets. Successful implementation of such plans could avoid the need to use mandatory Federal plans to reduce gasoline consumption.
- o Community leaders, industrial and commercial firms, and other major users of oil are requested to set voluntary targets and specific implementing actions for reducing oil consumption. Programs may include assistance and incentives for using carpools and vanpools or public transit; efforts by business firms to

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reduce gasoline used for employee commuting; and community campaigns to reduce discretionary driving.

- o State governments have been requested by the President to establish targets to reduce their direct government use of gasoline in motor vehicles by 10 percent, and to control their building temperatures at no cooler than 80 degrees in the summer and no warmer than 65 degrees in the heating season.
- o The Department also is instituting a major public information effort aimed at reducing gasoline use, and controlling temperatures in homes and offices at 65° in the heating season and 80° in the cooling season. Every driver has been requested by the President to reduce travel by 15 miles per week. If all drivers were to reduce travel by 15 miles per week, it could save 450,000 B/D of oil.
- o For purposes of developing total estimates of import savings from these actions, it was assumed that gasoline use would be reduced by approximately 3 percent or by 200,000 to 250,000 B/D, which is at the low end of the range of estimated savings from the above actions. It also was assumed that fuel oil savings would range between 200,000 and 400,000 barrels per day as a result of either voluntary or mandatory building temperature controls. See Attachment 5 for further information.

2. Encourage/Assist Switching to Alternative Fuels

- o The Administration is continuing the efforts started in January to maximize the use of the temporary natural gas bubble by urging that existing dual-fired facilities be switched from oil to gas. The Natural Gas Policy Act of 1978 has provided the essential foundation for this program by facilitating the transfer of

surplus gas from the intrastate market to the interstate market. The Department is encouraging sales between intrastate and interstate pipelines, and direct purchase arrangements between end users and producers or pipelines to facilitate this emergency gas conversion program. Savings of over 200,000 B/D of oil were already occurring in late March as a result of this effort. Estimated savings are 250,000 to 400,000 B/D. See Attachment 6 for further information.

- o The Department of Energy will be encouraging utilities to transfer electricity from coal burning and hydro powered facilities to utilities which are now using oil. It is expected that oil savings averaging about 100,000 barrels per day can be sustained through voluntary transfers of power. Major electric utility and power pools are already engaging in voluntary inter-regional transfers which have the direct effect of displacing oil use. Larger savings of up to 200,000 B/D are possible, particularly if substantial transfers of power from Canada are continued.

At this time, it is unclear to what extent electricity transfers will result in a net reduction in oil use from projected levels. The recent accident at the Three Mile Island nuclear plant, in addition to the shutdown of 5 other nuclear plants for safety reasons, will increase oil use significantly this summer if these units remain out of service for an extended period. This could offset some of the savings from electricity transfers. See Attachment 7.

3. Deferring the Phasedown of Lead in Gasoline

The Environmental Protection Agency is proceeding with an expedited rulemaking to defer the planned requirement that refiners phase down lead levels in gasoline to .5 grams per gallon

starting in October 1979. Instead, refiners would be required to limit lead to .8 grams per gallon, and to increase production of unleaded gasoline to assure adequate supplies for the increasing numbers of automobiles that are to use only unleaded gasoline. Prior to October 1, refiners will be given waivers from the current .8 grams per gallon limit subject to commitments to increase unleaded gasoline production.

This action will save 10,000 to 15,000 B/D of oil between now and October. More importantly, it will avoid the loss of 260,000 to 340,000 B/D of gasoline production capability, and the use of up to 30,000 B/D of additional oil, starting in October. See Attachment 8.

4. Building Temperature Controls

Mandatory building temperature controls will be implemented upon approval of the conservation plan by Congress.

A mandatory conservation Plan to require setting thermostats at no higher than 65° in the heating season and no lower than 80° in summer in commercial, industrial and public buildings has been submitted for Congressional approval. This measure is expected to have little or no adverse economic impact. Because building owners/managers have an incentive to comply, high levels of compliance are likely. This action will be particularly useful in saving oil use to rebuild distillate stocks before next winter. Estimated savings from application to commercial, industrial and public buildings range from 175,000 to 390,000 barrels/day, depending on time of year and level of compliance. See Attachment 9.

5. Higher Sulfur Limits for Residual Oil

The reduction in Iranian exports has curtailed the supply of low sulfur fuel oil that is needed to meet environmental standards.

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The Administration is determined to prevent environmental health regulations from being used as an excuse for price-gouging. In cases where shortages of low-sulfur fuel oil appear to exist, and where states request temporary suspension of Clean Air Act standards, the Administrator of EPA will consider unusually large increases in the price differential between complying and non-complying fuels as a basis for recommending approval of state suspension requests. The President has directed the Administrator of EPA to use his full authority to take into account price differentials and to provide the President with information on price differential increases when making recommendations to him on such requests. The President also will consult with the Secretary of Energy prior to making his determination.

6. Mandatory Actions by Federal Agencies

The President has directed all Federal agencies to reduce energy consumption by 5 percent. As part of this effort, all agencies are required to reduce use of gasoline in Federal vehicles by 10 percent, and control building temperatures at no warmer than 65° in winter and no cooler than 80° in summer.

As part of the effort to encourage Federal employees to use carpools, vanpools, or public transit, action is proceeding to begin charging full commercial rates for employee parking spaces provided by Federal agencies in urban areas. The full commercial rate is to be phased in, starting in October 1979. See Attachment 10.

7. Voluntary Distillate Stock Build Up Program

The Department will work with refiners to establish individual distillate stock level targets for October 1, 1979, to reach a total distillate primary stock level of 240 MMB by October 1. Intermediate monthly targets also may be established. DOE will take steps to be

prepared to require refinery yield shifts if this becomes necessary to build distillate stocks to safe levels.

If gasoline demand cannot be met because of the reduced stocks, constrained imports and the need to rebuild distillate stocks, refiners may be requested to allocate gasoline supplies voluntarily, using an allocation fraction suggested by the Department. DOE will be prepared to impose a mandatory industry-wide allocation program if necessary. See Attachment 12.

8. Crude Oil Allocation

If smaller refiners have serious crude oil shortages, DOE will direct larger refiners to sell crude oil to the smaller refiners under the current Buy/Sell program. If serious inequities in supplies of crude oil develop for larger refiners, DOE is prepared to take a range of actions, including using the current Buy/Sell program, establishing a separate Buy/Sell program for larger refiners, or implementing the full crude oil allocation program to allocate oil to all refiners based on a fraction of pre-interruption oil supplies. See Attachment 12.

B. Additional Actions if Early Actions are Inadequate

The following actions would be implemented only if the early actions are inadequate to deal with the problem.

1. Require Electricity Transfers

Use available authority to mandate electricity transfers from coal, nuclear, and hydro sources to displace oil-fired generation, if voluntary savings are inadequate. Estimated savings are 100,000 to 200,000 barrels/day, including voluntary transfers. See Attachment 7.

2. Ensure Maximum Use of the Temporary Natural Gas Bubble

If the voluntary switching from oil to natural gas is insufficient, the Department will

explore use of its allocation and other authorities to ensure this fuel switching. Savings could reach 400,000 to 500,000 B/D.

3. Restricting Gasoline Sales on Weekends

A mandatory conservation Plan has been submitted to Congress for its approval to permit the President to prohibit sales of gasoline for part or all of the weekend. The restrictions would also apply to pumps for aviation gasoline and fuel for boats. This action is estimated to have significant adverse economic impacts, chiefly in the tourism and recreational industries. It may cause some gas lines on Mondays and prior to the weekend. Estimated savings range from 110,000 to 270,000 barrels/day. States will have an opportunity to develop alternative proposals which may be more suited to the needs of the individual States. See Attachment 11.

4. Allocation of Products

Mandatory product allocation and refinery yield orders will be used if necessary to prevent excessive stock drawdown or to assure build up of adequate distillate stocks. It also may be used to allocate any remaining product shortages equitably among users if demand restraint measures are insufficient. In particular, allocation of gasoline may be necessary to equitably distribute shortages and to assure adequate build-up of distillate stocks for next winter's heating season. Product allocation can be implemented selectively or on all products. See Attachment 12.

C. Further Actions if the Shortage is Greater and if Demand Reduction Measures are Inadequate

1. Additional Mandatory Conservation Plans

Additional mandatory conservation plans are now under study and proposals may be completed this summer for use if the other available measures are insufficient.

2. Use the Strategic Petroleum Reserve (SPR)

The SPR will be used only if necessary to avoid chaotic supply conditions in the event of a large, sudden increase in the shortfall. The SPR could be used to provide a more gradual reduction in consumption than would otherwise be possible.

The SPR could be used to help avoid the most serious economic impacts of a long interruption. However, if there is a long-term reduction in world oil production, the use of the SPR will only delay the time when the U.S. economy will have to adjust to a lower level of consumption. After use of the SPR, the U.S. would be completely vulnerable to a more severe, short-term interruption.

By May 15, temporary drawdown facilities will be in place to permit drawdown at the rate of about 125,000 barrels per day. By October, a drawdown rate of about 1 million barrels per day will be possible.

3. Gasoline Rationing

Gasoline rationing would not be necessary except for conditions substantially more dire than the More Severe Case.

VIII. Summary of Potential Shortfalls and Savings

The following table summarizes the potential shortfalls from the two supply cases, and shows the estimated savings from each of the production, conservation and fuel switching measures being implemented.

The table shows that the U.S. can accomplish savings in accord with the U.S. obligations to the International Energy Agency, with a reasonable level of participation by Americans in reducing energy use.

Potential savings of petroleum use are more than adequate to cover the shortfall under the Base Case, with reasonable restraint in demand by all Americans. In the More Severe Case, the reductions may be inadequate in the third quarter of 1979 except with large voluntary conservation savings.

The reductions in use of distillate will be adequate to offset shortfalls and rebuild distillate stocks for next winter if the estimated savings are achieved from switching to natural gas and building temperature controls. The savings from these actions, plus additional potential savings from electricity transfers, could permit refiners to continue to produce relatively high levels of gasoline, rather than constrain gasoline production in order to build up distillate stocks. However, if the distillate savings are inadequate and stocks are not being rebuilt to safe levels, it will be necessary for the Department to require refiners to shift production from gasoline to distillate, to build stocks to acceptable levels. This would then result in greater shortages of gasoline, and may require allocation of gasoline.

The estimate of 200,000 to 250,000 B/D of savings in gasoline use may be adequate to avoid shortfalls under the Base Case, unless there is a need to reduce gasoline production in order to increase distillate stocks. Under the More Severe Case, higher levels of gasoline savings may be required if shortfalls are to be avoided.

The Department will monitor and report on the supply, demand and stock levels of petroleum products to assure that the U.S. meets its commitment to IEA. The Department will inform the American people of the progress in achieving this goal and of any further steps that may be necessary.

TABLE A

ESTIMATED SAVINGS FROM RESPONSE MEASURES
(Thousands of Barrels Per Day)

	<u>1979</u>			<u>1980</u>
	<u>Apr-Jun</u>	<u>July-Sept</u>	<u>Oct-Dec</u>	<u>Jan-Mar</u>
<u>Increased Domestic Production/ Reduced Consumption</u>				
. Decontrol of Crude Oil Prices	-	-	60-80	100-120
. Increased Elk Hills Production	5	10	20	20
. Increased Alaskan Production	-	-	0-150	0-150
<u>Immediate Demand Reduction Actions</u>				
. State, Local, Private Initiatives to Save Gasoline	200-250	200-250	200-250	200-250
. Switch to Natural Gas	250-400	250-400	250-400	250-400
. Electricity Transfers	100-200	100-175	100-200	100-200
. Building Temperature Controls	55-110	175-350	195-390	180-375
. Reductions in Federal Use	12	16	19	29
Subtotal	<u>622-977</u>	<u>751-1201</u>	<u>844-1509</u>	<u>879-1544</u>
<u>Additional Action if Necessary</u>				
. Mandatory Weekend Gasoline Sales Restrictions or Alternative State Plans	-	135-270	120-235	110-220

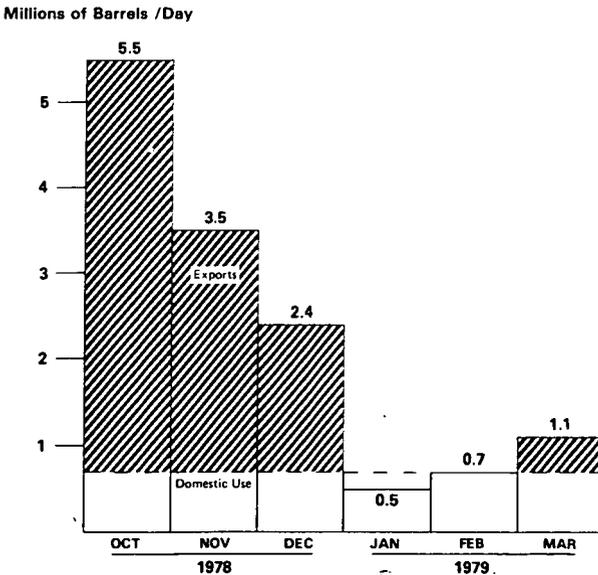
THE WORLD OIL SUPPLY PICTURE

Iranian Production

At the beginning of the fourth quarter of 1978, Iran ranked as the fourth largest producer of oil in the world and the world's second largest oil exporter. Iran's exports at that time averaged more than 5 million barrels per day (MMB/D) and provided approximately 10 percent of all oil consumed by non-Communist countries.

Following a series of political strikes and slowdowns in the Iranian oil fields, oil production dropped to about .5 MMB/D on December 26, 1978. This level of production was insufficient to support even Iran's domestic needs and exports came to a total halt. No crude oil was exported from Iran until March 5, 1979, when exports resumed at levels of about 1 MMB/D. Since then, Iran's production has increased to about 2.5 MMB/D, with approximately 1.8 MMB/D available for export.

Chart 1
Iran: Oil Production & Exports



The resumption of Iranian exports since March 5 has eased the oil supply crisis, although it will take 30-60 days for the renewed Iranian exports to arrive in the consuming countries and to alleviate physical shortfalls in the U.S., Europe and Japan. In addition, the cumulative shortfall of about 200 MMB since November represents an undesired draw-down of inventory that will have to be replaced primarily prior to next winter; this requirement will place additional demand pressure on world oil markets during the rest of this year. Finally, the Iranian government has indicated its intention to produce 3.5 to 4.0 MMB/D in the second quarter. Even if this level is sustained, it represents a reduction of 2 to 2.5 MMB/D from the level maintained prior to the change in regimes last year.

Other World Production

As Iran's oil production fell late last year, major exporting countries increased production. In particular, Saudi Arabia increased production by 1.4 MMB/D above its projected production level, while other major production increases came from Kuwait, Iraq, Venezuela and Nigeria. Table 1 provides a complete list of production changes during the first quarter of 1979, including estimated average total production by Iran during the first quarter.

Table 1
IMPACT OF IRANIAN CURTAILMENT ON FREE WORLD OIL PRODUCTION ^{1/}
(Millions of Barrels/Day)

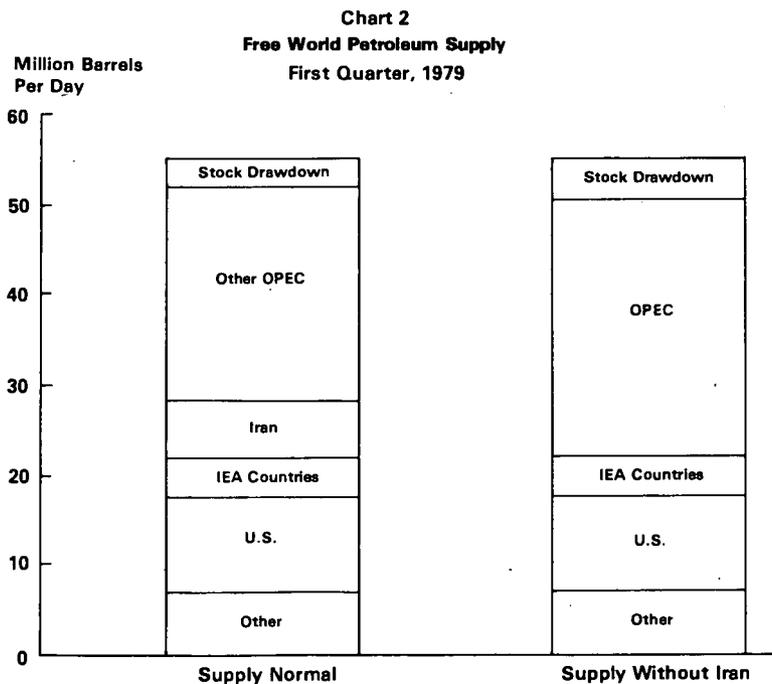
	Fourth Quarter 1978			First Quarter 1979		
	Projected	Actual	Change	Projected Before Iran Curtailment	Projected After Iran Curtailment	Change
OPEC						
Iran	6.2	3.8	-2.4	5.9	1.1 ^{2/}	-4.8
Saudi Arabia	9.2	10.2	1.0	8.7	10.1	1.4
Iraq	2.7	3.1	0.4	2.7	3.1	0.4
Nigeria	2.2	2.3	0.1	2.2	2.4	0.2
Kuwait	2.3	2.4	0.1	2.0	2.6	0.6
Libya	2.1	2.1	-	2.1	2.2	0.1
Venezuela	2.3	2.4	0.1	2.2	2.4	0.2
Other OPEC	5.6	5.8	0.2	5.6	5.8	0.2
Total OPEC	32.6	32.1	-0.5	31.4	29.7	-1.7
Non-OPEC						
United States	10.3	10.3	-	10.8	10.7	-0.1
Canada	1.6	1.7	0.1	1.7	1.8	0.1
North Sea	1.7	1.7	-	1.7	1.8	0.1
Other Dev Countries	0.8	0.8	-	0.9	0.9	-
Mexico	1.5	1.4	-0.1	1.5	1.5	-
Other LDCs	3.5	3.5	-	3.5	3.5	-
Net CPE Exports	1.0	1.0	-	1.0	1.0	-
Total Non-OPEC	20.4	20.4	-	21.1	21.2	0.1
Total Production	53.0	52.5	-0.5	52.5	50.9	-1.6

^{1/} Includes natural gas liquids and processing gains.

^{2/} Production at 600,000 b/d from Jan 1 to Mar 3, rising to 2.5 MMB/D by March 13, maintained at 2.5 MMB/D for rest of month.

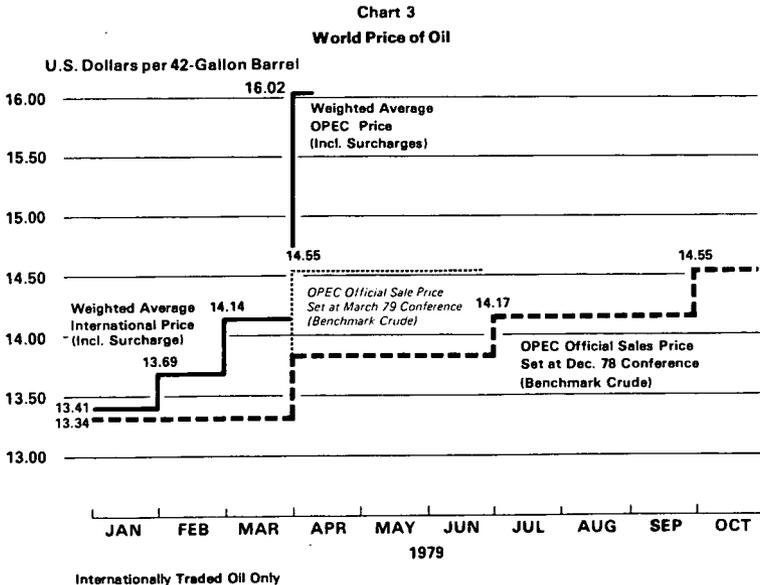
Production increases in these other countries alleviated about 3 MMB/D of the 5 MMB/D shortfall resulting from the loss of Iranian exports in the first 2 months of 1979. Oil supplies available to free world consuming countries have been estimated at about 51 MMB/D during that period, or about 2 MMB/D below expected levels. Because Iran resumed exports at a low level starting March 5, the estimated average daily shortfall for the full three months of the first quarter is estimated at 1.6 MMB/D, as shown in Table 1. The cumulative net shortfall of world oil supplies has been approximately 200 million barrels.

The net shortfall was made up primarily through the drawdown of petroleum inventories. Chart 2 summarizes the effects of increased OPEC production and the loss of Iranian supplies on the world supply situation for the first quarter of 1979.



The 2 MMB/D shortfall in supply and the corresponding drawdown of inventories led to widespread pressure on world oil prices. Price increases appeared first in January for the small volumes traded in spot markets and which were then translated into a series of surcharges by various producers in February. On the eve of the March 26 OPEC meeting, these surcharges averaged \$1.73/bbl and applied to 46 percent of internationally traded oil for an average price increase of 80 cents/bbl as shown below in Chart 3. Prices shown do not include transportation charges of \$1.00 to \$1.50 per barrel for shipment to the U.S., nor do they reflect the fact that the U.S. import mix is weighted towards light, premium crudes which adds \$0.75 to \$1.00 to the average U.S. import price.

Recognizing these pricing trends, OPEC decided on March 27 to raise its minimum prices by about 9 percent for the second quarter. These price increases moved the scheduled fourth quarter 1979 price forward to the second quarter and explicitly authorized the continuation of the surcharges which had appeared in February. Whether these surcharges will continue for the balance of the year will depend largely upon demand from the U.S. and other countries. Strong demand for oil will not only sustain the surcharges but also could lead to further increases in the official "base" price.



Summary of World Supply, Stocks and Demand

Given the changes in Iranian and other world production described above, the net loss of world petroleum production amounted to approximately 1.6 MMB/D during the first quarter of 1979. The cumulative effect of the curtailment in Iranian supplies has been a loss of about 200 million barrels of world oil supplies.

In the first quarter of 1979, the shortfall was relieved in part by drawing down industry stocks at higher than normal rates; this will affect the ability of consuming nations to meet peak demands for gasoline this summer while rebuilding fuel oil stocks to required levels for next winter.

Outlook for the Next Year

Because of the uncertainty which surrounds the current oil supply situation, supply projections for the next year cannot be precisely defined. For that reason, two scenarios have been defined to illustrate alternative developments in world oil markets over the next 12 months. These do not represent projections of what will occur, but rather provide a range of situations to which the United States should be prepared to respond. In calculating U.S. oil import levels, this analysis assumes that the U. S. share of any world oil shortfall is determined on the basis of the U.S. share of free world consumption, in keeping with the principles of the International Energy Agency's emergency sharing system. To the extent that companies would allocate the shortfall on the basis of the U.S. share of free world imports, the shortfall in U.S. oil imports would be somewhat lower.

World Supply Base Case

This case assumes a volume of exports from Iran and other producers that results in a net shortfall of supply on the order of 1 MMB/D from projected world demand. The need to rebuild inventories, the difficulties of sustaining production and exports in Iran, and reductions of supply by other producers combine to maintain pressure on world oil markets leading to further price increases until demand is brought into line with available supplies.

Estimated potential imports to the U.S. under this case range from 8.1 MMB/D in the second quarter, to 8.9 MMB/D in the first quarter of 1980. This is about 25 percent of total free world imports. (U.S. imports in the following two tables are on a 50-state basis and exclude SPR requirements in order to be consistent with EIA definitions in its Monthly Energy Review.)

Table 2

Base Case
(Millions of Barrels/Day)

	1979				1980
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
<u>Demand:</u>					
U.S.	20.7	18.5	18.4	20.0	20.5
Canada	1.9	1.8	1.8	1.9	2.0
W. Europe	15.5	13.6	13.1	15.2	15.9
Japan	6.0	5.2	5.4	5.9	6.1
Other Free World	11.6	11.5	11.4	11.5	12.0
Total Free World	55.7	50.6	50.1	54.5	56.5
<u>Supply:</u>					
OPEC	29.7	30.6	30.8	30.8	30.8
Non-OPEC	20.7	21.0	21.1	21.4	21.6
Processing Gain	.5	.5	.5	.5	.5
Total	50.9	52.1	52.4	52.7	52.9
<u>Stock change:</u>	-4.8	+1.5	+2.3	-1.8	-3.6
<u>Imports to U.S.</u>	8.6	8.1	8.2	8.8	8.9

World Supply More Severe Case

This case assumes a return to the more serious 2 MMB/D shortfall experienced earlier this year, caused by either another cessation of Iranian exports or by more severe curtailments of supply from other exporters. While perhaps not as likely as the precarious tight market of the Base Case, it remains a highly possible turn for the worse that would drive oil prices to much higher levels and require more drastic reductions of demand on the part of oil importing countries.

Table 3

More Severe Case
(Millions of Barrels/Day)

	1979				1980
	Jan-Mar	Apr-Jun	Jul-Sep	Oct-Dec	Jan-Mar
<u>Demand:</u>					
U.S.	20.7	18.5	18.4	20.0	20.5
Canada	1.9	1.8	1.8	1.9	2.0
W. Europe	15.5	13.6	13.1	15.2	15.9
Japan	6.0	5.2	5.4	5.9	6.1
Other Free World	11.6	11.5	11.4	11.5	12.0
Total Free World	55.7	50.6	50.1	54.5	56.5
<u>Supply:</u>					
OPEC	29.7	29.6	29.8	29.8	29.8
Non-OPEC	20.7	21.0	21.1	21.4	21.6
Processing Gain	.5	.5	.5	.5	.5
Total	50.9	51.1	51.4	51.7	51.9
<u>Stock change:</u>	-4.8	+0.5	+1.3	-2.8	-4.6
<u>Imports to U.S.</u>	8.6	8.1	7.8	8.4	8.5

Estimated potential imports to the United States under the More Severe Case range from 8.1 MMB/D in the second quarter of 1979 to 8.5 MMB/D in the first quarter of 1980, ranging from 26 percent to 27 percent of free world imports.

IMPACTS ON THE UNITED STATES OF THE
WORLD OIL SUPPLY SHORTFALL

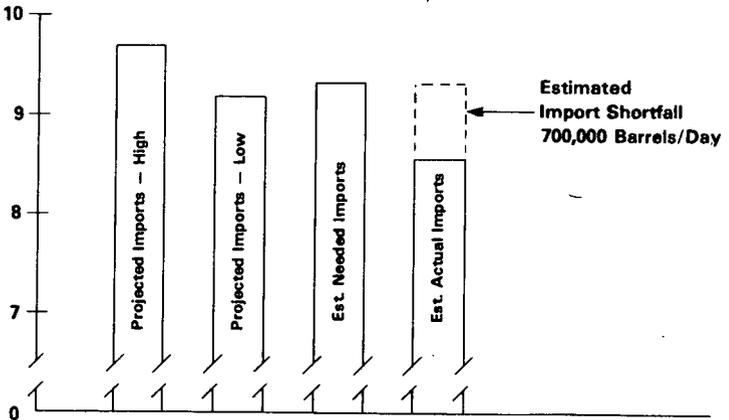
I. Impacts During the First Quarter of 1979

Imports

During the past three months, U.S. oil imports have averaged approximately 8.6 MMB/D. They had been projected to average between 9.2 and 9.7 MMB/D in order to meet normal U.S. petroleum demands. Because of the high demand during January and February for heating oil, gasoline and other products, imports should have averaged about 9.3 MMB/D during the first quarter in order to avoid excessive draw-down of U.S. oil stocks. Thus, the imports of 8.6 MMB/D were about 0.7 MMB/D less than would have been desirable. This is illustrated in the following chart.

Chart 1
**U.S. Import Shortfall
First Quarter 1979**

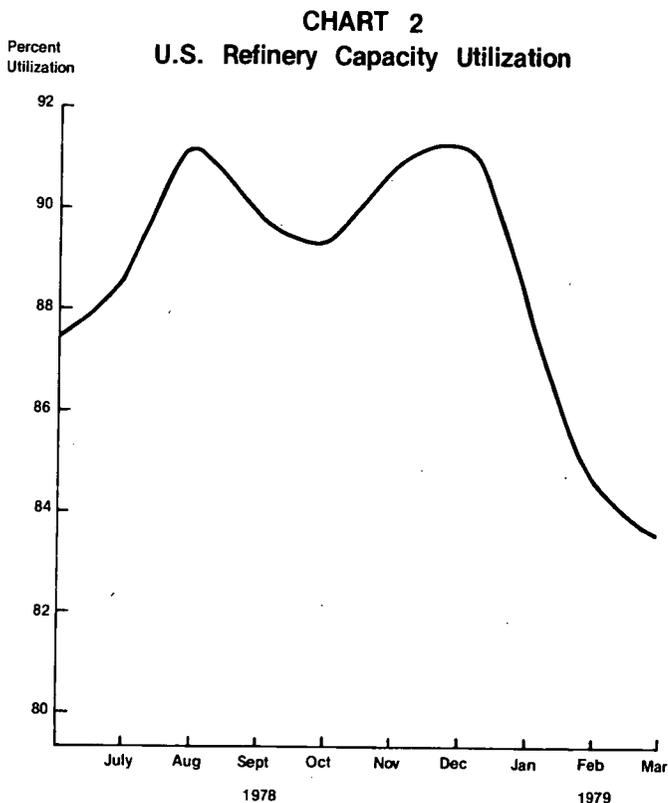
Millions of Barrels/Day



Refinery Utilization

Because of the shortfall of crude oil imports, it was necessary for refiners to reduce throughput at refineries, resulting in lower output of refined products.

The refinery utilization rate dropped from 91 percent last December to 88 percent in January, 84.5 percent in February, and 83.5 percent in March. This is shown on Chart 2.

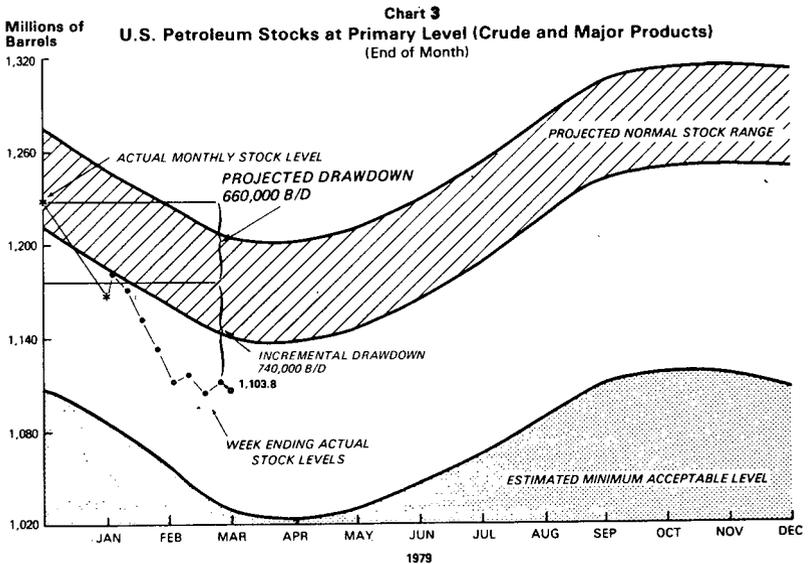


Source: July 1978 through September 1978: EIA *Energy Data Reports*
"Monthly Petroleum Statement." October 1978 through December 1978:
EIA "Monthly Petroleum Statistics Report. January 1979 through
March 1979: estimates based on data from the American Petroleum
Institute "Weekly Statistical Bulletin"

Industry Stocks

The shortfall of imports has been offset by using industry petroleum stocks at a faster rate than projected. The projected rate of stock drawdown during the first quarter of 1979 was about 0.7 MMB/D. The reported reduction in stocks is expected to have been about 1.4 MMB/D, or about 0.7 MMB/D faster than projected.

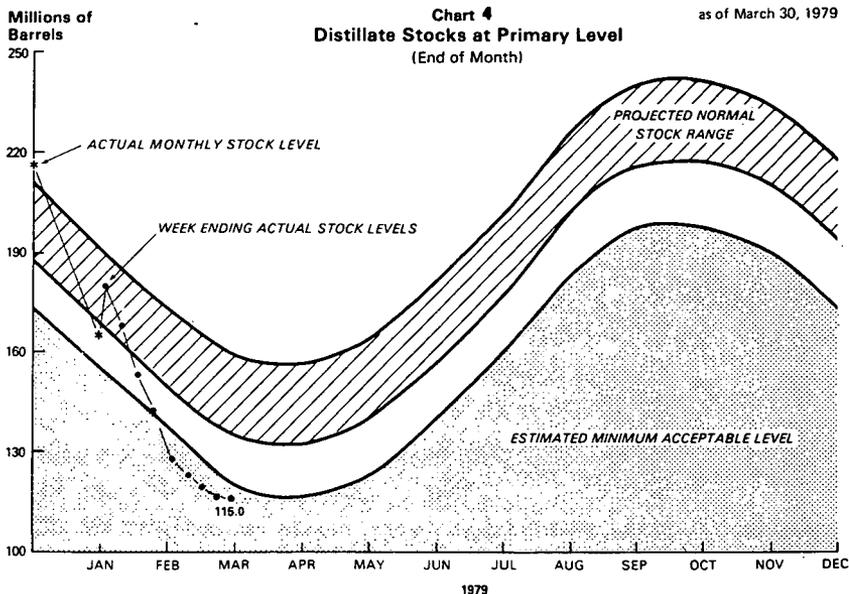
As shown in Chart 3, total crude oil and product stocks have declined by a total of 125 MMB from the end of December through March 30.



Source: Week ending average data American Petroleum Institute (API). "Weekly Statistical Bulletin"; Projections and estimates 1979: DOE Emergency Policy Council, Iranian Response Plan Actual Monthly Data (December 1978, January 1979) EIA "Monthly Petroleum Statistics Report."

- Notes (1) Projected Normal Stock Range — projections are based upon trends and seasonal patterns inherent in Bureau of Mines and DOE Actual Monthly Data from 1972-1978. The Band shown indicates a range of plus or minus one standard error. That is, extrapolations would fall inside the band approximately 2/3 of the time.
- (2) Estimated Minimum Acceptable Level — The level that stocks can fall to without disruption of consumer deliveries or the creation of spot shortages. This level is based upon the frequency with which stocks have fallen below normal patterns as determined from Bureau of Mines and DOE Actual Monthly Data from 1972-1978 and upon recent analysis of inventory requirements for efficient operation.
- (3) Product Stocks at the Primary Level include those held at refineries, in pipe lines, and at major bulk terminals. Crude Stocks at Primary Levels include those held at refineries, in pipe lines, and in leased tanks.

The large oil stock drawdown has particularly affected distillate stocks. These stocks have fallen below estimated minimum acceptable levels. The nation's weather has been colder than normal--by about 6 percent through March 26--and has contributed to the high rate of stock use, along with the shortfall of imports. As a result of these distillate stock drawdowns, spot shortages have appeared in several areas, and prices for end-users have risen rapidly.

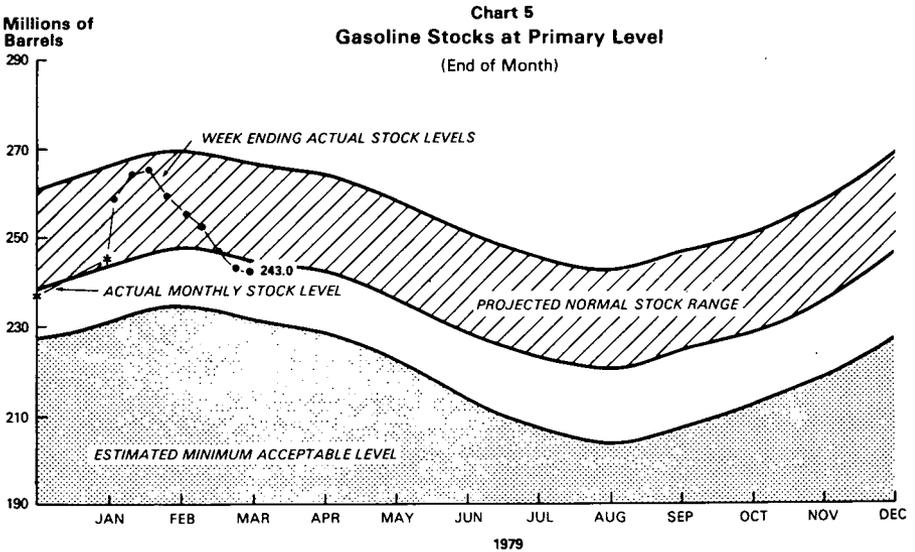


Source: Week ending average data: American Petroleum Institute (API), "Weekly Statistical Bulletin"; projections and estimates through 1979: DOE Emergency Policy Council, Iranian Response Plan. Actual Monthly Data (December 1978, January 1979): EIA "Monthly Petroleum Statistics Report."

Product stocks at the Primary Level include those held at refineries, in pipe lines, and at major bulk terminals.

See notes (1) and (2) of U.S. Petroleum Stocks at Primary Level.

Stocks of other products have also declined by larger-than-projected amounts. Motor gasoline stocks, for example, declined between mid-February and March 23 by 21.6 MMB. These stocks declined at a rate of over 630,000 B/D during those 5 weeks and are now slightly below estimated normal levels for this time of year.



Source: Week ending average data: American Petroleum Institute (API), "Weekly Statistical Bulletin"; projections and estimates through 1979: DOE Emergency Policy Council, Iranian Response Plan. Actual Monthly Data (December 1978, January 1979): EIA "Monthly Petroleum Statistics Report."

See notes (1) and (2) of U.S. Petroleum Stocks at Primary Level

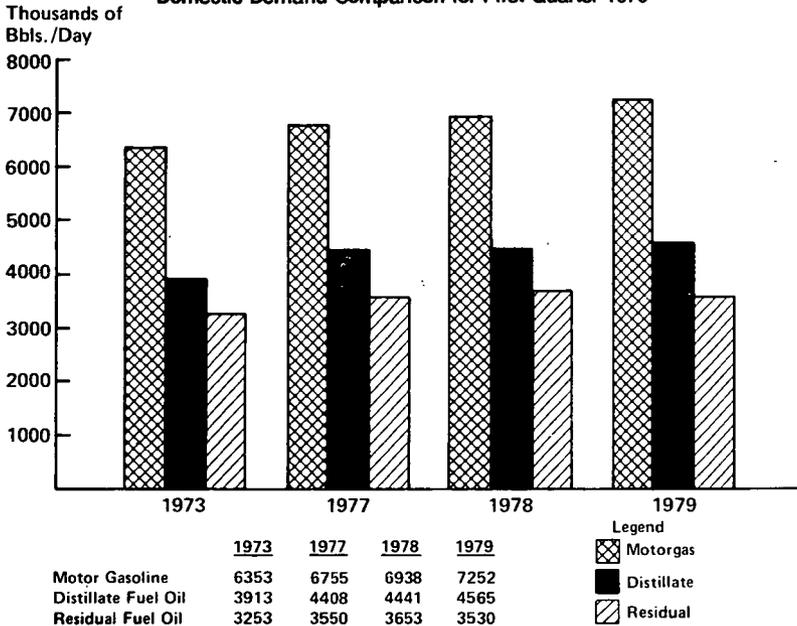
Summary of Supply and Demand

As a result of Iran-related oil production cutbacks, the U.S. in early 1979 experienced lower oil imports (of 8.6 MMB/D) and higher stock drawdowns (of 1.4 MMB/D) than projected. Domestic production has been at about the level projected, or about 10.7 MMB/D, including processing gains. The total of these three sources of supply, which is defined as total demand, was thus approximately 20.7 MMB/D for the first quarter.

Overall demand has not been unexpectedly strong for normal conditions, but there appears to have been little reduction in U.S. oil usage during the first quarter of 1979 as a result of the Iranian problem.

Of particular concern is that demand for motor gasoline has been averaging nearly 100,000 B/D more than the high estimate of demand for the first quarter. This is an increase of 4.5 percent over the year-earlier levels. The demand for residual fuel oil has declined slightly from last year and demand for most other petroleum products has risen less rapidly, by comparison.

Chart 6
Domestic Demand Comparison for First Quarter 1979



In summary, the United States during the past 3 months has experienced significant negative effects from the reduction in world oil production. U.S. oil imports fell short by about 700,000 B/D from expected requirements. The U.S. share of the overall shortfall seems consistent with its share of free world oil use. This shortfall in imports was caused in part by overall strong demand in spite of

higher prices. Thus oil stocks were drawn down at more than twice the projected rate during the first quarter, creating undesirably low stock levels.

U.S. Petroleum Prices

The world oil shortfall also has adversely affected U.S. oil prices. Retail prices have been rising rapidly. Preliminary estimates indicate the average retail price of regular unleaded gasoline rose since the beginning of the year by about 4 cents, or about 7 percent. Further increases seem certain in the months ahead. Similar increases have befallen heating oil, for which national average residential prices rose from just over 48 cents in August to almost 54 cents by early this year, more than twice the normal seasonal increase.

If markets remain tight, price pressures will continue. The recently announced increase in crude oil prices by OPEC of 9 percent plus surcharges is a reflection of the continued high demand for oil in conjunction with tight supply levels.

II. The U.S. Supply Picture for the Next Year

This section shows the potential oil shortfalls during the coming year for the two world supply cases discussed earlier.

Assumptions Regarding The Future

Because there is no certainty about the future of world oil supplies, two levels of imports have been used, corresponding to the Base Case and the More Severe Case in the world supply outlook discussed in Attachment 1. A single, projection of demand has been used which is the midpoint of the range of projected growth developed by the Energy Information Administration (EIA). The demand estimates assume normal oil supply conditions, prior to any conservation or fuel switching efforts as a result of the current oil shortfall and prior to any impacts of the March OPEC price increases.

These projections of supply and demand are shown on a quarterly basis in Table 1 below.

Table 1

(Millions of Barrels/Day)

	1979			1980
	<u>Apr-Jun</u>	<u>Jul-Sep</u>	<u>Oct-Dec</u>	<u>Jan-Mar</u>
<u>Demand:</u>				
Projected Consumption	18.84	18.68	20.33	20.77
Stock Build-up	<u>.75</u>	<u>1.05</u>	<u>0</u>	<u>0</u>
Total Demand	19.59	19.73	20.33	20.77
<u>Supply:</u>				
Domestic Supply	10.80	10.83	10.75	10.68
<u>Imports:</u>				
Base Case	8.07	8.21	8.77	8.93
More Severe Case	8.07	7.81	8.37	8.52
Stock Drawdown	<u>0</u>	<u>0</u>	<u>.30</u>	<u>.66</u>
<u>Total Supply:</u>				
Base Case	18.87	19.04	19.82	20.27
More Severe Case	18.87	18.64	19.42	19.86
<u>Shortfall:</u>				
Base Case	.72	.69	.51	.50
More Severe Case	.72	1.09	.91	.91

Total Petroleum Shortfalls for the U.S.

The two supply cases assumed above would result in the following average daily shortfalls for the United States:

Table 2

	(Thousands of Barrels/Day)			
	1979			1980
	<u>Apr-Jun</u>	<u>Jul-Sep</u>	<u>Oct-Dec</u>	<u>Jan-Mar</u>
Base Case	720	690	510	500
More Severe Case	720	1090	910	910

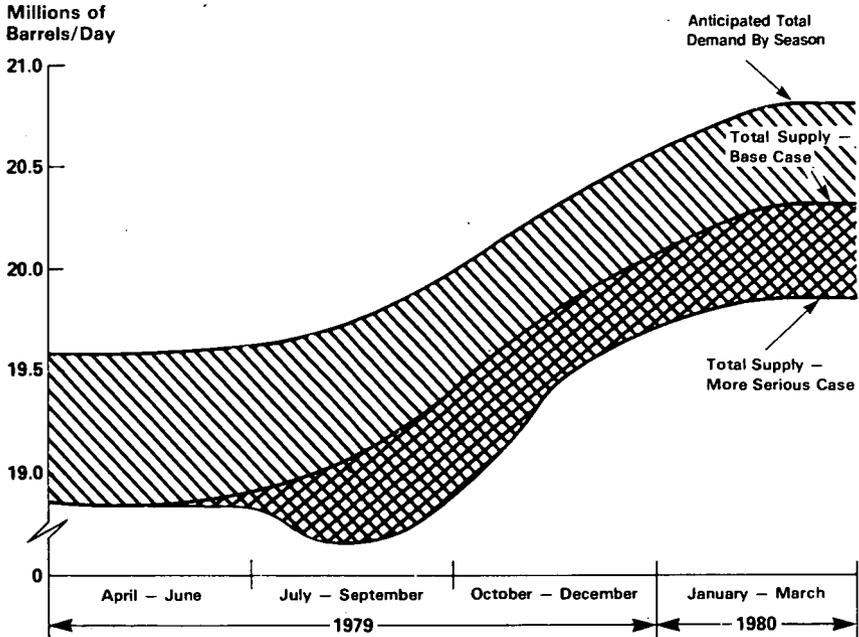
The estimated shortfalls reflect the higher than normal oil demand to rebuild petroleum stocks from current low levels, by October, as well as the shortfalls in future imports to meet current consumption. This is shown below:

Table 3

	(Thousands of Barrels/Day)			
	1979			1980
	<u>Apr-Jun</u>	<u>Jul-Sep</u>	<u>Oct-Dec</u>	<u>Jan-Mar</u>
Base Case				
Shortfall Due to				
Low Stocks	360	390	0	0
Reduced Current Imports	<u>360</u>	<u>300</u>	<u>510</u>	<u>510</u>
Total Shortfall	<u>720</u>	<u>690</u>	<u>510</u>	<u>510</u>
More Severe Case				
Shortfall Due to				
Low Stocks	360	390	0	0
Reduced Current Imports	<u>360</u>	<u>700</u>	<u>910</u>	<u>910</u>
Total Shortfall	<u>720</u>	<u>1090</u>	<u>910</u>	<u>910</u>

The shortfalls in supplies under the two cases are shown graphically in Chart 7.

Chart 7
Potential Oil Shortfalls



The single-hatched area shows that the potential shortfall in the Base Case could be about .7 MMB/D in the second and third quarters and about .5 MMB/D through the fourth quarter of 1979 and first quarter of 1980. The More Severe Case is depicted by the total shaded area. The shortfall under this scenario increases to about 1.1 MMB/D in the third quarter and to .9 MMB/D in the following two quarters.

In both supply cases, the most critical period for the United States will be the next 6 months. It will be during this period that gasoline demand will peak for the year, and it will be necessary to rebuild low distillate stocks for next winter, by October.

Gasoline Supplies

The shortfalls of gasoline under the two supply cases would be approximately as follows:

Table 4

	(Thousands of Barrels/Day)			
	1979		1980	
	<u>Apr-Ju</u>	<u>Jul-Sep</u>	<u>Oct-Dec</u>	<u>Jan-Mar</u>
Base Case				
Shortfall due to				
Low Stocks	65	110	0	0
Reduced Current Imports	160	135	220	220
Total Shortfall	<u>225</u>	<u>245</u>	<u>220</u>	<u>220</u>
More Severe Case				
Shortfall due to				
Low Stocks	65	110	0	0
Reduced Current Imports	160	310	380	380
Total Shortfall	<u>225</u>	<u>420</u>	<u>380</u>	<u>380</u>

The shortfalls from stocks reflect the fact that gasoline stocks already have been drawn down more than normal because of shortfalls of imports. Therefore, there will not be as much available in seasonal gasoline stocks to be used for consumption if stocks are to be kept at safe levels. The shortfalls from current imports are approximations of the impact on gasoline production capability from the total import shortfalls for each quarter.

The supply of gasoline in the second and third quarters could be increased by about 150,000 B/D by drawing down gasoline stocks to minimum working levels, but this would increase our vulnerability to a further significant reduction in world oil supplies.

The amount of the shortfall due to reduced oil imports in the coming months could increase above these estimates if refiners find it necessary to shift production away from gasoline production in order to rebuild distillate stocks to safe levels before next winter.

Supplies of unleaded gasoline may be impacted more seriously than leaded gasoline, because stocks of unleaded gasoline

already are very low at 66 MMB. Unleaded stocks were only 27 percent of total gasoline stocks, while unleaded gasoline was about 39 percent of gasoline consumption in February.

Distillate Supplies

The shortfalls of distillate fuel oil under the two supply cases would be approximately as follows:

Table 5

	(Thousands of Barrels/Day)			
	1979			1980
	<u>Apr-Jun</u>	<u>Jul-Sep</u>	<u>Oct-Dec</u>	<u>Jan-Mar</u>
Base Case				
Shortfall Due to				
Low Stocks	150	255	0	0
Reduced Current Imports	<u>80</u>	<u>70</u>	<u>120</u>	<u>115</u>
Total Shortfall	<u>230</u>	<u>325</u>	<u>120</u>	<u>115</u>
More Severe Case				
Shortfall Due to				
Low Stocks	150	255	0	0
Reduced Current Imports	<u>80</u>	<u>150</u>	<u>210</u>	<u>210</u>
Total Shortfall	<u>230</u>	<u>405</u>	<u>210</u>	<u>210</u>

Distillate stocks are at very low levels now, with resulting spot shortages in several areas of the country. With warmer weather, distillate stocks will begin to rebuild for next winter.

The critical objective with distillate is to rebuild stocks to safe levels by next October. Without high stocks, the U.S. would be dangerously vulnerable to a cold winter and a further reduction in world oil supplies. The shortfalls of about 230,000 B/D and 325,000 B/D in the second and third quarters under the Base Case reflect the requirement to rebuild stocks rather than actual shortfalls for use during the summer.

Supplies of Other Products

Supplies of other products also would be short under both supply cases. For all other products, shortfalls would average about 180,000 B/D for the four quarters under the

Base Case. In the More Severe Case the shortfalls would average about 295,000 B/D.

Lower sulfur residual oil could be in particularly short supply, because the higher sulfur content of crude oils which are being produced to substitute for lost Iranian exports makes it more difficult and costly to produce low sulfur residual fuel oil.

Price Impacts

The reduction in OPEC oil production and the related increase in prices will have a substantial affect on the U.S. economy both in the short-term and the long-term.

The average delivered cost of a barrel of imported crude oil to the United States is about \$18.00 as a result of the OPEC pricing action on March 27, and the continued surcharges. This represents an increase of about 20 percent since last December. As these higher imported crude oil costs are passed along in petroleum products, it can be expected that gasoline and fuel oil prices will increase by 5 to 6 cents per gallon.

If the U.S. demand for foreign petroleum remains high and continues to grow as it has, the U.S. should anticipate further price increases by the foreign producers, and greater difficulties in acquiring the quantities of oil required.

Summary of the Impacts on the U.S. of the Limited World Oil Supply

The primary immediate impact of the curtailment of world oil supplies on the U.S. oil supply situation has been to reduce industry stocks to unacceptably low levels, impacting oil supplies over the next 6 months to 1 year, even if world oil production remains at current levels.

An important objective must be to rebuild distillate fuel oil stocks during the next 6 months. A reduction in distillate consumption averaging over 270,000 B/D during these 6 months will be necessary if world oil supplies are at the Base Case level. A reduction of over 315,000 B/D would be needed if world oil supplies drop to the More Severe Case level. Alternatively, gasoline production could be reduced to increase distillate production, but this would worsen the gasoline shortfall. Nevertheless, this action may be necessary in order to rebuild distillate stocks to safe levels.

Without any reduction in gasoline production to increase distillate stocks, there will be a need to reduce gasoline use below the projected demand levels to avoid shortages this summer and in the future. Consumption should be reduced by about 225,000 to 250,000 B/D below the projected demand levels during the next 6 months in order to maintain stocks at safe levels, under the Base Case.

These reductions in oil consumption are necessary to offset the loss of oil imports earlier this year, and to live within the constrained world supply of oil in the future. Reductions in consumption also are essential if we are to reduce pressures to increase prices still further.

CRUDE OIL PRICE DECONTROL

The crude oil pricing proposal has five basic objectives:

- A. To provide incentives to increase domestic production.
The proposal would:
- o Allow all production from marginal wells to receive the upper tier price by the end of 1979.
 - o Allow newly discovered oil to sell at the world price.
 - o Implement a program to stimulate tertiary production by allowing producers investing in certain projects to release specified volumes of lower tier oil to the upper tier price as partial reimbursement.
 - o Allow the upper tier price to rise gradually after January 1, 1980.
- B. To bring U.S. domestic crude oil prices to world levels by October 1, 1981.
- o The combination of regulatory actions DOE intends to pursue will bring the average cost of all crude oil purchased by the U.S. refiners close to the world price by October 1, 1981.
 - o The refiner acquisition cost of domestic crude oil will rise from approximately 86 percent of the world price to 96 percent by October 1, 1981.
- C. To reduce oil imports.
- o By stimulating increased domestic production and inducing additional conservation, this crude oil pricing policy will reduce oil imports by:

	<u>Thousands of Barrels Per Day</u>
1979	60 to 80
1980	180 to 200
1981	370 to 440

D. To minimize the inflationary effects of increases in domestic oil prices.

- o All measures to increase crude oil prices will be structured to phase the increases gradually between now and October 1, 1981. . This will limit the inflationary impact over time.

E. To dismantle the cumbersome system of price controls and crude oil entitlements.

The measures to move domestic oil prices to world levels will:

- o Allow price controls to expire in 1981 without any serious dislocations in the economy.
- o Eliminate the need for the cumbersome entitlements system.

Attachment 4

INCREASED PRODUCTION FROM THE
NAVAL PETROLEUM RESERVE AT
ELK HILLS

I. Description

The Naval Petroleum Reserves are being produced under Maximum Efficient Rate (MER) principles as specified in the NPR Production Act of 1976. The current rate of production at Elk Hills is about 140,000 B/D. Production at the MER entails pumping oil from the various pools at rates which will not cause reservoir damage, thus permitting pressure maintenance and maximum ultimate recovery of all hydrocarbons. Through the drilling of new wells and the development of a water injection system, production would be increased to 160,000 B/D at Elk Hills by the end of 1979.

Resolution of litigation between Chevron and the United States concerning part of Elk Hills production could add another 30,000 B/D to Elk Hills production within 90 days after resolution of the case.

II. Implementation

The DOE is proceeding with drilling new wells, developing a water injection system and expanding the gathering system for the Elk Hills reservoir. This is expected to lead to an increase in production of 20,000 B/D by the end of 1979 and 40,000 to 60,000 B/D by October 1980.

The DOE is working with the Department of Justice to resolve the litigation with Chevron concerning a portion of the Reserve. There is an action pending before the 9th Circuit Court of Appeals to reverse the stay which has caused the 30,000 B/D reservoir to be shut-in.

III. Increased Production Resulting from these Actions
(in thousands of barrels per day)

<u>Incremental Production</u>	<u>2Q'79</u>	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
Estimate	5	10	20	20

IV. Costs

- o Increasing production above the current MER will cost approximately \$20 million.

V. Benefits

- o Increased Elk Hills production would contribute to reducing U.S. dependence on foreign oil.

STATE, LOCAL AND PRIVATE
INITIATIVES TO REDUCE PETROLEUM USE

I. Description

The Administration requests State and local government leaders to develop programs suited to their areas to reduce oil consumption to help prevent shortages of oil and to reduce upward pressure on prices. Individuals, firms and organizations are requested to participate, to help minimize the economic impacts and inconvenience on any one sector or region of the country. The Department of Energy will assist State and local leaders and organizations in this voluntary conservation effort.

Actions which are requested include the following:

- o States have been requested by the President to develop specific targets and implementation plans to reduce gasoline usage in each state. States also have been requested to reduce direct government use of gasoline, and to control temperatures in government buildings, similar to the requirement being placed on Federal agencies.
- o All Americans are requested to reduce gasoline consumption, by reducing and consolidating private business trips, increasing the use of carpooling, vanpooling and mass transit, enforcing and obeying the 55 MPH speed limit, and curtailing pleasure driving, motor boating, and flying. The President has requested each individual driver to reduce driving by 15 miles per week; and commercial and industrial firms are requested to assist and encourage the use of carpooling and vanpooling and develop other measures suited to their firms and communities.
- o All Americans are requested to reduce the use of distillate and residual heating oil both directly and indirectly (by reducing use of electricity) by controlling thermostat settings at no more than 65° in the heating season and 80° in the cooling season. These standards should be followed in homes, offices, public buildings and commercial and industrial establishments.

II. Implementation

The Department of Energy will undertake a major public awareness information program to encourage maximum cooperation in this conservation effort.

Meetings are being held with State and local groups, to identify voluntary, as well as mandatory, demand restraints that worked in the past. That information is being used to form the basis of communications to Governors and private organizations requesting implementation of previously successful efforts to reduce consumption.

DOE will continue to work with the States, industries, labor unions, trade associations and other organizations, to establish specific energy savings goals and implementation actions.

III. Savings in Consumption of Petroleum Products Resulting from this Measure (in thousands of barrels per day)

	<u>2Q'79</u>	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
<u>High Estimate</u>				
Fuel Oil	300	280	360	420
Gasoline	<u>390</u>	<u>388</u>	<u>372</u>	<u>362</u>
Total	690	668	732	782
<u>Low Estimate</u>				
Fuel Oil	180	168	216	252
Gasoline	<u>234</u>	<u>233</u>	<u>223</u>	<u>217</u>
Total	414	401	439	469

The high savings figures assume a 5 percent reduction in use of gasoline and fuel oil, and the low savings estimates assume a 3 percent reduction in gasoline and fuel oil use.

For purposes of estimating total petroleum savings, it is assumed that fuel oil savings of about 200,000 to 400,000 B/D will be achieved either through voluntary actions or as a result of the mandatory building temperature control plan. These savings are accounted for under the Building Temperature Controls category in Table A. It also is assumed that the gasoline savings would be near the low estimate, or 200,000 to 250,000 B/D. These savings are accounted for under the category of State, Local and Private Initiatives to Save Gasoline in Table A.

IV. Costs

- o The Federal government would incur costs of \$500,000 to \$1 million for public awareness materials.
- o Additional costs may be incurred by State and local governments and the private sector to implement the voluntary plans.

V. Benefits

- o There would be little or no reduction in output or income as a result of these actions.
- o These actions may avoid the need for mandatory measures, thus minimizing interference with the petroleum market and freedom of choice of energy users.

NATURAL GAS INITIATIVESI. Description/Legal Authorities

Utilize the temporarily available natural gas bubble to replace the use of oil by utilities and other major industrial and commercial users.

Section 311(b) of the Natural Gas Policy Act of 1978 provides for sales of available gas by intrastate pipelines to interstate pipelines. In addition, temporary (60-day) emergency sales of natural gas by intrastate to interstate pipelines are allowed under prior Federal Power Commission legislation.

II. Implementation

1. The Secretary of Energy has issued a policy statement emphasizing the need to switch from oil to natural gas on a short-term basis. Some substitution of gas for oil has already taken place in response to the oil shortage in the first quarter.
2. The Secretary has proposed to FERC that it facilitate short-term, direct purchases of gas by industrial or commercial facilities now using oil, particularly distillate oil.
3. FERC is considering a rule providing that natural gas used to replace oil during this emergency will not be considered in determining interstate curtailments or in market classification proceedings. FERC is now accepting comments on the proposed rule and is expected to make a final determination by May 17, 1979.
4. DOE is surveying interstate pipelines and distributors most likely to have surplus deliverability.
5. DOE has implemented a program to facilitate matching deliverable supplies with potential users.

III. Savings in Consumption of Petroleum Products Resulting from this Measure (MB/D)

	<u>2Q'79</u>	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
<u>High</u>				
Residual/ Distillate	400	400	400	400
<u>Low</u>				
Residual/ Distillate	250	250	250	250

Roughly two-thirds of the oil savings will be residual fuel oil; the other third will be distillate.

Some estimates of the potential to switch to natural gas are higher than the above estimates and indicate that savings of up to 500,000 barrels of oil per day are possible, if every effort is made to use natural gas. DOE will be pursuing these higher targets.

IV. Costs

Under intrastate to interstate sales, high priority users (e.g., home heating) would have to absorb rolled-in increases in rates.

V. Benefits

- o Utilizes existing excess supply of domestic natural gas.
- o Frees distillate and residual fuel oil for replenishment of stocks.
- o Offsets demand for imported fuels/crude oil.
- o May decrease cost for users of oil, particularly distillate, who switch to natural gas.

ELECTRIC ENERGY TRANSFERSI. Description/Legal Authorities

Encourage, facilitate and, if necessary, order utilities to transfer electricity from coal and hydro sources to utilities which are now dependent primarily on oil.

Regional Electric Reliability Councils would be used to encourage voluntary energy transfers. Section 202(c) of the Federal Power Act could be used to order specific emergency interconnections and energy transfers if voluntary arrangements fail to achieve desired objectives.

II. Implementation

Major electric utility and power pools are already engaging in large-scale voluntary inter-regional transfers (primarily economy exchanges) which have the direct effect of displacing oil use. Greater levels of voluntary transfers will evolve with increasing oil prices. The clearly stated intention of DOE to exercise emergency authority under Section 202(c), is likely to result in sustaining maximum practicable levels of energy transfers without the need for direct Federal intervention.

Cooperation of State regulatory commissions is necessary to insure that there are no impediments to the import/export of power such as permission to deviate from economic dispatch recovery of purchased-power costs.

In addition, FERC has initiated action on rules relating to tariffs for emergency electric power transfers and fuel conservation tariffs under non-emergency conditions.

In order to determine the effectiveness of the voluntary program, a detailed monitoring program has been established.

III. Savings in Consumption of Petroleum Products Resulting From This Measure (MB/D)

	<u>2Q'79</u>	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
<u>High</u>				
Residual	174	149	176	174
Distillate	<u>36</u>	<u>25</u>	<u>38</u>	<u>38</u>
TOTAL	210	174	214	212
<u>More Likely</u>				
Residual	85	85	85	85
Distillate	<u>15</u>	<u>15</u>	<u>15</u>	<u>15</u>
TOTAL	100	100	100	100

The high savings estimates are limited duration transfers and cannot be sustained over time. The low estimates represent long-term sustainable transfer levels based on seasonal load variations, normal unit maintenance schedules, forced outage rates and system reliability considerations.

The high estimates include wheeling from and to the following areas:

<u>From</u>	<u>To</u>	<u>Approximate Daily Average over 5 quarters (1000 barrels)</u>		
		<u>Total</u>	<u>Resid.</u>	<u>Distillate</u>
ECAR	Mid Atlantic Region, New York and New England	112.0	95.0	17.0
TVA, ECAR, MAIN	Louisiana-Arkansas	80.0	65.0	15.0
Pacific Northwest	California	4.5	4.0	0.5
Southeast	Florida	<u>4.5</u>	<u>4.0</u>	<u>0.5</u>
All Electricity	Transfers	201.0	168.0	33.0

IV. Costs

- o Consumers in importing regions may experience some increases in electric bills under a mandatory transfer program if emergency conditions warrant deviation from economic dispatch. Estimates of increased costs to consumers range from about 0.5 cents to 1 cent per kilowatt hour. Some of this cost may be attributable to existing rate structures which permit charges for transfers in excess of costs.
- o Lack of uniform, approved interchange tariffs and state regulatory provisions may lead to large differences in cost impacts to various states and regions.

V. Benefits

- o Simple to initiate and monitor; the operational feasibility is very high.
- o Relies primarily on established industry procedures to make the most effective use of non-oil fired generation and transmission networks. Government involvement in this project is minimal except for oversight and monitoring effort.

LEAD PHASEDOWN FOR GASOLINEI. Description/Legal Authorities

Lead phasedown regulations have been promulgated by EPA for the last seven years to reduce the amount of lead used in leaded gasoline to limit the total amount of lead emitted to the atmosphere. These standards have been established to reduce human exposure to lead.

Current regulations limit the amount of lead in gasoline to 0.8 grams per gallon (gpg), but waivers have been allowed so that the 0.8 standard applies to only about 18 percent of all production. This limitation was scheduled to apply over the next six months to an increasing number of refiners, and on October 1, 1979 all but very small refiners would have been required to limit lead to 0.5 gpg.

Because reducing the lead content of gasoline requires additional volumes of oil in the refining process to produce the same amount of gasoline and reduces the capability of U.S. refiners to produce gasoline, EPA has agreed to act on requests for waivers from the current limit of 0.8 gpg for the next six months and to proceed with an expedited rulemaking to establish the 0.8 gpg requirement on October 1, 1979 rather than the 0.5 gpg limit scheduled. Waiver of the existing requirement will save about 10,000 to 15,000 B/D of crude oil between now and October 1. Phasedown to 0.8 gpg in lieu of 0.5 gpg will avoid crude oil losses of 20,000 to 30,000 B/D after October 1, and avoid the loss of 260,000 to 340,000 B/D of gasoline production capability. The 0.8 gpg standard will protect urban children, those most vulnerable to lead.

II. Implementation

1. EPA will act on requests for waivers of the 0.8 gram limit for refiners which are now subject to the requirement.
2. EPA will proceed with an expedited rulemaking to implement a phasedown to 0.8 gpg in lieu of 0.5 gpg on October 1 1979.

3. The waivers and deferral requirements will be subject to agreement by the refiners to increase unleaded gasoline production to meet the rising needs for this fuel.

III. Savings in Consumption of Petroleum Products Resulting from this Measure (MB/D)

<u>Estimated Savings</u>	<u>2Q'79</u>	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
Crude Oil Savings	10-15	10-15	(20-30)	(20-30)
Increased Gasoline Production Capability	20-35	20-35	(260-340)	(260-340)

The crude oil savings in the first two quarters would result from reduced refinery processing fuel use. The estimates for the last two quarters represent losses avoided rather than savings from current consumption levels.

The increased gasoline production capability would result from the additional flexibility in refining operations which would be permitted in the absence of the lead phasedown requirement. Increases in the first two quarters could result from waivers of the 0.8 grams per gallon limit for those refineries currently not on waivers from this standard. The gasoline production impacts subsequent to October 1, 1979, are again losses avoided rather than increases from current consumption.

IV. Costs

Would result in a temporary delay in achieving the planned standards for lead in gasoline, but preliminary results of studies indicate that there may be little additional health benefits from a .5 standard rather than a .8 standard.

V. Benefits

- o Savings in crude oil will reduce the impact of the world oil shortfall. The avoidance of a major loss in gasoline production capability could help prevent serious gasoline shortages in the summers of 1979 and 1980.
- o This action would have no adverse economic impacts.

EMERGENCY BUILDING TEMPERATURE RESTRICTIONSI. Description/Legal Authorities

This plan would restrict thermostat settings to 65 degrees for heating purposes, and 80 degrees for cooling purposes in commercial, industrial and public buildings. Legal authorities for development and implementation of this plan are primarily contained in Section 201 and 202 of the Energy Policy and Conservation Act (EPCA) of 1975 (P. L. 94-163).

II. Implementation

Administrative Actions Required:

- o The plan was submitted to Congress on March 1, pursuant to EPCA.
- o Congress has 60 days within which to consider the measure and approve or disapprove it.
- o Pending Congressional approval, DOE will prepare implementing regulations; and will complete pre-implementation activities (such as development of a compliance strategy, exemption procedures, exceptions and appeals procedures, etc.). States have the option and are encouraged to develop alternative plans which achieve the same level of savings as the Federal plan but are better suited to the specific economic conditions of each state.
- o Upon Congressional approval, the President plans to inform the Congress of his decision to implement the plan, with a statement of the effective date and manner for exercise of the plan.
- o This measure could be implemented in about 2 weeks after a Presidential decision.

III. Savings in Consumption of Petroleum Products Resulting From This Measure (in thousands of barrels per day)

	<u>2Q'79</u>	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
<u>High</u>				
Residual	25	90	100	95
Distillate	85	260	290	280
Total	110	350	390	375
<u>Conservative</u>				
Residual	15	45	50	40
Distillate	40	130	145	140
Total	55	175	195	180

The high savings estimates are based on a compliance rate of 100 percent. Conservative savings are based on 50 percent compliance. Distillate savings primarily result from reduced peak load electricity generation.

IV. Costs

May adversely affect specific businesses, if not given exemptions, which cannot operate efficiently at prescribed temperatures.

V. Benefits

- o This action will have little adverse economic or social impacts.
- o It has a relatively quick start-up time.
- o A high rate of compliance is expected.

FEDERAL GOVERNMENT INITIATIVES

I. Description

The President has directed all agencies to reduce energy consumption by 5 percent in response to the shortfall in world oil supplies. The 5 percent target level is taken against April 1978 to April 1979 consumption levels. Coal use is excluded from the total. Switching from oil to natural gas or coal will help satisfy the reduction goal.

In achieving this 5 percent reduction, agencies must reduce gasoline use in Federal vehicles by 10 percent, and set building thermostats at no more than 65° in the heating season and 80° in the cooling season. Agencies have been directed to develop additional initiatives to achieve the full 5 percent reduction.

The Administration is proceeding to charge full commercial rates for employee parking spaces provided by Federal agencies in urban areas. The full rates are to be phased in starting in October.

II. Implementation

Immediate reductions in Federal energy consumption will be achieved as a result of a directive issued by the President. The directive will require all agencies to:

1. Reduce energy use by at least 5 percent.
2. Reduce gasoline use in Federal vehicles by at least 10 percent, and to control building temperatures at 65° in winter and 80° in summer.
3. Reduce all hot water settings to 105 degrees except where required for health and safety.

The full commercial parking rate will be phased in, with one-half the full rate charged starting in October 1979.

III. Savings in Consumption of Petroleum Products Resulting from this Measure (MB/D)

	<u>2Q'79</u>	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
Petroleum Products	12	16	19	29

EMERGENCY WEEKEND GASOLINE SALES RESTRICTIONSI. Description/Legal Authorities

This plan would prohibit sales of gasoline and diesel fuel by retail filling stations during all or a portion of the weekend hours (Friday noon to Sunday midnight). Fuel would be dispensed only to emergency and certain types of commercial vehicles. The development of this plan was undertaken to fulfill requirements of Sections 201 and 202 of the Energy Policy and Conservation Act of 1975 (P.L. 94-163).

If gasoline shortages were severe, full closure from Friday noon until Sunday midnight for one or more weekends of the month would be possible. Closings could be made effective only on Sundays, however.

The President has submitted an Amendment to the plan under which States would be permitted to develop alternatives to the Federal plan. If mandatory sales restrictions are required, States first would be permitted to develop their own plans and submit them to the Department for approval. A State would have 60 days to demonstrate that its alternative plan had achieved the target gasoline savings set for that state.

II. Implementation

Administrative Actions Required:

- o This plan was submitted to Congress on March 1, pursuant to EPCA. Congress has 60 days to consider the measure.
- o Pending Congressional approval, DOE will complete implementing regulations; and will complete pre-implementation activities. States have the option and are encouraged to develop alternative plans which achieve the same level of savings as the Federal Plan but are better suited to the specific economic conditions of each state.

- o The President would determine whether putting the plan into effect is required by a severe energy supply interruption or in order to fulfill U.S. obligations under the international energy program.
- o The President would submit this finding to the Congress with a statement of the effective date and manner for exercise of the plan.
- o This plan can be implemented in about 2 weeks after a Presidential decision is made.

III. Savings in Consumption of Petroleum Products Resulting From This Measure (in thousands of barrels per day)

	<u>3Q'79</u>	<u>4Q'79</u>	<u>1Q'80</u>
<u>High</u>			
Gasoline	270	235	220
<u>Low</u>			
Gasoline	135	120	110

The "high" savings estimates are based on an assumption of essentially 100 percent compliance, and that none of the savings would be realized in the absence of the measure. The "low" estimates assume approximately 50 percent of "high" savings, because of possible countervailing activities, e.g., increasing inventories by tank-topping and/or increased gasoline use associated with queueing.

IV. Costs

- o May increase queueing before and after limitation periods, e.g., Thursdays, Fridays and Mondays.
- o May result in filling of car gas tanks and home garage-can storage, both of which could produce reductions in industry inventories and could have safety problems.
- o Will adversely impact some segments of the recreational and tourism industries. Potential losses are estimated at 7-8 billion dollars over a nine month period, but the saved petroleum would permit a higher level of economic activity in other sectors of the economy to more than offset those losses.

V. Benefits

- o Emphasizes to all Americans the importance of voluntary reductions in gasoline use.
- o Would have relatively low administrative and enforcement costs, and could be implemented relatively rapidly.

ALLOCATION AND PRICE CONTROLSI. Description/Legal Authorities

The Department of Energy in January 1979 promulgated as final rules: (1) the Standby Mandatory Crude Oil Allocation and Refinery Yield Control Program and (2) the Standby Product Allocation and Price Regulations. The regulations could be put into effect pursuant to Section 4(a) of the Emergency Petroleum Allocation Act (EPAA) P.L. 93-159.

Refiners will be requested to establish individual distillate stock level targets for October 1, 1979, to reach a total distillate primary stock level of 240 MMB. DOE will be prepared to use available standby authorities, including mandatory gasoline allocation, if necessary.

II. Implementation

Both the crude oil and product allocation regulations require a determination by the Administrator of the Economic Regulatory Administration (ERA) that they are necessary to carry out the purposes of the EPAA. Once that determination is made, they can be implemented immediately, although the Department may first want to receive public comment. All or any portion of either or both could be implemented. Implementation would involve:

Crude Oil

1. Using the current Buy/Sell program if only small refiners have serious crude shortages.
2. If the Administrator determines that a few large independent or major refiners are experiencing a serious shortage of crude oil, he can use the current Buy/Sell program to allocate oil to them also.
3. If the Administrator determines that a significant number of large independent and major refiners have shortages, he can maintain the current Buy/Sell program for small refiners and invoke a separate program for large refiners.

4. If a general emergency is declared or if the International Energy Program is triggered, a single allocation program involving all refiners could be put into effect, and crude oil would be allocated to all refiners in accordance with a national allocation fraction.
5. If there is a severe shortage of one product relative to others, ERA could issue orders to refiners requiring them to maximize their yields of the product in short supply.

Petroleum Products

- o The standby product allocation regulations can be implemented selectively or on all products. In the case of products already under controls, they can be substituted for the present controls.
- o Special provisions can be implemented to prevent commercial, industrial or utility customers from receiving their allocations of oil if they can switch to gas, propane or other alternate fuel.
- o If consumption remains high but stocks are being drawn down dangerously, mandatory allocation fractions can be imposed to restrict the available supply and build stocks. This step would likely be taken in advance but in anticipation of serious shortages.

III. Savings in Consumption of Petroleum Products Resulting from this Measure (MB/D)

In general no savings are involved because these controls equitably allocate and price whatever the available supply is. However, the mandatory allocation fraction can cause a short term reduction in consumption to virtually any level desired, and this and other provisions can facilitate programs to switch users from oil to gas or other available fuels. An advantage of using mandatory allocation fractions as a short term demand restraint measure is that it assures that the desired reduction in consumption is achieved.

IV. Costs

- o Distortions caused by the present controls on motor gasoline, propane, butane, and natural

gasoline would be continued, together with the existing disincentives to invest in expanded refinery capacity.

- o Allocations inevitably result in some inequities because the allocations are based on historical usage rates which cannot accurately reflect current and future needs.

V. Benefits

- o Crude oil allocation controls would assure that all refiners have relatively equal access to crude oil and would help prevent competitive inequities at the refinery level.
- o Product allocation controls could be used to reduce demand in the short term, by imposing mandatory allocation fractions, and increase inventories for use later if the shortage becomes progressively worse.

Senator KENNEDY. Now, during the period from January to May, did we continue to put oil into this strategic reserve?

Mr. O'LEARY. We did. We had contracted crude. And in January and February and again in March, we reviewed whether or not we should continue to require the contracted crude to come into our tanks. There was a total of, as I recall it, 20 million barrels that were under contract as of January 1 that we determined that we would continue to ask the producers to honor those contracts and continue to accept the oil.

Senator KENNEDY. So you continued, even though you established the mechanism about the dangers of shortages, in January, February, and March? We put in 20 million barrels of oil in the strategic reserves?

Mr. O'LEARY. I would say probably January, February, March, and April, and perhaps a little bit of May.

Senator KENNEDY. We were still putting oil in the strategic reserves in May?

Mr. O'Leary. We were probably.

Senator KENNEDY. Even after the gaslines?

Mr. O'LEARY. We were putting the last remnant, a very small amount; perhaps 2 to 3 million barrels had not been produced, had not been delivered at that time. And I am pretty sure in at least early May we were still putting crude into the holes.

Now, at the same time, I inquired—

Senator KENNEDY. Maybe you could give us some idea, some reason, when you have people in gaslines all over the country, they were putting the oil and gas in there, given this particular kind of a crisis situation and the kind of crisis situation that we are faced with in agriculture and the kind of crisis situation we are facing even at the present time in terms of the independent truckers and the needs that they have for diesel oil and the kind of crisis that we see arising here about the dangers of home heating oil over the next several months.

Mr. O'LEARY. Yes, I would be very pleased to, because I think that we should share with you our considerations.

At that time, when the bulk of this went in, let's say, of January, February, and March as the period, I would say, 17 million out of the 20 million went in, the United States was still in business-as-usual mode. Gasoline consumption was about 4 percent above where it was 1 year ago. There was still wide-spread Saturday night driving, pleasure driving was rising constantly, people were in a recreation vehicle mood at that particular point in time.

We felt, to ourselves, there is a possibility that later in the year we may have a true emergency in the event there is a further disruption; we better put some of this stuff away. We are not disrupting anything now.

Further, if we cancel the contracts or use the contracts for purposes other than the strategic petroleum reserve—it is very important that you understand this—that would be regarded as modification of the contracts by some of the suppliers.

One country, for example, indicated that if we took off the destination, that if it was not going to petroleum reserves, they would assert

force majeure, and they would exercise their opportunity under force majeure to sell the oil on the world markets.

Under that circumstance, we said to ourselves, "The most prudent course is continue during this period when there is such supply to put this aside."

And at the same time, I insisted that the Department make an earlier date for withdrawal. We had originally scheduled the completion of our withdrawal capacity by the end of September. That is still the case, Senator Kennedy, but I insisted that we add a capacity for early withdrawal. And by May 15, we had a tested capacity for withdrawal.

Now, what that says to me is this: We now have 84 million barrels in stocks in the event that we really get into a terrible situation. I testified earlier to the petroleum global situation. We are in a bad situation today. But the situation is not of crisis proportions as of the moment.

If we were to lose a producing nation—and I mentioned reasons why we might: Not hostility at all, just facility breakdowns, a fire in a loading facility—we could get precipitated into a crisis situation, one with severe disruption, if we didn't have the strategic petroleum reserve and withdrawal capacity.

Consequently, the decision we made, which may seem—and I am sure your question was directed—an anomaly, of saying in the light of a world shortage, do you really build stocks. My answer to that is "Yes," rather than let it be diverted outside the United States or go into a further honeymoon of business as usual. It was the prudent course of action for the Government to keep those contracts. And I would do that again.

Senator KENNEDY. What part can you recover of the strategic reserve?

Mr. O'LEARY. We can recover essentially all of it. The mechanism is this: We have a hole that is filled with oil, 2,000 feet under saltwater in the salt dome. We simply put in saltwater which goes to the bottom and the oil, being of a greater density, floats out. So, the recovery is virtually 100 percent.

Senator KENNEDY. Over what period of time?

Mr. O'LEARY. We can withdraw beginning on October 1 at the rate of 1 million barrels a day. Today's withdrawal capacity is somewhere between 125,000 and 250,000. We can sustain that million-barrel-a-day withdrawal through at least the first 60 days.

That is to say, we can get 60 million barrels out of our 84 million barrels out in 60 days.

Senator KENNEDY. Is the decision to continue adding the oil to the strategic reserve a decision that was made by Mr. Schlesinger? Was it made in concert with the chairmen of the energy committees in the House and Senate?

Mr. O'LEARY. It was made by Mr. Schlesinger, and I don't know the consultations. It was made, in part, on my recommendations.

Senator KENNEDY. Well, do you know whether the energy committees of the House or Senate were involved?

Mr. O'LEARY. He may well have had private consultations with the leadership, of which I was not aware. I am simply not aware of that.

Senator KENNEDY. Was there any evaluation instead of storing of the 20 million, you may have stored 18, released 2 million more, to

spread that out, the 3 or 4 percent, and therefore avoided the gaslines and avoided the disruption and avoided the dramatic economic impact?

Mr. O'LEARY. It is simply not valid, Senator. If we had taken the whole 18 million out, it wouldn't have avoided this. We would have been that worse off if we had a real crisis.

Senator KENNEDY. You will supply that information, of course.

Mr. O'LEARY. I will be most pleased to.

Senator KENNEDY. Spread out over any period of time, the fact you were still adding to reserves in April and May.

Mr. O'LEARY. I would be glad to.

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

DIVERSION OF CRUDE OIL SHIPMENTS DESTINED FOR THE STRATEGIC PETROLEUM RESERVE

At the beginning of February 1979, approximately 15 MMB of crude oil were under contract for delivery to Strategic Petroleum Reserve (SPR) sites during March through July. The Department of Energy (DOE) could have exchanged this oil with domestic refiners, which would have permitted them to use the oil during the first half of this year in exchange for deliveries to SPR sites at a later time.

The DOE did not pursue this option because U.S. refiners would not have received the full benefit of the 15 MMB, if it were released for current consumption. If U.S. refiners had received the SPR oil, it is likely that remaining free world oil supplies would have been redistributed among all consuming nations, based on each country's share of total consumption. Based on that reallocation, U.S. refiners would have received no more than about 40 percent of the benefits, reflecting the U.S. share of free world oil consumption.

If this oil had been released for current consumption, the amount of oil under direct government control would have been reduced by about 15 percent. This would reduce the Government's flexibility in using the SPR to respond to potentially greater shortfalls later this year and in the future.

The price to the Government for replacement supplies for exchanged SPR crude would also have been higher because of the increase in oil prices which has taken place in the last several months.

Mr. O'LEARY. I said earlier, the difference it might have made is instead of having the sort of discomfort we have experienced, began to experience, in May, we would have been able to go until June. It might have made 1 month's difference in the discomfort season.

Remember, we are 1 million barrels a day down now. And if we had taken that million barrels a day, it would have bought us, at the outside, the whole 20 million. It would have bought us, at the outside, 20 days of business as usual. I really think it is improvident, given the sort of world we live in today, Senator Kennedy, to do that.

I will tell you that during February and March we were under pressure from refiners to give them crude. And when I inquired carefully into why they wanted the crude, they wanted our crude at the market price. They didn't want it at the spot market price.

Senator KENNEDY. You will supply the million-barrels-a-day shortage?

Mr. O'LEARY. Yes. In my testimony, I covered that in detail earlier, Senator. And I would be pleased to provide the basis for that for the record.

Senator KENNEDY. And can we get some backup documentation on that, too?

Mr. O'LEARY. We have got a lot.

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

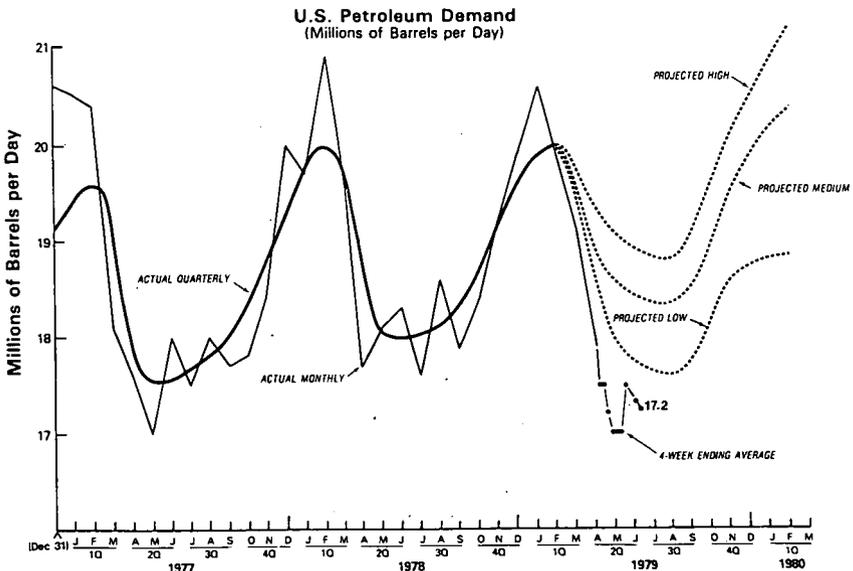
U.S. QUARTERLY PETROLEUM DEMAND—PROJECTED AND ACTUAL

(Millions of barrels per day)

	1978 actual				1979 actual, 1st quarter							
	1st quarter	2d quarter	3d quarter	4th quarter								
Motor gasoline.....	6.94	7.62	7.62	7.46	7.10							
Distillate fuel.....	4.45	2.99	2.65	3.63	4.36							
Residual fuel.....	3.67	2.76	2.81	2.82	3.50							
Other.....	5.01	4.67	4.98	4.92	5.05							
Total.....	20.06	18.04	18.06	18.82	20.01							
	1979 projected									1980 projected		
	2d quarter			3d quarter			4th quarter			1st quarter		
	L ¹	M ²	H ³	L ¹	M ²	H ³	L ¹	M ²	H ³	L ¹	M ²	H ³
Motor gasoline.....	7.69	7.95	8.12	7.64	7.89	8.06	7.18	7.42	7.58	6.90	7.42	7.68
Distillate fuel.....	2.93	2.99	3.01	2.61	2.68	2.71	3.61	3.74	3.81	4.08	4.28	4.34
Residual fuel.....	2.50	2.76	2.99	2.43	2.74	2.99	2.77	3.15	3.43	2.90	3.46	3.91
Other.....	4.86	4.92	4.92	4.94	5.04	5.06	5.04	5.19	5.23	4.99	5.19	5.25
Total.....	17.98	18.61	19.05	17.61	18.35	18.82	18.59	19.49	20.04	18.86	20.36	21.18

- ¹ Low.
² Medium.
³ High.

Source: EIA Office of Applied Analysis, "Current U.S. Petroleum Situation and Short-Term Supply/Demand Outlook," Analysis Report AR/AOA 179-30, June 1979.



- Source: • 1977: Energy Information Administration (EIA) Energy Data Reports, "Petroleum Statement, Annual"
• January 1978 through January 1979: EIA, "Petroleum Statement, Monthly"
• January 1979 through April 1979: EIA, "Monthly Petroleum Statistics Report"
• 4-week ending average data: EIA, "DOE Petroleum Demand Watch"
• Projections through fourth quarter 1979: EIA, Office of Applied Analysis

U.S. PETROLEUM DEMAND¹

[Millions of barrels]

	1977	1978	1979	1979 projection			1980 projection		
				High	Medium	Low	High	Medium	Low
January.....	20.5	19.7	20.6						
February.....	20.4	20.9	20.0						
March.....	18.1	19.6	19.1						
Average quarter.....	19.6	20.0	19.9				21.2	20.4	18.9
April.....	17.6	17.7	17.9						
May.....	17.0	18.1							
June.....	18.0	18.3							
Average 2d quarter.....	17.5	18.0		19.1	18.6	18.0			
July.....	17.5	17.6							
August.....	18.0	18.6							
September.....	17.7	17.9							
Average 3d quarter.....	17.8	18.1		18.8	18.4	17.6			
October.....	17.8	18.4							
November.....	18.4	19.2							
December.....	20.0	19.9							
Average 4th quarter.....	18.8	19.2		18.6	19.5	20.0			
4 week average ending:									
1977: July 1.....									18.0
1978: June 30.....									18.3
1979:									
May 4.....									17.5
May 11.....									17.5
May 18.....									17.2
May 25.....									17.0
June 1.....									17.0
June 8.....									17.0
June 15.....									17.5
June 22.....									17.3
June 29.....									17.2

¹ DOE defines domestic demand as disappearance from primary supply. Primary supply is defined as output from refineries and natural gas processing plants plus imports minus exports plus or minus changes in primary stocks.

Source: 1977: EIA, "Petroleum Statement, Annual". January 1978 through January 1979: EIA, "Petroleum Statement Monthly". February 1979 through April 1979: EIA, "Monthly Petroleum Statistics Report." 4-week ending average data: "DOE Petroleum Demand Watch". Projections through first quarter 1980 (updated June 22, 1979): EIA, Office of Applied Analysis.

Senator KENNEDY. The committee stands in recess.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 9:30 a.m., Thursday, June 28, 1979.]

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

RESPONSE OF JOHN F. O'LEARY TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE HAMILTON

Question 1. What are the main causes of the gasoline shortage?

Answer. The fundamental cause of the gasoline shortage is that imports of oil since January have not been adequate to meet demand.

Although petroleum imports for February through May averaged 3.3 percent higher than in those 4 months in 1978, imports should have been 13.9 percent higher than in 1978 just to provide total U.S. supplies at the 1978 level.

The primary reasons that a higher level of imports was needed this year is that imports were abnormally low in the first half of 1978 because industry was drawing down large crude and product inventories, which they had in early 1978, at a high rate. This reduced the need for imports in the first half of 1978.

Also, domestic crude oil production averaged about 215,000 B/D less this year. The comparisons are shown in the following table:

COMPARISON OF PETROLEUM SUPPLIES FOR FEBRUARY THROUGH MAY IN 1977, 1978, AND 1979

	1977	1978	1979 ¹	Percent 1979 versus 1977	Percent 1979 versus 1978
Crude oil: (thousands of barrels per day):					
Domestic production.....	8,112	8,673	8,457	104.3	97.5
Net crude oil imports.....	6,700	5,508	5,863	87.5	106.4
Crude stock use.....	-289	92	-217		
Crude oil losses.....	-16	-15	-15		
Total crude available.....	14,507	14,258	14,088	97.1	98.8
Total petroleum available:					
Crude.....	14,507	14,258	14,088		
Refinery gain.....	485	473	515		
Other hydrocarbons.....	52	52	54		
Natural gas liquids.....	1,640	1,575	1,557		
Product imports.....	2,418	2,130	2,026	83.8	95.1
Product exports.....	-189	-211	-235		
Product stocks use.....	-598	777	205		
Total available.....	18,315	19,054	18,210	99.4	95.6

¹ Preliminary data subject to revision.

The table highlights the large drawdown of product and crude stocks during this four-month period in 1978. Because product and crude stocks were generally very low at the end of January 1979, there was a small net stock buildup this year during these four months.

At the end of January 1979, total primary stocks were at 1168 million barrels, compared with 1256 million barrels at the end of January 1978.

The general shortage of petroleum shown above has been most noticeable in gasoline, starting in May. During February through April 1979, gasoline supplies continued to be consumed at about the same rate as in 1978 as refiners drew down gasoline inventories. In May, refinery output, gasoline imports and draw-down of inventories was not adequate to meet demand. Preliminary estimates indicate that gasoline use in May was about 90 percent of the level in May 1979.

The following table compares average gasoline supplies in February through May of 1979 with the same months in 1978 and 1977. This shows gasoline supplies about 3 percent below 1978 for the four months. The shortfall was about 20 MMB. If the shortfall had been spread evenly over the four months, the average daily shortfall would have been only about 220,000 B/D. But most of this shortage was compressed into May, so that the shortfall was about 750,000 B/D in May, based on this preliminary data.

The following table emphasizes that the shortage in gasoline supplies compared with 1978 was due primarily to the lower level of gasoline stocks available at the beginning of February 1979, which restricted the rate of stock drawdown this year. If oil imports had been available, however, gasoline supplies could have been adequate without use of stocks as occurred in 1977.

GASOLINE SUPPLIES, FEBRUARY-MAY

	1977	1978	1979 ¹	Percent 1979 versus 1977	Percent 1979 versus 1978
Gasoline supplies: (thousands of barrels per day):					
Domestic production.....	6,997	6,777	6,773	96.8	99.9
Refinery yield (percent).....	44.1	43.3	43.7		
Gasoline imports.....	229	177	153	66.8	86.4
Gasoline stock use.....	-75	323	133		
Total gasoline available.....	7,151	7,277	7,059	98.7	97.0
Stocks: (millions of barrels):					
Beginning.....	253	272	246	97.2	90.4
Ending.....	263	234	230	87.5	98.3
Change.....	+10	-38	-16		

¹ Preliminary data.

The gasoline supply situation in June remained similar to May. Oil imports were not adequate in late May and early June to permit gasoline production at 1978 levels and to start to rebuild distillate stocks.

Question 2. How long will the gasoline shortage last?

Answer. Gasoline supplies are likely to be about 5 percent below the 1978 level at least through the next 3 to 4 months. Whether a shortage will continue or not will depend on the extent to which Americans and other countries reduce demand for petroleum, and on the crude oil production levels of Iran, Saudi Arabia and other exporters. Worldwide demand is expected to be reduced as a result of higher oil prices and government programs to reduce consumption. This could bring supply and demand back into balance over the next few months.

Question 3. Does it appear that there could be a shortage of home heating oil this winter?

Answer. DOE has a target of achieving 240 MMB of distillate in primary stocks in October. This level of distillate stocks will assure adequate heating oil supplies this winter even if we have a winter similar to the 1976-77 winter, which was the coldest of the last 3 winters, and if crude oil input to refineries is limited to 14.2 to 14.4 MMB/D as it was during February-May of this year.

DOE has requested the largest refiners to set targets to build distillate stocks at rates to assure 240 MMB of stocks this fall. DOE will be monitoring closely the rate of distillate stock build-up and will be prepared to order a shift to greater distillate output if that is necessary. Refineries have significant capability to increase distillate production over current levels if this becomes necessary, and could substantially increase distillate output in September and October to build stocks to acceptable levels.

Because of the flexibility of refineries to increase distillate output, DOE believes that there will be adequate heating oil this winter even if the weather is colder than normal. This may require yield orders, and it could result in significant shortages of gasoline. Efforts by all Americans to conserve on heating oil use this winter will help reduce or avoid gasoline shortages this winter and next summer.

If oil imports remain at the levels of the past three weeks, it should be possible to build distillate stocks to safe levels without making the gasoline crunch worse later this summer.

Question 4. Are the allegedly depleted crude stocks of last winter being replenished?

Answer. The table below indicates that refiners have restored crude stocks to acceptable levels from the low level of 297 MMB at the end of February. Crude oil stocks reported as of June 29, 1979, were 331 MMB and are comparable to levels of 334 MMB and 333 MMB at the end of June in 1977 and 1978.

Crude oil stocks (MMB)

February :		
1977	-----	336
1978	-----	350
1979	-----	297
June :		
1977	-----	334
1978	-----	333
1979	-----	331

DOE believes that the crude oil stock levels represent prudent inventory management under normal conditions, but that it would be in the national interest to reduce the crude stocks by about 20 to 30 million barrels over the course of the summer. This could increase crude input to refineries by 200,000 to 300,000 barrels per day and provide a small increase in petroleum products to help ease the gasoline shortage and build heating oil stocks for next winter.

DOE has reviewed the stock situation of the major refiners and has found no evidence of large amounts of useable stocks that were not being used by refiners. There are some cases in which refiners have purchased more crude oil than they are able to use immediately; these refiners are running at full capacity now and expect to draw down their stocks over the course of the summer. Some refiners are running substantially below capacity and have drawn down crude oil stocks to the bare minimum.

Some refiners are running below capacity and have stocks above minimum levels but below their normal levels. DOE has urged those refiners to improve

their inventory management practices to pull down those stocks closer to the minimum levels.

If DOE identifies any situations in which refiners have stocks higher than normal and are not fully utilizing available refining capacity, DOE will be prepared to allocate the excess crude oil to refiners which are willing and able to process the oil.

Question 5. Why does the gasoline shortage "migrate" from one place to another?

Answer. Compared to base period purchases (i.e., from June or July 1978), all parts of the nation have been experiencing about the same degree of reduction in gasoline supplies. However, gasoline lines seem to have been a more serious problem in certain metropolitan areas than in the rest of the country. There are four possible reasons for this:

The growth adjustment provision of the gasoline allocation formula compensates for only a small part of the increased consumer demand in rapidly growing parts of the country. For example, California's 7 percent growth in demand for gasoline between the spring of 1978 and the spring of 1979 was well above the national average of 4 percent, a fact which contributed to its early spring gas lines. Metropolitan areas which are enjoying boom periods (e.g., Houston or Dallas) were experiencing longer lines than those which are not (e.g., most industrial cities in the Midwest).

As the public becomes more and more aware of a gasoline shortage, people are less likely to take weekend trips to the countryside or long vacation trips in the family car. This decreases the demand for gasoline in vacation spots (and rural areas generally) and increases it in areas where the most people live. This is an effect that we expect to be more serious during the summer than during other times of the year.

The current gasoline shortage has been accompanied by a significant increase in the price of gasoline. The differences between gas lines in various parts of the country may be explained, in part, by socioeconomic factors which cause some regions to be more sensitive than others to increases in gasoline prices.

Long gas lines seem to be a phenomenon which is abetted by heavy news reporting and rapid word-of-mouth communication. Once concern develops about an impending shortage, drivers begin tank-topping. The tank-topping results in the gasoline stations selling their daily allotment of gasoline earlier in the day and they begin to close earlier. The earlier station closings reinforce the motorists' concerns and they buy gasoline earlier in the day, thereby resulting in still earlier station closings, until all gasoline sales are compressed into a few early morning hours. The more impersonal characteristics of metropolitan areas may make them relatively more vulnerable to this pattern of behavior.

There appears to be relatively little correlation between the amount of the reduction of gasoline supplies from the 1978 base, and the occurrence of gasoline lines. Changes in consumption patterns account for much of this; rural areas and slower growth areas generally have been able to adjust to the lower gasoline supply levels with minimum difficulty. Among the major metropolitan areas which have been required to make the greatest reductions in gasoline consumption, there have been substantial differences in the severity and persistence of gasoline lines. These differences appear to be due as much to psychological factors as to actual variations in supply levels.

Question 6. How widespread is price gouging at the pump? By middlemen?

Answer. There have been substantial indications of price violations at the retail level. During the period from February 15, 1979 to July 6, 1979, the Office of Enforcement, Economic Regulatory Administration (ERA), conducted 4,289 targeted audits of retail outlets of which 1,770 or 41.3 percent were in violation. Amounts overcharged ranged from 1.13 cents to 48 cents per gallon.

There are also indications of violations by middlemen. Audits of suspected violators are currently underway, but no determination of the extent of violations are yet available.

Question 7. Is there any evidence that the oil companies have contrived or intentionally aggravated the gasoline shortage?

Answer. DOE has not yet found evidence that oil refiners have contrived or intentionally aggravated the gasoline shortage. Some refiners have been conservative in their use of their stocks, possibly because of uncertainties about

the availability of oil imports in the future, but the crude stock levels have been lower than normal. Refinery output might have been about 200,000 B/D (1.5 percent) higher during February through May if crude oil stocks had been kept at very minimum levels. DOE is continuing to monitor actions by refiners, and will be reviewing actions by distributors to determine whether any inappropriate actions have been taken.

Question 8. What basic steps is the Department of Energy taking to end the gasoline shortage?

Answer. The Administration is taking the following actions to help relieve the gasoline shortage:

It has requested refiners to take all reasonable actions to obtain and process crude oil to increase gasoline and distillate supplies, and is prepared to take regulatory action if it is found that any refiner is not making effective use of its crude oil.

It has requested all States and individuals to take steps to conserve gasoline to help respond to the current shortage.

It has directed all Federal agencies to reduce gasoline used by at least 10 percent.

It has delegated to the Governors of the states the authority to implement actions to prevent or reduce gasoline lines, including minimum purchase requirements, staggered station hours, and odd/even day sales.

It is attempting to adjust the gasoline allocation system to minimize the inevitable inequities and hardships that result.

It is assisting and encouraging major users to switch from the use of oil to natural gas in the short term and coal in the long term.

It has issued a rule to provide an incentive to import distillate fuel oil from Caribbean refineries, to reduce the need to shift refinery output from gasoline to distillate.

Question 9. What has DOE done to get information on the gasoline shortage to the public?

Answer. DOE efforts to get information on the gasoline shortage to the public have included meetings with groups and individuals, public information dissemination, and a public service conservation campaign.

The potential for gasoline shortages this summer, and heating oil shortages next winter, was recognized immediately following the cutoff of exports from Iran in late December. By early February a series of meetings with various constituent groups, those representing either large users of energy or able to communicate to a large number of users, were convened to outline the nature and scope of the problem. These meetings were used to urge the various groups to support additional conservation efforts. They continued throughout the spring and included such groups as the American Automobile Association, National Association of Manufacturers, Chamber of Commerce, consumer interest representatives, state legislators, mayors, governors, petroleum marketers and producers.

The public information effort through the news media has included frequent press conferences and interviews; the issuance of press releases, fact sheets and new features; and information for specialized publications such as the Office of Consumer Affairs' "Consumer Buying Alert" and American Telephone and Telegraph's internal publication. The type of information has ranged from broad overviews of the current situation to relatively narrow discussions on specific rule changes and regulatory actions involving individual gasoline stations. Since April, the Department has been issuing a Weekly Petroleum Status Report.

Regarding public service advertising, the Office of Public Affairs distributed the first wave of public service materials on energy saving tips in late April to newspapers, radio and television stations, magazines, corporations, trade associations, labor unions, public interest groups, colleges, school systems, the Congress, and state, local and city governments. Responses indicate that the materials are receiving widespread use, particularly in grassroots media, i.e. weekly newspapers, local radio and television, corporate publications, and special audience journals. In the six weeks ending June 15, approximately 400,000 of each of the two publications offered in the campaign materials had been distributed.

The second wave of print materials and radio and television public service announcements are now being distributed. The second wave effort includes seven print ads vs. three in the first wave, ten television spots vs. two, and

twenty radio spots vs. two. As the second wave goes into distribution, the telephone industry is beginning distribution of "Gas Saver" billstuffers to customers nationwide, transit cards are being distributed by the American Public Transit Association for back-of-the-bus and inside-the-bus use nationwide starting with Washington Metro, and the U.S. Postal Service is beginning distribution (which will take about two weeks) to every post office nationwide of a "Gas Saver" poster depicting a 15-cent stamp. These three collateral programs encourage readers to write for "Tips for Energy Savers" and "How To Save Gasoline . . . and Money."

Question 10. Is the DOE afraid to use all its powers against the oil companies where it might want to compel them to take a certain action?

Answer. The DOE is not afraid to use all of its powers to ensure supplies of petroleum, but we need to be realistic about the ability of DOE to control effectively refinery operations. At this time DOE has not identified any situation where we believe additional DOE orders could clearly improve upon the operational decisions of the refiners. As we identify any situations where DOE orders will improve the supply situation, DOE will not hesitate to use its authorities.

Question 11. What mistakes or misjudgments of the oil companies may have contributed to the gasoline shortage?

Answer. In hindsight, it would have been desirable if oil companies had maintained higher levels of oil stocks during 1978, to cushion the impact of the Iranian oil cutoff. But it is not appropriate to expect that the oil companies should have anticipated the Iranian revolution.

It appears that many oil companies initially may have underestimated the impact of the Iranian oil export cutoff on their ability to import oil. It appears that many companies did not realize the impact of the cutoff until about March, and continued business as usual during the first 2 to 3 months of the interruption, with high levels of gasoline supplies being made available. An earlier recognition of the problem might have resulted in spreading the shortage more evenly over the first 6 months of 1979, and reducing the amount of the gasoline shortage in May and June.

Question 12. What mistakes or misjudgments of the DOE may have contributed to the gasoline shortage?

Answer. The gasoline allocation regulations of the DOE may have contributed to shortages in certain areas of the country, as attempts were made to improve the allocation system to reflect more accurately the current demand for gasoline.

DOE made the following four changes in the gasoline allocation rules:

(1) After promulgating the final Standby Product Regulations on January 18, 1979, the Economic Regulatory Administration (ERA) issued Standby Activation Order No. 1 on February 28, 1979 (44 FR 11202), to update the base period from calendar year 1972 to the period July 1, 1977, to June 30, 1978. This order was issued to prevent substantial supply inequities, especially in high growth areas.

(2) Evidence presented in subsequent months suggested that the July 1977 to June 1978 base period did not reflect current demand as accurately as would a later period. Therefore, on May 4, 1979, ERA adopted an interim final rule which changes the base period to November 1, 1977, through October 31, 1978. This interim rule will be in effect until September 30, 1979. In determining whether to continue this base period, ERA will consider the comments received at the June 7 and June 19, 1979, public hearings.

(3) In the May 4 notice, ERA also added an automatic growth adjustment provision to enable rapidly growing retail outlets to get extra supplies, based on their gasoline purchases during the period from October 1978 through February 1979. If their average monthly purchases during that six-month period exceeds their purchase during the 1978 base period month by 10 percent or more, that average purchase may be used as their base period. For example, if a gasoline station purchases 100,000 gallons during June 1978, but averaged 110,000 gallons per month from October through February, its base period purchases for the purpose of determining its June 1979 allocation entitlement would be 110,000 gallons. If its distributor's allocation fraction is 80 percent, the station would receive 88,000 gallons rather than 80,000. However, had the station purchased 100,000 gallons during June 1978 and only 90,000 gallons during the October through February period, its

base period volume or allocation entitlement would be 100,000 gallons, and it would receive 80,000 gallons in June 1979.

(4) On May 25, 1979, DOE increased the state set-aside from 3 percent to 5 percent. This change was published in the *Federal Register* on June 1, 1979. This increased the amount which states hold in reserve to be distributed according to local needs, as determined by state governments. Because this increased set-aside came at the expense of supplies immediately available for retailers, it had the effect of reducing the initial allocation fractions by the same amount—2 percent.

The change in the allocation system to allow the use of October 1978–February 1979 as a base period was intended to more accurately reflect the real needs in high growth areas, and DOE believes that it serves this purpose. It also may have the undesirable impact of reflecting seasonal increases in gasoline use in some areas of the country last winter, which may now result in allocations higher than their needs in the summer months, and reduced allocations for other areas.

Allocation of gasoline among users under the price control and allocation system inevitably leads to distortions because the supply is based primarily on historical use rather than current demand.

Faster growing areas generally will suffer greater shortages. Urban areas generally will have greater shortages than rural areas, as motorists curtail their normal weekend or vacation trips from metropolitan areas to or through rural areas. The gasoline allocation system must be based on principles of equity, and must be workable during an emergency situation. Therefore any allocation system is unlikely to accurately reflect variations in needs among areas of the country. DOE will continue to work to make the allocation system as equitable as possible, as we learn from this experience.

Question 13. Is the DOE planning to improve the quality of its data on suppliers?

Answer. The DOE is constantly striving to improve the quality of its data in all areas. Significant effort is expended on validation activities as well as analytical comparison or "benchmarking" of data with other sources to assure comparability. These sources include the Internal Revenue Service, State tax data, customs data, State production data, data collected by independent firms, and data from distributors and jobbers supplied by the oil companies. In addition to these data checks, there are over 200 Economic Regulatory Administration (ERA) auditors assigned to the 34 largest refiners who audit their books.

Question 14. Will the President resubmit a proposal to ration gasoline?

Answer. The President has asked the Congress to join with him, on a priority basis, to insure that he has the authority to develop a standby rationing plan which will enable us to manage an emergency fairly. The House of Representatives is now considering a bill (a substitute to S. 1030) which would provide authority to the President to prepare a detailed rationing plan which would be subject to Congressional veto.

Question 15. Why did domestic oil production reach its lowest point last winter, just as a resolution was taking place in Iran?

Answer. Overall the United States has been experiencing a long term downward trend in domestic crude oil production. Since 1970, production in the lower-48 states has declined by nearly 2.5 million barrels a day. Thus, based upon recent history the annual decline in lower-48 has average 380,000 barrels per day. Further, there are three other factors which contributed to domestic production reaching its lowest point last winter:

(1) Tax treatment—producers frequently purchase and install new equipment before the end of the year to receive the investment benefits on their income tax. Accordingly, it is not uncommon for December and January output to be depressed;

(2) Weather—cold weather freezes valves, flow lines, batteries for generators, etc. It also forces termination of water flood and steam flood projects;

(3) Uncertainty—speculation on the President's crude oil pricing program, which was not announced until April 5, could have dampened investment. Further, for those producers with marginally economic production, some withholding (in anticipation of decontrol effective June 1, 1979) could have occurred.

These four factors are the major reasons for domestic production reaching this low-point.

Question 16. Is there any evidence that "priority consumers" of gasoline have been hoarding the extra gasoline supplies allocated to them?

Answer. The Energy Information Administration has no information available which would prove or disapprove the proposition that "priority consumers" of gasoline are hoarding supplies.

The DOE is currently reviewing the level of crude and product stocks held by refiners. The department has urged refineries to process as much of their crude oil as possible in order to increase supplies of gasoline and stocks of distillate. If DOE identifies any cases of hoarding of crude oil or products by refiners, it is prepared to issue orders to allocate that oil for use.

At the distributor, dealer and end-user levels DOE does not yet have adequate data on actual stock levels, but it is working to obtain useful information as soon as possible. Some information has been developed relating to heating oil inventories at fuel oil dealers and stocks of petroleum fuels at utilities as follows.:

(1) Stock of No. 2 heating oil were significantly lower at the end of the 1978-79 heating season than at the end of the 1977-78 heating season. Most heating oil stocks are owned or held by refiners or large retailers or resellers with heating oil sales of more than 10,000 gallons annually. Forty-eight refiners reported total inventories of 2,832 million gallons of No. 2 heating oil as of April 1, 1979. These inventories were 24 percent below the 3,744 million gallons these refiners reported for April 1, 1978. Eleven refiners reported higher inventories for 1979 but 37 companies reported lower inventories of No. 2 heating oil.

Seventy-three large nonrefining companies reported total inventories of 163 million gallons of No. 2 heating oil as of April 1, 1979. These inventories were 14 percent below the 188 million gallons these companies reported for April 1, 1978. Thirty-eight of these nonrefining companies reported higher inventories for April 1, 1979, but this gain was more than offset by reduced inventories for the remaining 35 companies.

Primary stocks of distillate measured 113.3 million (42 gallon) barrels as of March 31, 1979. These stocks increased to 135 million barrels as of June 22, 1979, but still were at a level 13 percent below those of a year earlier. Continued increases in the levels of distillate stocks at such weekly rates as necessary to assure safe levels for the winter and to meet the President's stated goal of 230-240 million barrels.

(2) Based on currently available information, petroleum stocks at utilities do not appear to be either higher or lower than expected at this time of year. Stock levels are comparable to those of prior years except in the Pacific Region where stocks are lower though there has been a shift to greater dependence on natural gas. Additionally, in 1977 there was a shortage of hydroelectric power generation which led to higher than normal oil-fired electrical generation and stocks of oil.

On April 30, 1979, as reported on FPC Form 4, electric utility oilstocks totalled 116.2 million barrels, a 13 percent decrease compared to utility oil stocks of a year earlier. While electric utility oil stocks in the United States decreased by 13 percent, electric utility oil stocks in 28 states increased. On April 30, 1979, stocks in these 28 states represented 28.8 percent of the total electric utility oil stocks or 33.5 million barrels, an increase of 6.2 million barrels. Of this, 9 states¹ accounted for 4.8 million barrels.

The greatest increase in oil stocks from last April was reported in Massachusetts, totalling 1.4 million barrels. Over half this increase reported by the New England Gas and Electric Company resulted from a change in ownership of existing storage facilities. The second greatest increase in oil stocks was reported in Louisiana, totalling 1.2 million barrels. This increase resulted from an apparent conservation of oil for the past several months by a higher than normal consumption of natural gas. The increased consumption of natural gas. The increased consumption of natural gas for the generation of electricity for the first four months of 1979 compared to 1978 is equivalent to a consumption of over 2.5 million barrels of oil.

¹ Connecticut, Delaware, Massachusetts, New Hampshire, Arkansas, Louisiana, Tennessee, Kansas, Hawaii.

The increase in some states in electric utility oil stocks from last April is the apparent conservation of oil by the increase utilization of alternate fuels along with normal monthly fluctuations in stock levels.

(3) The proposed Form EIA-403, "Usable Fuel Inventories," which will be used to collect data on usable fuel stocks and storage capabilities and the justification for this form have been submitted for OMB clearance. The form will provide the Energy Information Administration with the data necessary to monitor secondary fuel inventories at the utility level.

Industries with a total installed generating capacity of 10 megawatts or greater will also be required to file Form EIA-403.

The proposed initial submission of the form is scheduled for the month of August 1979, which will collect data as of the last day of July 1979. The initial submission will include historic data as of the last day of the months of July 1978 and January 1979. The respondents will be required to submit this data at future periodic dates as determined by DOE to effectively monitor changes in stocks.

The most widespread instance of what might be termed hoarding may be gasoline tank topping by motorists. While no one motorist can "hoard" much gasoline in this manner, the aggregate effect can severely strain the distribution system. Therefore, the Department has urged the elimination of maximum gasoline purchase requirements and suggested that minimum gasoline purchases requirements be imposed. In order to facilitate this, the President, through Executive Order 12140 (44 F.R. 31159, May 31, 1979), delegated to Governors the authority to impose minimum purchase requirements in cases where a Governor does not otherwise have authority.

Additionally, on May 16, the President announced that he was directing DOE and Justice to undertake a study of the oil industry to ensure that supplies of gasoline are not being withheld or manipulated. That study is nearing completion and has focused on refiners. Data has been compiled and is being analyzed. Efforts also have been begun to obtain data on actions by firms in the distribution system between the refiners and the users. It will take several weeks to obtain useful data on these firms because such data has not been collected in the past.

Question 17. Will the U.S. boost its oil imports from Mexico in the near future?

Answer. In 1978, Mexico produced about 1.3 million barrels of oil per day, with total exports of 0.35 mmbd.

The U.S. purchased about 80-90 percent of Mexico's total oil exports for 1978 and is expected to purchase about the same percentage for 1979. However, in the future, two factors are likely to constrain any immediate or large increases in the amount of Mexican oil available for the U.S. market.

First, Mexican plans call for output to reach 2.25 mmb/d in 1980, with exports of about 1 mmb/d. There are no immediate plans for further increases in the 1980's. Although some increases are likely, it should be noted that the decision to increase production much above the projected level of 2.25 million b/d will be made by the new Mexican President when he assumes office in 1982.

Moreover, Mexico has declared a policy of diversifying its oil export markets. This is likely to mean that the future U.S. share of Mexican exports is likely to drop somewhere between 70 and 50 percent. Clearly, even if Mexican hydrocarbon production increases significantly in the short term, the total amount of oil available to the United States is not likely to increase dramatically above current levels.

Question 18. Why is there a shortage of gasoline in spite of a high level of oil imports?

Answer. As described in detail in the answer to Question 1, petroleum to meet demand, even though they averaged 3.3 percent higher than imports during those four months in 1978. Even higher import levels were needed this year because it was not possible to draw down industry stocks this year at the high rate of 1978.

Industry stocks were very high at the end of January 1978 and could support the high drawdown rates that took place during February through May 1978. The high rate of stock drawdown in those four months in 1978 reduced the need for imports in the first half of 1978.

Question 19. What is the DOE doing to promote the development of experimental automobiles with extremely high fuel efficiency?

Answer. DOE efforts to promote the development of high efficiency experimental automobiles has focused on gas turbine and Stirling engines. This work involves both component and full system development. Demonstration of this technology has taken the form of full vehicle systems for testing purposes. This program is supported by additional basic combustion research. DOE's expenditures for this work are about \$10 million per year with auto manufacturers, universities and private research firms sharing in the work. Cost sharing type arrangements are also employed with various auto manufacturers.

In addition DOE is developing advanced diesel engines and improved subsystem components such as the bottoming organic Rankine cycle heat recovery unit for diesel truck engine. Both the advanced diesel engines and the heat recovery unit are now being demonstrated in actual vehicle operation.

Question 20. What are the limitations on the production of synthetic fuels?

Answer. Considered broadly, synthetic fuels are solid, liquid, and gaseous fuels derived from sources other than petroleum and natural gas—e.g., from coal, shale, forest and agricultural products, tar sands, and organic wastes. Limitations on their production arise, for the most part, from the factors that also limit the production of conventional fuels. These include:

Environmental and land-use regulation, which limit the sites on which energy production facilities of any kind can be located and restrict the design, scale, and operation of such facilities.

Siting permit and approval processes, which often involve lengthy and cumbersome procedures that add months and even years to the period between the time a project is formally proposed and the time it can be constructed and begin operation.

Capital formation by entrepreneurs which entails either having enough liquid assets to undertake significant projects or being able to borrow large sums of money in financial markets. Some synthetic fuel projects—such as plants to produce alcohol from agricultural products—are relatively small (\$20 to \$70 million), but the firms interested in such projects are often also small and thus may need assistance in raising the necessary initial capital. Other synthetic fuel projects are quite large—requiring over \$1 billion in investment—and thus pose a capital formation challenge even for quite large firms.

These factors appear likely to be the principal limits to early production of synthetic fuels.

Question 21. Why do estimates of the cost of synthetic fuels keep rising, apparently in tandem with increases in the costs of oil?

Answer. Several sets of factors have contributed to the rising estimates for costs of synthetic fuels. These include:

Inflation in construction costs, which have out-paced general prices. During the period 1972–1977, for example, construction costs increased roughly 60 percent while the consumer price index increased 40 percent. Heavy construction, which dominates the cost of most energy facilities, increased even faster.

Changes in regulatory standards, particularly environmental standards, have greatly increased the costs of process plants, including the estimated costs of synthetic fuels plants. Uncertainty about the effects of new laws for which regulations are still being developed has also increased estimates dramatically, to cover possible requirements that could be quite expensive to meet.

Technological uncertainties in early estimates, based on inadequate data, the resolution of which has increased estimated costs. Optimism in preliminary estimates occurs in all endeavors, including those as routine as building construction. As development proceeds, and as information improves, estimates become much better and much closer to the costs realized when construction is complete.

THE 1979 MIDYEAR REVIEW OF THE ECONOMY

THURSDAY, JUNE 28, 1979

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

The committee met, pursuant to recess, at 9:40 a.m., in room 2168, Rayburn House Office Building, Hon. George McGovern (member of the committee) presiding.

Present: Senators McGovern and Javits; and Representatives Reuss and Wylie.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC (Special Study on Economic Change); Lloyd C. Atkinson and L. Douglas Lee, professional staff members; and Mark Borchelt, administrative assistant.

OPENING STATEMENT OF SENATOR MCGOVERN, PRESIDING

Senator MCGOVERN. Congressman Reuss and I have called this hearing to enlarge the public debate regarding inflation. I believe that a reassessment of current anti-inflation efforts is essential, as is the use of alternative modes of analysis.

Since the fall of 1976, when the inflation rate was growing at 4.5 percent annually, we have gone to 6.8 percent in 1977 and 9.2 percent in 1978. Projections for this year put us around 14 percent. In each case, the increase has destroyed our budget estimates and all the programmatic plans based on those estimates. The increased unemployment that has accompanied this trend has also make a mockery of the conventional economic wisdom that would trade off the two.

I believe that if this trend is allowed to continue much longer, an absolutely destructive long-term no-growth, high-unemployment bias will be ingrained in our economy. Interest rates will grow, people will be pushed into higher income brackets, and real income will be reduced. Capital investments will be postponed as the rate of return on new investment diminishes. We will have a recession. Our competitive posture in foreign markets will further erode, our currency will weaken, and our import imbalance will deepen.

In yesterday's Wall Street Journal, Walter Heller said, "The U.S. recession is under way." The day before, Barry Bosworth told this committee we "can't look forward to any moderation of inflation in the months ahead." Mr. Bosworth, whose candor and perception will be sorely missed, was, uncharacteristically, guilty of an understatement. The independent truckers have struck; retail food prices have failed to respond to lower wholesale prices; and, incredibly, OPEC is

about to raise its prices by 40 percent. How could the situation do anything but deteriorate?

I had a call yesterday morning. Robert Osborne in Dakota; he operates a string of men's clothing stores, some 15 of them in half a dozen different States. He said,

As far as I'm concerned, the recession is already here. Business is down in all 15 stores, every part of the country, from Wisconsin, Nebraska, South Dakota all the way to Colorado and California. I don't need to read theories.

He has been operating men's clothing stores for 35 years. When all 15 have a sharp drop in profits the first 6 months of the year, I know we are in a recession.

Today's problems demand the same kind of Government commitment on behalf of the public that was made in the Depression, to put people to work. Energy and inflation problems aren't going to be solved unless the government acts boldly and provides a necessary leadership role. The private sector is not automatically going to make the necessary policy shifts—people's private interests don't add up to the innovation, investment, and leadership that we need.

My approach would have three components. One, I'd put selected wage and price controls in place, as an option designed to slow things down and buy us time. Two, I'd create a National Board for Energy Development, bringing the best minds to Washington to help us develop energy alternatives. And, three, I'd totally redesign those parts of Federal law which impact on productivity. Unless we put on the brakes, produce more of our own energy, and build up our productivity, our other anti-inflation efforts are unimportant.

What I am looking for in today's hearing are both an analysis of the current situation from other perspectives, concentrating on the basic necessities analysis, and a list of specific policy recommendations that have a realistic potential for enactment.

I know the COIN approach is beginning to receive a wider audience, and I look forward to today's hearing. Congress can only benefit from a broader discussion of this topic.

Congressman Reuss is one of those in the Congress I always look to for innovative and well-informed thinking on economic matters, both at home and on the international front. My friends who are professional economists tell me he is one of the few people in Congress who really understand the economic problems that face the country. It's a pleasure to chair this hearing with him present.

I don't know whether you have an opening statement to make or not.

Representative Reuss. I don't, except to indicate my total agreement with your statement, particularly the last portion, and to thank the panel for being here.

I think their early discernment that you can have a superb fiscal policy fashioned by Albert Einstein and a marvelous monetary policy crafted by Albert Schweitzer, and you still don't really lay a glove on inflation, has been demonstrated in recent years. Accordingly, you early have suspected something else may be the cause of our miseries, and your research in specific sectors like food and energy and housing and health have rightly excited the interest of people like Senator McGovern and myself. We are delighted you're here.

I think your format, whereby you talk a bit about each of the sectors and then try to put it all together, will be useful.

Senator McGOVERN. Thank you.

Mr. Alperovitz, could we start with you?

Mr. ALPEROVITZ. We appreciate very much the opportunity you have offered us today.

In the interest of a coherent and brief approach, we would like to organize our discussion by beginning with Mr. Oswald.

**STATEMENT OF RUDOLPH OSWALD, DIRECTOR OF RESEARCH,
AFL-CIO, WASHINGTON, D.C.**

Mr. OSWALD. Senator McGOVERN, I appreciate this opportunity to present the views of the AFL-CIO and participate in this discussion of the inflation situation.

I ask my prepared statement be made part of the record. I will refer to parts of that prepared statement as a means of trying to put in perspective some of the changes that have been taking place, both in terms of prices, productivity, and effects of the current controls program, and others will address the specific solutions. I would like also to have an overall comment about that later.

If I may call your attention to the background statement entitled "Inflation: Sources and Causes" we have prepared, on page 7 of that background statement, it clearly shows the impact of the change of the price of necessities during the last 6-year period and its impact on the current rate of inflation. The Senator spoke earlier about the increase in the rate of inflation from approximately 4.8 percent in 1976 to the current rate of nearly 13, 14 percent.

The increases have been specifically in the rate of inflation in the necessities, where in the 6 months ended in April, the annual rate of inflation for food was running at a 14.8 percent annual rate; shelter, 13 percent; energy, 23.1 percent; medical care, 9 percent; for a total average annual rate of increase for these necessities of 14.7 percent during that 6-month period.

For the nonnecessities, the increase has been only 7.7 percent, not substantially faster than the rates of 1978 or 1976, but again somewhat faster than the 4.6-percent rate in 1977 or the 3.4 percent for the nonnecessities in 1973. The necessities—food, shelter, energy, and medical care—account for 60 percent of the Consumer Price Index and are clearly the leading factors that push that up.

Let me talk a bit about the impact of the current administration's wage and price guidelines on that inflation rate and what happened in the 6 months since that program has been put into effect. I call your attention particularly to page 57, and those that follow, in the background statement.

That clearly shows that the rate of inflation for the 6 months ending in October 1978 was running at an annual rate of 9.4 percent in the Consumer Price Index, and for the 6 months ending April of this year, that accelerated to 11.9 percent, nearly a third faster.

I would just like to say, parenthetically, that the attacks that have appeared recently in the paper in terms of the CPI being an inappropriate measuring rod for changes in price are clearly misdirected

because of the enormous review that has taken place in terms of the Consumer Price Index. As you well know, the Bureau of Labor Statistics has just put into effect within the last 2 years a complete reweighting, based on extensive review of consumer expenditures and review of all the methodology involved in terms of pricing of goods and services. It is the best overall tool we have today in terms of measuring changes in price.

In terms of other measures of the effect of the wage and price program, the producer price indexes or the so-called wholesale price index has accelerated from an inflation rate of 8.4 percent in the 6 months prior to the President's wage and price guidelines to an annual rate for the 6 months ended in April of 12.2 percent, nearly a 50-percent rate of increase.

On the profit side, the Senator did indicate there were some problems of the recession that may well cut back profits of corporations in the future, but during the 6 months following the enactment of the President's wage and price guidelines, overall profits have accelerated substantially. In the 6-month period prior to the President's announcement, the rate of profit increase for the economy was growing at a 14- to 17-percent rate. In the 6 months following the President's new program, the after-tax profits of all corporations rose by 25 percent in the fourth quarter of 1978 over the similar quarter in 1977. In the first quarter of this year, after-tax profits were up 35 percent from the similar period in 1978, on a year-to-year basis.

On the other hand, the guidelines have been quite effective in terms of holding down the wages of workers. In the 6 months prior to the President's program, average hourly earnings were increasing at an annual rate of 7.5 percent, and in the 6 months ending in April of this year, they were increasing at a 7.7-percent rate. Average weekly earnings actually were going up at a slower rate, causing a decline in average weekly earnings. Similarly, negotiated wage increases weren't accelerating from similar periods in 1978, but actually showing declines.

The real impact of the very rapid inflation was that there have been substantial decreases in real earnings. In the 6 months prior to the President's new program, real after-tax earnings of the average worker in our economy, nonsupervisory production worker—not counting the increases of corporate executives who had increases in 1978 of 16.7 percent, according to figures reported by Business Week—but for the average worker, real after-tax earnings were decreasing at a 3.6-percent rate prior to the new program and are now decreasing at a 5.5-percent rate.

In that respect, I would like to make reference to the 7-percent guideline that was established for wages under the wage-price program. As you know, controls existed in World War II. Under that control program and under the Korean war control program, wages were allowed to keep up with changes in the cost of living.

During the Kennedy era, the Council of Economic Advisers established a so-called wage guideline of 3.2 percent, based on productivity gains. That was established at a time when the cost of living was increasing at a 0.7-percent annual rate, so there were real increases of 2.5 percent under those guideline programs.

Even under the recent Nixon guidelines, you all remember the famous 5.5 percent. That 5.5 percent was put into effect at a time when the inflation rate was 4 percent, so that workers again not only were able to keep up with the changes in the cost of living but received real increases over and above.

This is the first time that Government has tried to decree, not by legislative action but purely by an administrative decision, that workers are to take a real decrease in earnings, a real decrease of more than 50 percent in terms of what is currently happening in terms of the rate of inflation. Now, I would like to relate to some of the discussions spoken about earlier in terms of low productivity. I think some of the discussion of low productivity is often a problem of an emphasis and the statistics that are reported, and I would like to call to the committee's attention a chapter in our background statement dealing with productivity, starting on page 39. I call attention particularly to the table on page 41, which compares the rate of productivity changes for the total private business sector and the manufacturing sector for the period of the 1970's.

As that table clearly demonstrates, the productivity lag is not in manufacturing, but is in the nonmanufacturing sectors. For the last 12 months ending in the first quarter of this year, manufacturing productivity increased at an annual rate of 4.2 percent, first quarter 1978 to first quarter 1979. For the private business sector, the increase in productivity was 0.4 percent.

For all of the 1970's, the increase in manufacturing productivity was substantial, except for the very severe drop in 1974 related to the substantial drop in productivity as a result of the great recession that took place.

If I may also call your attention to the data on page 43, it clearly indicates that the rate of increase in productivity in the manufacturing sector of 2.4 percent in the 1970's is as good as it was in the 1950's and would have been as good as it was in the 1960's, almost, if it hadn't been for that 5-percent drop in productivity that, I indicated earlier, resulted from the severe recession. So, in manufacturing, productivity has been fairly well up to the sorts of experiences of the last few decades.

The very low productivity growth and negative productivity figures are reported for construction, where there are severe questions about the validity of the numbers. The Bureau of Labor Statistics does not normally publish those figures because they don't feel they are sufficiently accurate. There is real question of how accurately BLS measures output in retail trade and services, growing sectors of the economy, both areas where it's very difficult to measure output.

Also, Senator McGovern, I call your attention to the relationship in terms of changes in unit labor costs in the United States versus other countries that are shown in terms of figures by the Bureau of Labor Statistics from 1967 to 1977. It shows unit labor costs in manufacturing have increased less rapidly in the United States than in most of our competitive countries. According to other data by the Dresdner Bank of Germany, the relative unit labor cost in the United States against most of our trading partners is substantially lower.

I think when we address the question of productivity and real wage change, we need to look at the details rather than just be looking at the

gross overall figures, which may mislead us in terms of what is happening in productivity. We think that these are not the answers and the explanations for what is happening in the increase in the prices of necessities, in food and energy and housing and medical care.

Others on the panel will address what is happening there, and solutions to part of that problem.

Thank you, Senator.

Senator McGOVERN. Thank you, Mr. Oswald.

[The prepared statement of Mr. Oswald, together with the background statement entitled "Inflation: Sources and Causes," follows:]

PREPARED STATEMENT OF RUDOLPH OSWALD

Mr. Chairman, my name is Rudy Oswald. I am Director of Research for the AFL-CIO. We appreciate this opportunity to present the views of the AFL-CIO on the problems of inflation. Workers and their families are among the chief victims of inflation. We want this nation to have an effective and fair anti-inflation program.

To fight inflation successfully, it is important to understand the most important causes of inflation. A wrong analysis of inflation leads to misguided and ineffective anti-inflation programs. And an unfair, inequitable anti-inflation program destroys the necessary social consensus that makes an effective anti-inflation program possible.

Food, energy, medical care, housing, and interest rates have been key factors in the rapid inflation of the 1970s. These are areas where labor costs have little or no impact on prices. Wage-push does not explain current inflation.

Wages for the average worker are being eroded by inflation and by the current misguided Administration's anti-inflation program. As of April 1979 real weekly earnings after taxes were down 4.5 percent from a year ago and the annual rate of decline in the six months since last October is at a 5.5 percent rate of real wage loss.

Prices have been rising more rapidly during the past six months than they had prior to the imposition of the guidelines. For the six months ended April, they were rising at an annual rate of 11.9 percent, as against the 9.4 percent increase rate in the six months ended October. Wholesale prices rose even faster, increasing at a 12.2 percent annual rate through April, up from an 8.4 percent rate during the previous six months.

Also business profits have risen at annual rates of 25 to 35 percent during the last six months.

Meanwhile, unemployment is at historically high levels for a non-recession period and the nation faces the threat of a recession and substantially higher unemployment. Low production and unemployment also contribute to inflation. Unemployment means lost production and lost income. Low production means higher overhead costs and lower levels of investment in new, more efficient and productive plant, machinery, and equipment. Full employment and faster economic growth, therefore, are essential parts of an effective anti-inflation program.

The attached background statement analyzes the specific inflationary elements in the Consumer and Wholesale Price Indexes. Particularly troublesome have been the increases in food, shelter, energy, and medical care—sixty percent of the average family's expenditures.

In the six months from October 1978 to April 1979, the Consumer Price Index rose at an annual rate of 11.9 percent. In terms of major categories of increase, the leading components were food, up at an annual rate of 14.8 percent, shelter, up 13.0 percent, energy up 23.1 percent and medical care up 9.0 percent. These necessities rose at a 14.7 percent annual rate. All other items in the index rose at a 7.7 percent rate.

Food prices have swung widely during the past decade with big increases in some years and small increases in other years. In 1973, large and sudden grain sales to Russia drove up the price of wheat and grains and led to sharp increases in the cost of feeding livestock and in the price of meat. Bad weather cut food supplies which also drove up food prices. In 1978 and 1979, exports, weather, and special factors again accelerated the rate of food inflation.

Energy prices rose sharply following the 1973 oil embargo and again in 1979 as a result of the major OPEC increases. But even sharper price increases have been allowed the domestic natural gas industry under new governmental energy policies. Coal prices have also risen steeply. Prices for energy are a major part of the inflation picture.

The high cost of medical care reflects new medical technology, over-extension of medical facilities, excessive increases in physicians' fees, and exorbitant drug charges, as well as organizational and administrative problems that could be alleviated by a national health insurance program.

High mortgage interest rates and other high interest rates push costs for consumers and business throughout the economy. In April 1979 mortgage interest rates on new homes were over 10 percent and the prime rate charges by big banks to their big corporate borrowers was 11¼ percent.

CONTROLS AND INFLATION

In October 1978, with inflation rising rapidly, President Carter launched a so-called "voluntary" anti-inflation program. This new program called for an inflexible 7 percent wage control and a flexible, non-specific price guideline. There was no proposal for controls, of any kind of profits, interest rates, or dividends. The program proposed unspecified reductions in federal spending and a regulatory council to put unspecified limits on government regulatory actions. It proposed cuts in the federal work force and continued discriminatory wage controls on federal employees.

The wage-price standards were clearly the key part of the anti-inflation program. It was also clear that the government would find it much easier to monitor wage control compliance than to monitor price guidelines compliance. And it was clear that employers would be a key part of wage control enforcement.

On October 31, 1978, the AFL-CIO denounced the Carter Administration's anti-inflation program as inequitable and unfair and called for mandatory, legislated economic controls. The Council declared:

"We do not like controls. We do not welcome government operation of the market place. But recession is worse; run-away inflation is worse; the discriminatory application of wage controls is worse; the distorting of laws for purposes other than those intended is worse; public scapegoating without due process is worse.

"Therefore, we urge the President to draft a legislative program of full economic controls, covering every source of income—profits, dividends, rents, interest rates, executive compensation, professional fees, as well as wages and prices.

"Such a program should be detailed—not a standby grant of unspecific authority to the President. It must be a program that treats all Americans equally, provides prompt and proper mechanism for the adjustment of inequities, controls prices for everything and lasts only for the duration of the emergency. Such a full, legislated economic control program has now become the only responsible method for halting this inflation.

"Since we believe the Administration is already headed in the direction of overall controls in piecemeal and ill-designed stages, America might as well do it right and do it now. That means legislative action must be prompt, the mechanism fair and effective, and the sacrifice equal.

"If those criteria are met in a legislated controls program, such a program would have our support."

Since the time of that statement in October, the AFL-CIO has maintained its position that the anti-inflation program is a one-sided wage control program and has renewed its call for a legislated mandatory, across-the-board program of full economic controls.

In March 1979, the AFL-CIO and nine affiliated unions filed a lawsuit in the U.S. District Court for the District of Columbia to block the Administration from enforcing its supposedly voluntary wage guidelines by denying federal contracts to business firms that gave pay raises above the guidelines. It was clear that the entire controls program had no basis in law, and, in fact, the so-called voluntary controls program constituted mandatory wage controls by indirection and subterfuge in the face of explicit congressional action denying this authority to the President.

On May 31, Federal Judge Barrington Parker ruled that the President exceeded his authority by seeking to control incomes and thereby prices through the procurement power. The so-called voluntary program established a mandatory system of wage and price controls, unsupported by law, and was unconstitutional, Judge Parker declared. On June 22nd, the Circuit Court of Appeals reversed Judge Parker on a six to three vote. The AFL-CIO will appeal that ruling to the Supreme Court.

MANDATORY ANTI-INFLATION CONTROL PROGRAM NEEDED

The AFL-CIO believes a comprehensive, mandatory, controls program is essential to achieve effective anti-inflation action with equity and fairness and equal sacrifice by all members of American society. A comprehensive program of economic controls must cover all prices and all forms of income—profits, dividends, rents, interest rates, executive compensation, professional fees, and other sources of income, as well as wages and prices.

A full and fair mandatory anti-inflation controls program should be detailed by the Congress. It should not be a standby grant of broad, unspecific authority to the President. It must be a program that treats all Americans equally. It must provide a prompt and proper mechanism for adjustment of inequities. It must control prices for everything. And it must last only for the duration of the inflation emergency. Such a full, legislated economic controls program is now the only responsible method for halting the current inflation.

A comprehensive mandatory control program is necessary to break the back of the inflation spiral facing the nation. Such a controls program could deal with both the immediate economic pressures and break the existing inflationary psychology. The majority of businessmen already expect controls, according to a Gallup-Chamber of Commerce survey. The survey, released by the Chamber in December, showed that more than three-fourths of a cross-section of 1,000 business executives anticipated a form of mandatory controls by 1980. According to a number of polls, the majority of Americans also favor controls.

The mandatory economic control program should be comprehensive, covering all sources of income and all prices. The authority in the legislation should be explicit in terms of requiring such controls, and Congress must accept the fact that controls will require a sizeable administrative body. Without such a commitment, there will not be an effective anti-inflation program.

The program should provide for controls to be administered on an industry basis and there should be special attention given to particular industry problems, with special attention to those industries where bottlenecks and inflation pressures are most severe, such as food, energy, housing, medical care, and financial markets where interest rates are determined. Furthermore, the program should provide a mechanism for future decontrol action on specific parts of the economy on an industry-by-industry basis.

Price controls and price determination should provide for participation by consumers as well as producers and government representatives. Similarly, wage controls and wage determination must involve workers' representatives as well as employers and government representatives.

It is essential that the overall economic policy encourage and stimulate economic expansion so that controls can be an effective means of holding down price increases during economic growth, rather than simply trying to hold down prices and possibly contributing to shortages.

The mandatory controls program must also include a formal process for appropriate review of decisions and it must include guarantees of due process so that all affected groups are assured a mechanism for prompt and proper adjustment of inequities.

ACTION ON THE NECESSITIES

In addition to the broad, comprehensive, mandatory anti-inflation controls program, the AFL-CIO is calling for specific, targeted policies and programs to focus on that major portion of inflation that has been concentrated in food, fuel, health, housing, and interest rates. It is in these areas of concern where determined anti-inflation action can supplement an overall controls program in addressing the specific inflationary pressures.

FOOD

One of the central elements in the federal farm program should be the goal of mitigating food price increases. The nation's agricultural policy must encourage maximum production to redress the lack of balance between domestic food supplies and the demand for American farm products at home and abroad.

Adequate stockpile reserves of agricultural goods should be established to assure a measure of protection against erratic price and supply fluctuations.

Effective export controls on agricultural products and other raw materials in short supply should be established and maintained during times of inflationary shortages and upward pressures on prices.

The Secretary of Agriculture should be directed to curtail or postpone the export of any food products, when the domestic price for that food product rises by 10 percent or more.

A National Grain Board is needed to protect the interests of the United States in foreign markets for American agricultural products and to provide price and supply stability in domestic U.S. markets. We believe a mechanism like the National Grain Board should be established to handle foreign sales of U.S. grain to protect the interests of consumers and family farmers and the nation as a whole.

Legislation of this kind is needed because exports of U.S. agricultural commodities are now conducted almost exclusively by five big profiteering international grain trading companies which act in their own self-interest, usually to the disadvantage of family farmers and often against the national interest in terms of food price inflation and national security.

In grain dealing with Communist and other centralized economies, bargaining on a government-to-government basis must protect the American economy and the American people against a repetition of the 1972 Russian grain deal in which the private grain trading corporations put their own profits ahead of the welfare of the American people—and set off a round of food price inflation which still is contributing to inflation in the United States of America.

Effective government regulation of commodity speculators also would help protect American consumers against profiteering and excessive food price increases. The role of commodity speculators, who add to food price inflation through paper profits, must be regulated to restrain food price manipulation.

The growth of corporate agribusiness farming, which is driving many farm families out of agriculture, raises questions about food monopolies, concentration of corporate power dominating the nation's vital food supply, and inflation in food prices. Furthermore, U.S. farm land is being purchased at alarming rates by foreign corporations and individuals, especially from major oil-exporting states. This is raising the cost of farm land and thus the price of food. Control of productive farm land in the United States of America by foreign interests could add to food price inflation and seriously injure the nation's economic health. These problems deserve careful attention and action by Congress in the fight against inflation.

ENERGY

In the short-run, rationing and allocation of gasoline and other fuels are necessary.

To attack inflation in the field of energy for the long-run, the AFL-CIO is calling for a broad, comprehensive program which includes energy conservation, development of new supplies of energy, and action to break up the monopolistic control that the big oil companies have in the broad energy industry.

The AFL-CIO program calls for keeping controls on crude oil prices and mandatory conservation measures. We are calling for a government agency to handle all the nation's oil imports, including determining the level of imports and setting prices and domestic allocation of oil.

Energy price increases need to be stemmed, not exaggerated. In this respect, the governmental programs the AFL-CIO advocates will affect prices directly and indirectly through encouraging greater supply and energy conservation.

Specifically we recommend :

1. Continuation of oil price controls as the most immediate action to be undertaken to mitigate further substantial increases in oil prices.
2. The Congress should also reinstitute controls over natural gas pricing.

3. The United States should develop an import-purchasing mechanism at the governmental level which can deal as an equal with OPEC nations. The Government should establish an Energy Import Board, with sole authority to determine the level of U.S. imports and to allocate oil imports, to negotiate with suppliers to develop a purchase mechanism and to take any other steps necessary to end the stranglehold the OPEC nations and the major oil companies now have on the American economy.

4. An Energy Independence Authority should be established to help achieve energy security for the United States, including the power to launch projects for the production and distribution of energy patterned after the TVA concept.

It should encourage and undertake programs for development of alternative energy sources such as solar biomass, fusion, geothermal, gasohol, coal liquefaction and gasification, wind, tidal and any other sources.

5. Conservation should be encouraged through a variety of measures, including expanded support for mass transit systems, and passenger railroads, for improved insulation, fuel efficient engines and motors, and other conservation policies.

6. Legislation should be enacted to prohibit a single company from owning competing sources of energy. Horizontal integration has hampered the development of alternative sources of energy.

7. Legislation should be passed to require the dissolution of vertically integrated oil companies. The separation of the marketing of petroleum from the production and refining would benefit the independent marketer as well as the consumer.

8. The nation should make a major effort toward increasing the domestic use of coal and nuclear power under proper environmental, safety and health standards.

HEALTH

To deal with inflation in health care, the most effective step would be enactment of a universal and comprehensive national health insurance program. Hospital cost containment legislation is an important interim step needed to get a grasp on hospital costs. Also comprehensive health planning and development of health maintenance organizations will be steps to mitigate health care price increases.

Other steps that can be taken to alleviate the spiral in health care costs are such programs as hospital pre-admission testing, prospective surgical review, utilization review of hospital services, and expansion of alternatives to in-patient hospital treatment.

HOUSING

To counteract inflation in housing, the President and the Federal Reserve Board should adopt selective credit regulations and allocate credit to protect the housing industry from the full impact of high interest and tight money policies. Congress and the Administration should undertake programs to increase the supply of low and moderate-income housing. Specific actions to be undertaken are:

Increase funds for emergency assistance under Government National Mortgage Association for single-family homes.

Reduce the $7\frac{1}{2}$ percent ceiling on mortgage interest rates under tandem plan financing to 6 percent. The law—Title III of the National Housing Act, Section 313—only stipulates that a mortgage interest rate of $7\frac{1}{2}$ percent is the most that can be charged. Therefore, legally, there is no reason why the interest rate could not be lowered.

Lower the interest rate for HUD Section 235 homebuyers from the current 4 percent to the 1 percent statutory minimum. Such action would enable low-income families to buy homes, thus stimulating the production of tens of thousands of additional assisted homeownership units.

Encourage mortgage revenue bond programs by municipalities. These tax-exempt revenue bonds would be used to finance low-interest mortgages, but the benefits should be restricted to families who cannot afford to pay private market rates.

Establish a Federal Housing Bank. Such a bank would assure that loans will be available at 5 to 6 percent interest—and under special circumstances at lower rates—for families below a given income level.

Increase the authorization for the debt service and operating subsidy programs in the Housing and Urban Development and Farmers Home Administration. Such programs assist low- and moderate-income families in acquiring homes and meeting monthly payments.

Increase the authorization for the Public Housing program, which provides rental housing for low-income families and elderly individuals in projects owned by local public housing authorities.

Increase the authorization for Section 8 Rental Housing Assistance to support additional units. This program provides for low- and moderate-income families with leased standard rental housing units in privately-owned structures, employing a flexible subsidy, so that increasing utility and other operating costs can be met without raising costs of low-income tenants.

INTEREST RATES

High interest rates and tight money policies are adding fuel to the fires of inflation. They are adding to costs and restricting investment and supplies throughout the economy. Credit crunches are hurting housing and other socially desirable and needed investment activities.

The President should authorize the Federal Reserve Board to allocate credit at reasonable interest rates where such action will have a significant impact in the anti-inflation fight. Congress granted the President and the Federal Reserve Board the authority to allocate credit under the Credit Control Act of 1969. Such allocation would alleviate credit problems in essential sectors of the economy such as housing, small business, state and local public investment, and family farming.

Interest rates on borrowed money have rocketed upward and are approaching or surpassing the all-time highs reached in the credit crunch of 1974.

The cost of money enters into every price in the economy—those paid by consumers, by business and by government. Rising interest costs in themselves help fuel inflation. Not only do they increase the costs of short-term loans used by business in the course of normal operations but they burden the costs of long-term capital investment in plant and equipment. And they make up a large part of the cost of housing. Eventually, if money becomes very tight and very expensive, borrowers cut back, economic activity slows down, production is reduced, sales drop and a recession develops. The recessions of 1969-70 and 1973-75 were both preceded by rapid and severe escalations of interest rates.

The Federal Reserve Board should reduce its basic "discount rate," which directly influences interest rates throughout the economy. This discount rate has jacked up seven times during 1978, starting with the January 9 increase to 6½ percent (from 6 percent). On November 1, the rate was increased to an all-time record of 9½ percent—58 percent higher than the 6 percent rate at the beginning of 1978. The rate is still at this record level in June 1979.

EXCESS PROFITS TAX

Another important tool to fight inflation is an excess profits tax, similar to the type of excess profits tax enacted during the Korean War. Such a tax would dampen the normal corporate drive to raise prices in order to raise profits. An excess profits tax would in that way be a companion policy to the price control program, and it would tend to equalize the degree of sacrifice expected of all Americans.

In summary, the AFL-CIO is urging an overall mandatory economic control program that covers all prices and all forms of income—profits, dividends, rents, interest rates, executive compensation, professional fees, and other sources of income, as well as wages and prices. This program should be supplemented by various direct actions to address the inflationary forces in the four necessities: food, shelter, energy and medical care. An excess profits tax should complement the price program and equalize the sacrifices demanded. Overall fiscal and monetary policy should be designed to encourage the expansion of supply, and reduce the debilitating economic and social losses from unemployment and curtailed production.

These policies, we believe, will break the economic and psychological forces influencing today's inflation and will address directly the most serious problem areas of the economy. The overall economic milieu should be one of expansion, growth, and prosperity, rather than shortages, recession, and hardship.

INFLATION: SOURCES AND CAUSES

Appendix to Testimony

Before

House Budget Committee, June 26, 1979

And

Joint Economic Committee, June 28, 1979

By Dr. Rudolph Oswald, Director, Department of Research,
American Federation of Labor and Congress of Industrial Organizations

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I. INTRODUCTION

Inflation -- which means higher prices throughout the American economy -- has seriously affected the welfare of workers and their families over the past 10 years, and particularly severely in the first half of 1979. While inflation is a persistent problem not only in the United States but in other industrial nations, inflation has worsened in 1979 because of price increases in food, energy and housing.

The necessities of life, food, energy, medical care, housing and interest rates, have been key factors in the rapid inflation of the 1970's. These are areas where labor costs have little or no impact on prices. Wage-push does not explain current inflation.

Business profits have risen to historically high levels and to an above average share of the nation's income. Meanwhile, the after-tax buying power of workers' paychecks have been declining as inflation erodes the value of the dollar. The Administration's wage-price policies have aggravated this disparate treatment of wages and profits. Moreover, recent tax changes help corporations and wealthy individuals and reinforce unfair income distribution in the United States.

Wage increases for the average worker have been eroded over the past few years by inflation and taxes. Real earnings are down from a year earlier and well below the level of five years ago. Over the past few years, union increases generally have been higher than non-union increases, but the reverse is true for the first quarter of 1979. Professionals, salesmen, and executives received large increases in 1977 and 1978. Many other blue and white collar workers have failed to keep pace.

High unemployment and low production also contribute to inflation. Unemployment means lost income and lost consumer buying power, lost business sales, high overhead costs, and low levels of investment in new, more efficient and productive plant, machinery, and equipment.

Full employment and faster economic growth, therefore, are essential parts of an effective anti-inflation program.

In spite of the U.S. economic problems of the 1970's, American workers are still the most productive workers in the world. In comparison to other major industrial countries, labor costs per unit of output are rising much less rapidly than in other countries.

The U.S. experienced a long period of relative price stability from the time of the Korean War in the early 1950's until the late 1960's when Vietnam War spending added price pressures to a booming economy. High interest rates and tight money policies during the Nixon-Ford-Burns years brought serious unemployment and recessions in 1969-70 and 1973-75, but also -- contrary to economic theory and contrary to the Nixon-Ford-Burns game plan -- brought still higher prices and higher inflation.

The experience of simultaneous high unemployment and high inflation -- "stagflation" -- seemed impossible according to traditional economists' expectations that nations can bring down inflation if they are willing to accept more unemployment. Since 1970 the U.S. has been plagued by simultaneous high unemployment and high inflation.

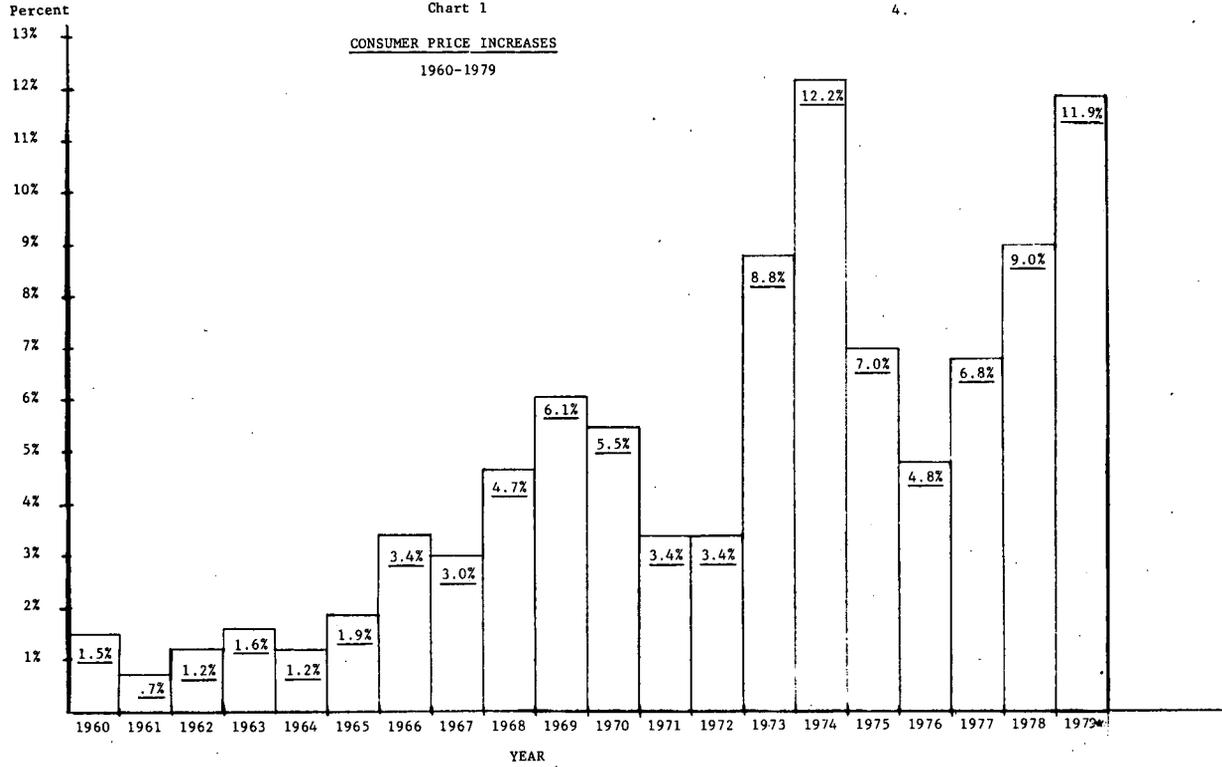
Today high interest rates are again threatening the nation's economic vitality. The Federal Reserve Board has raised the discount rate to an all-time record at 9½ percent, and commercial bank prime

are at near record levels. Home mortgage rates are again well above 10 percent and are pushing the cost of housing beyond the reach of many Americans.

Policies dealing with inflation must take into account the total economy. Such policies cannot ignore the big variations in price change, and the particular price problems related to food, housing, energy and medical care. Profits and interest rate levels affect income distribution. Inflation is not explained just by wages.

The Administration's inflation plan of October 1978, set forth a price and wage guideline program with an explicit wage standard, limiting wage increases to 7 percent, while prices were governed by a vague guideline. Moreover, the price guideline has numerous exceptions for various products. Since October 1978, prices have risen substantially while wages have been effectively controlled. The result is that workers have been forced to bear the brunt of the inflation.

The following chart shows the big fluctuations in the year to year inflation rate, and the big increase in 1978 and the first part of 1979. Just as wage increases did not cause the 12.2 percent price rise in 1974, neither do they cause the double-digit inflation rate of price increases in early 1979.



(*1979 figure is the annual rate, 6 mos. ended April)
Source: Bureau of Labor Statistics, Consumer Price Index for Urban Wage Earners and Clerical Workers, December to December.

II. PRICESCONSUMER PRICES

Increases in living costs have been particularly serious since 1973.

Year-to-year rates of consumer price increase have mainly been affected by strong movements in prices for food and shelter, which together account for 47 percent of the present CPI "market basket" for urban wage earners and clerical workers. Of lesser direct impact on the price index as a whole, but critically important to consumers, have been high rates of price increase for energy (now 9 percent of the index market basket) and medical care (4 percent). Medical care costs are not fully reflected in the index, because the index covers only direct outlays by consumers and does not reflect costs assumed by government and employers through insurance and other assistance. On a combined basis, these four categories of "necessities" -- food, shelter, energy, and medical care -- make up about 60 percent of the total "market basket" of the Consumer Price Index for Urban Wage Earners and Clerical Workers.

Over the years beginning with 1973, prices for the combined group of "necessities" have persistently risen more than the index as a whole, except for 1976. The year 1976 was the low point during the 6 year period and reflected strong abatements in price increases for food and shelter. Since 1976, however, prices have been rising at an accelerating rate, paced by food and shelter and more recently by startling increases in energy prices. Since 1976, the rise in "necessities" prices has been

well ahead of the rest of the index. In the six-month period ended April 1979, the necessities group was rising at an annual rate of 14.7 percent as against 7.7 percent for the remainder. The index as a whole was rising at a rate of 11.9 percent.

TABLE 1
Increase in Prices of "Necessities"
 1973-1978

(December/December)

	<u>Total CPI*</u>	<u>Food</u>	<u>Shelter</u>	<u>Energy</u>	<u>Medical Care</u>	<u>Total "Necessities"</u>	<u>Total Other Items</u>
1973	8.8%	20.1%	7.0%	16.8%	5.2%	12.9%	3.4%
1974	12.2	12.2	11.3	21.6	12.5	12.9	11.2
1975	7.0	6.5	7.3	11.6	9.9	7.8	5.8
1976	4.8	.6	4.2	6.9	10.1	3.6	6.5
1977	6.8	8.0	8.7	7.2	8.8	8.3	4.6
1978	9.0	11.7	11.5	8.1	8.9	10.8	6.3
1979 (Annual rate, 6 mos. ended April)	11.9	14.8	13.0	23.1	9.0	14.7	7.7
Relative Importance Dec. 1978		20.0%	27.0%	9.0%	4.0%	60.0%	40.0%

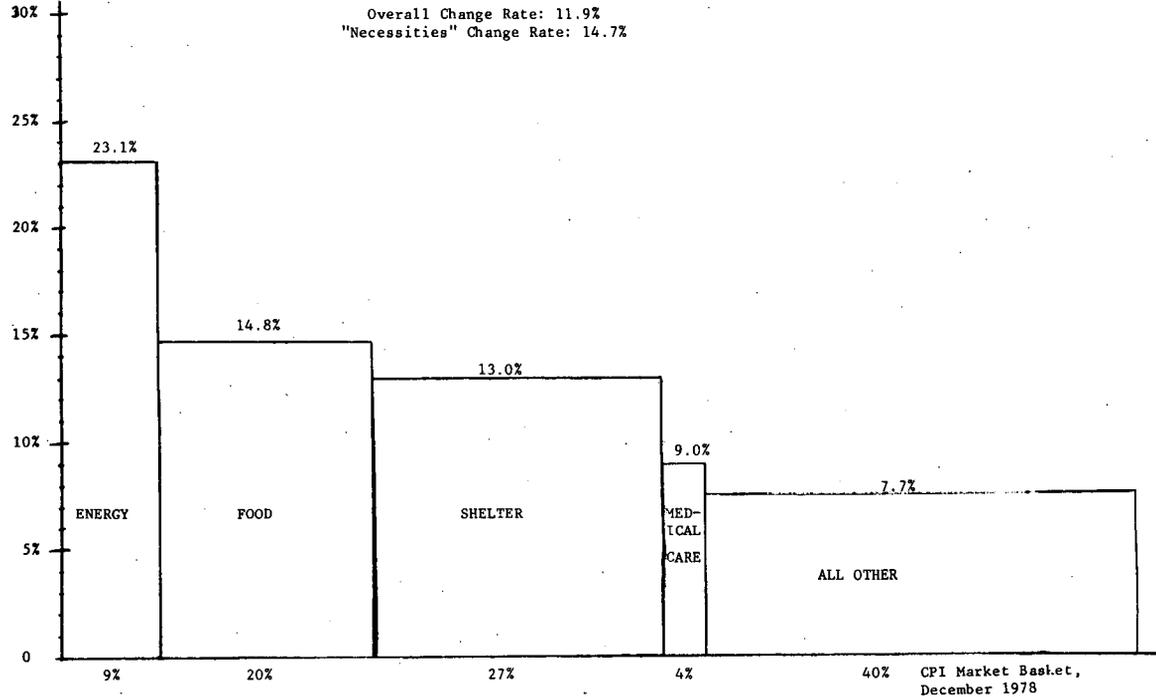
* Consumer Price Index for Urban Wage Earners and Clerical Workers

Chart 2

Seasonally Adjusted
Annual Rate of Change

Price Increases in the "Necessities"
October 1978 - April 1979

Overall Change Rate: 11.9%
"Necessities" Change Rate: 14.7%



CPI-W Urban Wage Earners and Clerical Workers

SOURCE: Bureau of Labor Statistics

FOOD

Food prices swing widely, with big increases in some years and small ones in other years. They have been a large element in the uneven pattern of overall inflation beginning with 1973. Over the 1973-1978 period, food price increases ranged from a high of 20 percent in 1973 to a low of 0.6 percent in 1976. Currently they are running at an annual increase rate of nearly 15 percent for the six months ended April 1979.

Farm commodity prices are erratic because of varying conditions of abundance and shortage. These may be brought about by weather conditions and diseases of plants and animals. But supplies and prices are also affected by export demand and by government programs to maintain farm incomes through price supports and supply controls. Within the farm system, prices and supplies of grain used for feeding livestock strongly affect supplies and prices of meat.

Most foods in the U.S. market are domestically produced but a portion is imported, principally fish and seafood, coffee, bananas and sugar. The United States is the largest exporter of food in the world, and foreign demand can readily put pressure on domestic prices unless adequate reserves are maintained.

In 1973 domestic food prices exploded mainly because large and sudden grain sales to Russia drove up the price of wheat and feed grains and led to sharp increases in the cost of feeding livestock and in the price of meat. Bad weather also contributed to a cut in food supplies and higher prices.

The recent upsurge in food prices beginning in 1977 has been largely a meat supply shortage, as farmers first allowed herds to dwindle

in the face of high feed costs and then began rebuilding herds as meat prices rose, thus keeping them out of the food supply.

However export increases continue to affect domestic prices. In 1978, wheat exports rose by over 25 percent while domestic grain prices rose by more than 10 percent.

Government programs designed to maintain farm incomes can sometimes have the effect of aggravating food price inflation for consumers. They include price support programs, import restrictions, marketing orders and acreage set-asides which withdraw land from crop production.

Farm commodity prices are not the only component of the consumer food dollar since between the farmer and the consumer lie successive stages of food processing, wholesaling, retailing and food service in restaurants. The ultimate price of food to the consumer at the grocery or in the restaurant is thus far greater than its original farm price. The farm value of domestically produced foods is about one-third of the price to the consumer. However, retail price changes to consumers do tend to follow changes in farm prices, although not always at precisely the same time or in the same magnitude. Table 2 illustrates that in the early 1960's farm prices rose at an annual rate of 1.1 percent and retail food prices rose only 0.8 percent. In the last three years, the volatile swings in farm prices, from a decline of 5.3 percent in 1976 to an increase of 16.5 percent in 1978, were followed by modest retail food price increases of 1 percent in 1976 and 2.2 percent in 1977 and a large 11.3 percent increase in 1978. Thus, when farm price increases dropped or moderated in the last three years, retail food price increases moderated to a lesser extent, but conversely when farm prices rose rapidly, retail food prices rose but at a lesser pace. Over the entire

period 1960 to 1978, farm prices rose by 4.5 percent and retail food prices by 4.4 percent.

Food price increases particularly hurt poor and moderate income families, since they spend a disproportionately large share of their income for food. Table 3 illustrates that as household income rises, a smaller and smaller share of income is devoted to food purchases. For households with incomes of under \$5,000, nearly a third (31.7 percent) of their income is spent for food, while families with incomes of \$50,000 or more spend less than 5 percent of their income for food. Thus, the recent rise of food prices of 14.8 percent has a particularly devastating impact upon the poor and middle income families, since such a large proportion of their income is spent for food -- the most basic of all necessities.

TABLE 2

Retail Food Price Changes Reflect Changes in Farm Prices

<u>Year</u>	<u>Average Annual Increase</u>	
	<u>Farm Price</u>	<u>Retail Food Price</u>
1976	- 5.3%	1.0%
1977	0.2	2.2
1978	16.5	11.3
1960-65	1.1	0.8
1965-72	3.4	3.4
1972-78	8.8	8.6
1960-78	4.5	4.4

Source: U.S. Department of Agriculture

TABLE 3

Food Expenditures by Income Group

<u>Household Income</u>	<u>Food as % of Expenditures</u>
Under \$5,000	31.7%
\$5,000 to 9,999	18.4
10,000 to 14,999	14.7
15,000 to 19,999	13.0
20,000 to 24,999	11.6
25,000 to 29,999	10.5
30,000 to 34,999	9.9
35,000 to 39,999	8.8
40,000 to 49,999	6.9
50,000 and over	4.5

Source: 1972-73 Consumer Expenditure Survey used by BLS
to update the CPI. Data includes meals away from home.

SHELTER

Prices of shelter in the Consumer Price Index reflect both rent and home ownership costs. Home ownership, however, is the main part of the index and has been the principal source of changes in overall shelter prices in the 1973-78 period.

Home ownership costs have risen erratically and sometimes by very large amounts. In 1979 they were rising at an annual rate of 14.8 percent (six months ended April 1979).

Increases in Shelter Prices
(Dec./Dec.)

	<u>Shelter Total</u>	<u>Home Ownership</u>
1973	7.0%	7.7%
1974	11.3	13.3
1975	7.3	7.9
1976	4.2	3.8
1977	8.7	9.2
1978	11.5	12.5
1979	13.0	14.8
(Annual rate, 6 mos. ended April)		

The costs of home ownership are chiefly affected by rising house prices and equally important, by charges for mortgage interest. Maintenance and repair costs also affect costs but they are of far less importance.

Home Ownership: Increases in Home Purchase and Finance Costs
(Dec./Dec.)

	<u>Home Purchase</u>	<u>Finance, Insurance, Taxes</u>
1973	3.4%	11.1%
1974	10.1	14.6
1975	10.0	7.6
1976	4.3	1.6
1977	8.4	11.2
1978	11.1	15.2
1979	12.0	18.1
(Annual rate, 6 mos. ended April)		

House prices principally reflect the current state of housing supply and land availability in relation to population growth and consumer incomes in particular areas. Most homes priced for the Consumer Price Index (about three-quarters) are existing homes, already built, and do not involve new construction.

There has, in fact, been substantial underproduction of housing relative to needs for the past several years.

Construction costs of new single family homes have shifted considerably in their composition over the years, with prices for land, construction financing charges, overhead and profit, accounting for enlarged shares of total costs. The proportion accounted for by labor and materials has dropped.

Housing Cost Components - New Single Family Homes
Percent of Total Cost

	<u>1949</u>	<u>1969</u>	<u>1977</u>
On-Site Labor	31%	18%	17%
Building Material	38	38	30
Land (Developed)	11	23	25
Financing Charges (Construction)	5	8	11
Overhead & Profit	<u>15</u>	<u>13</u>	<u>17</u>
Total Cost	100%	100%	100%

SOURCE: National Association of Home Builders

Upward movements in mortgage interests costs have usually reflected government efforts to restrain the money supply, as a means of combatting inflation. Mortgage costs are the principal component of the CPI category that includes "Finance, Taxes, and Insurance."

The interest rate charged on new home mortgages has risen from 6 percent in the mid-1960's to more than 10 percent at present. This has pushed the total interest paid on a \$40,000 30-year mortgage from \$46,000 to \$86,000.

ENERGY

Beginning with 1973, the prices of energy have been basically determined by the OPEC oil cartel which raises prices at will on exports of oil to other countries. U.S. prices are secondarily influenced by policies of the U.S. government under laws controlling prices of domestically produced oil and gas.

OPEC oil price increases have been directly reflected in huge price increases for gasoline and oil and subsequently in higher prices for other types of energy as well, including electricity, gas and coal.

After very large increases in 1973 and 1974, energy prices showed a decelerating trend through 1976. Price increases began accelerating again in 1977, reaching 8.1 percent in 1978. OPEC then announced a 14.5 percent increase in prices for 1979. This action and the effects of subsequent disorders in Iran have sent energy prices skyrocketing in recent months. In the six-month period ended April 1979, energy prices rose at an annual rate of 23.1 percent. Gasoline prices were rising at a 40 percent rate. Fuel oil, coal and bottled gas rose at a 32.1 percent rate. These were partly offset by the as-yet modest increases for gas and electricity, up at a 2.8 percent rate. During the last half of the 6-month period, however, gas and electric prices were rising at a 9.3 percent annual rate.

The price for crude oil produced in the U.S. increased from \$2.86 a barrel in 1965 to \$3.18 a barrel in 1970, an increase of 11 percent during that five-year period. In 1965, foreign oil was cheaper than domestic oil, and the average price paid by refiners for all oil was \$1.80 a barrel. By 1978, domestic oil had risen to an average of \$9.00 a barrel, an increase of 215 percent since 1965, and the average of all oil, foreign and domestic, rose to \$12.40 a barrel for an increase of 589 percent. (See Table 4 for details).

The biggest price increases for domestic fuels has been for natural gas. The average well-head price for natural gas has risen from 15 cents per thousand cubic feet in 1965 to 88 cents in 1978 for an increase of 487 percent. Coal prices have also risen steeply from \$5.83 a ton in 1965 to \$24.51 a ton in 1978 for an increase of 320 percent.

TABLE 4
PRICE INCREASES FOR OIL, GAS AND COAL

	1965-1978									
	ANNUAL AVERAGES									
	<u>1965</u>	<u>1970</u>	<u>1973</u>	<u>1974</u>	<u>1975</u>	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>% Change '74 to '78</u>	<u>% Change '65 to '78</u>
<u>CRUDE OIL (\$/BBL)</u>										
Refiner acquisition costs, composite of domestic and imported ¹	\$1.80			\$ 9.07	\$10.38	\$10.89	\$11.96	\$12.40	36.7	588.9
Wellhead prices (domestic)	\$2.86	\$3.18	\$3.89	\$ 6.87	\$ 7.67	\$ 8.19	\$ 8.57	\$ 9.00	31.0	214.7
<u>NATURAL GAS (¢/MCF)</u>										
Average annual wellhead price committed to interstate commerce ²	\$.15	\$.17	\$.21	\$.30	\$.44	\$.58	\$.79	\$.88 ⁴	193.3	486.7
<u>COAL (\$/SHORT TON)</u>										
Average delivered prices of coal at utilities - Composite actually paid ³	\$5.83	\$7.08	\$9.32	\$14.81	\$18.71	\$19.29	\$20.97	\$24.51 ⁵	65.4 (1978)	320.4 (1978)

1 Source: DOE Monthly Review, February, 1979, page 74.

2 Source: 1947-1977 API Basic Petroleum Data Book, page VI-2.

3 Source: EEI Statistical Yearbook of the Electric Utility Industry, various issues, table 42.

4 Average of monthly prices, January-June.

5 Average of monthly prices, January-August.

MEDICAL CARE

Medical care prices have shown persistently high rates of increase since 1974, when they jumped by 12.5 percent. There has been a steady pattern of yearly increases in the 9 to 10 percent range since that time. In the six months ended April 1979, they were rising at a 9 percent annual rate.

Hospital room costs have shown especially high rates of increase. Physicians' services have also contributed in large measure to sustaining a huge plateau of overall medical care increase rates. In the six months ended April 1979, hospital room rates were down to an annual increase rate of 9.8 percent, but physicians' services had stepped up to a 10.4 percent rate.

Increases in Prices of Hospital Rooms
and Physicians' Services

	<u>Medical Care Total</u>	<u>Hospital Rooms (Dec./Dec.)</u>	<u>Physicians' Services</u>
1973	5.2%	5.7%	4.0%
1974	12.5	16.5	13.3
1975	9.9	14.7	11.8
1976	10.1	13.0	9.7
1977	8.8	10.8	9.2
1978	8.9	12.2	8.1
1979 (Annual rate, 6 mos. ended April)	9.0	9.8	10.4

The chief factors responsible for the high rate of increase in hospital costs have been the provision of increasingly costly and more sophisticated equipment, excessive and expensive hospital construction and the use of costlier procedures involving larger inputs of staff services per patient. Costly equipment and facilities are often wastefully duplicated in the same geographical area.

These excessive outlays are traceable to the widespread availability of privately provided insurance, unaccompanied by firm cost controls.

WHOLESALE PRICES

Wholesale price movements affect business costs and often foreshadow future price increases for consumer goods.

Wholesale prices are now published in three separate "Producer Price Indexes", one for Finished Goods, one for Intermediate Goods, and one for Crude Goods.

These indexes are for commodities only. They therefore exclude important components of the Consumer Price Index, particularly "services," such as rent, insurance, mortgage interest, maintenance and repair, public transportation, etc. Also excluded are home purchases (both new and existing homes) and used cars. Only about half of the expenditures covered by the Consumer Price Index are represented in the Producer Price Indexes.

On the other hand, in the Finished Goods Index, capital goods prices are included as well as those for consumer goods.

1. Crude Goods Up the Most

During the six months from October 1978 to April 1979, the Crude Goods Index advanced very sharply -- at a seasonally adjusted 12-month rate of 17.1 percent, much more than either the Finished Goods Index (12.2 percent) or the Intermediate Goods Index (13.2 percent).

Labor costs play little part in influencing crude goods prices. Crude goods are products entering the market for the first time. They have not been manufactured or fabricated but will be processed before becoming "finished goods." They include farm products and such items as crude fuels, ores, natural rubber, wastepaper and scrap. They sometimes show large swings up or down depending on the state of supply and demand, both foreign and domestic.

2. Foods and Feeds

In all three indexes, prices for foods or feeds advanced sharply over the six-month period as a whole. However, there were signs of at least temporary abatement at the end of the period.

Crude foodstuffs and feedstuffs increased at an annual rate of 16.4 percent through the six-month period ended in April. There was a small drop in April (0.3 percent) followed by another in May (0.3 percent).

In the Intermediate Goods Index, foods and feeds rose at a 13.0 percent annual rate. A drop of 0.7 percent appeared in the subsequent May index.

At the Finished Goods level, consumer foods rose at a 13.4 percent rate, but with a drop of 0.3 percent in the last month of the period (April) followed by a further drop of 0.7 percent in May.

3. Nonfoods

Through April 1979, nonfoods were rising at rates close to or even above those for foods and feeds, propelled in large part by steep rises in petroleum and petroleum based products. These were showing no signs of abatement at the end of the period.

Nonfood crude items rose at a 19.3 percent annual rate during the six month period. Intermediate nonfood items rose at a 13.4 percent annual rate, and in Finished Goods, they rose at a 12.6 percent rate.

4. Energy Prices

Gasoline and kerosene were rising at rates approaching 40 percent per year, and home heating oil 41 percent. Diesel fuel was up at a 36.5 percent rate, and residual fuel at 39.2 percent. Crude petroleum price rises were far less excessive, with an annualized rate rise of 12.3 percent. Crude natural gas, however, rose at a 29.4 percent annualized rate. (See Table 5).

Some energy products showed only small rates of increase: coke, 2.8 percent; liquified petroleum gas, 2.4 percent; electric power, 5.7 percent; coal 3.2 percent.

5. Consumer Goods Impacted More than Capital Goods

The Finished Goods Index showed an increase rate of 13.2 percent for consumer goods as against 10.3 percent for capital equipment.

6. Detailed Items

For detailed commodities in the Producer Price Indexes, over-the-year price changes from April 1978 to April 1979 ranged very widely -- from a drop of 13.8 percent for cocoa beans to a rise of 100.4 percent for hides and skins. Both of these extremes were in the volatile crude materials category. But large differences occurred in the intermediate and finished goods categories as well.

Price changes for intermediate goods ranged from a drop of 11.6 percent in the price of liquefied petroleum gas to an increase of 81.0 percent for leather.

Finished goods price extremes (all in the consumer sector) ranged from a drop of 21.1 percent in roasted coffee to a rise of 31.8 percent for beef and veal.

Table 6 shows all items with increases of 10 percent or more in the year ended April 1979. Table 7 shows items which either dropped in price or rose less than 4 percent in the same period.

TABLE 5
Annual Rates of Change in Energy Items
Producer Price Indexes
October 1978-April 1979

	Annual Rate of Change <u>Oct. 78-April 79</u>
Finished Goods:	
Gasoline	39.6%
Kerosene	39.9
Fuel Oil No. 2	41.1
Finished Lubricants	14.8
Intermediate Goods:	
Coke	2.8%
Liquefied Petroleum Gas	2.4
Electric Power	5.7
Commercial Jet Fuel	11.7
Diesel Fuel	36.5
Residual Fuel	39.2
Lubricating Oil Materials	27.7
Crude Goods:	
Coal	3.2%
Natural Gas	29.4
Crude Petroleum	12.3

TABLE 6

Large Increases in Wholesale Prices¹ - 1979Increases of 10% or More
Year Ended April 1979Finished Goods

Consumer:

Beef and veal	31.8%	Tobacco	11.6%
Fish	27.7	Tires & tubes	11.3
Gasoline	24.0	Finished lubricants	11.2
Fuel Oil	23.4	Pharmaceutical preparations, proprietary	11.0
Kerosene	22.3	Barley products	10.5
Eggs	21.8	Misc. processed foods	10.0
Fresh fruits	19.2	Other misc. products, (nonfood)	10.4
Footwear	18.1		
Dairy products	12.2		
Processed fruits & vegetables	12.2		

Capital Equipment:

Metal forming machine tools	14.7%	Hand tools	10.9%
Metal cutting machine tools	14.6	Commercial furniture	10.6
Motor trucks	11.6	Mining machinery & equipment	10.3
Special industry machinery & equipment	11.3	Oil field machinery & equipment	10.1

Intermediate Goods

Leather	81.0%	Gypsum products	14.0%
Fats and oils, inedible	48.9	Metal containers	14.0
Primary nonferrous metal refinery shapes	36.2	Paper boxes & containers	13.8
Secondary nonferrous metal & alloy basic shapes	34.3	Millwork	13.3
Residual fuel	22.8	Pig iron and ferro alloys	12.9
Nonferrous wire & cable	21.1	Lumber	12.1
Diesel fuel	19.7	Wiring devices	11.7
Pesticides	18.7	Portland cement	11.6
Parts for metal cutting machine tools	18.6	Paper	11.4
Animal fats and oils	18.1	Tires & tubes	11.3
Nonferrous mill shapes	17.6	Other nonmetallic minerals	11.3
Lubricating oil materials	17.5	Paperboard	11.2
Plain bearings	17.5	Ball & roller bearings	11.0
Woodpulp	16.6	Structural clay products, excluding refractories	10.9
Concrete products	15.4	Valves & fittings	10.8
Other wood products	15.0	Plastic resins & materials	10.5
Plywood	14.5	Industrial chemicals	10.4
Parts for metal forming machine tools	14.1	Crude vegetable oils	10.4
		Refrigerant compressors & compressor units	10.4
		Foundry & forge shop products	10.1
		Asphalt roofing	10.1

Large Increases in Wholesale Prices (cont'd)Crudes

Hides and skins	100.4%	Potash	17.6%
Nonferrous scrap	50.1	Fluid milk	14.9
Crude natural rubber	42.7	Hay, hayseeds, oilseeds	14.6
Iron and steel scrap	34.6	Wastepaper	12.8
Livestock	30.2	Crude petroleum	10.7
Natural gas	22.2	Iron ore	10.7

¹Producer Price Index

Source: Bureau of Labor Statistics

TABLE 7

Small Increases or Decreases in Wholesale Prices¹ - 1979Increases Under 4%
Year Ended April 1979Finished Goods

Consumer:

Fresh & dried vegetables	- 10.1
Milled Rice	- 13.0
Pork	3.9
Vegetable oil end products	2.1
Home electronic equipment	1.1
Roasted Coffee	-21.1

Intermediate Goods

Finished fabrics	2.4
Liquefied petroleum gas	- 11.6
Nitrogenates	- 1.9
Miscellaneous chemical products	- 1.6
Unsupported plastic film & sheeting	2.8
Building paper & board	- 2.8
Arc welding electrodes	3.6
Photographic supplies	3.7

Crudes

Grains	- .2
Green coffee	- 11.9
Cocoa beans	- 13.8
Cane sugar, raw	2.1

¹Producer Price Index

Source: Bureau of Labor Statistics

DECLINING VALUE OF THE U.S. DOLLAR IN WORLD MARKETS

The declining value of the U.S. dollar in the world economy has aggravated inflation in this country.

The dollar is the world's major reserve currency. More than \$500 billion is held outside the U.S.A. The confidence of foreign dollar-holders in the value of the dollar affects their willingness to hold dollars and thus in itself affects the value of the dollar.

The weakness of the dollar encourages big U.S. banks and multinational corporations -- and foreign dollar-holders too -- to speculate against the dollar and to sell their dollar-holdings, thus driving the dollar still lower in value. This makes imports from foreign countries more expensive for Americans and makes U.S. exports less expensive for foreign buyers. While the decline of the dollar somewhat stabilized between November 1978 and May 1979 the dollar still remained vulnerable, and its fluctuations affected domestic inflation. During 1978, the U.S. trade deficit rose to a record \$34 billion. The increase in imports in 1978 was essentially of manufactured products, and the U.S. imported \$6 billion more of manufactured products than it exported.

The price of U.S. imports in dollars goes up as the dollar goes down in value on world money markets. The higher price of imported commodities and imported goods in the U.S. adds to domestic inflation pressures. In addition, American business firms then raise their prices to enjoy higher profit margins. Thus, the rising cost of imports becomes part of the rising cost of living.

Also, as the dollar goes down in value, U.S. exports become cheaper to foreign buyers. Exports rise when the dollar falls -- but this adds to inflation in the U.S.A. as foreign buyers compete with American consumers

and American business firms in the American market for items in short supply such as hides, coal, logs, scrap steel, food and other raw materials and commodities.

Furthermore, as dollar-purchases become cheaper to foreign investors, they are increasingly buying up U.S. banks and businesses. Foreign direct investment and acquisitions of business firms in the U.S. economy are encouraged by devaluation of the dollar because foreigners can buy more with their German marks or Japanese yen. This situation not only adds to inflation pressures but raises possibilities for increasing foreign control over significant sectors of the U.S. economy.

III. INTEREST RATES

Traditionally interest rates were considered one means of curtailing inflation, but in today's economic environment, higher interest rates are actually contributing to inflation.

Interest rates on borrowed money have rocketed upward and are approaching or surpassing the all-time highs reached in the credit crunch of 1974.

The cost of money enters into every price in the economy -- those paid by consumers, by business and by government. Rising interest costs in themselves help fuel inflation. Not only do they increase the costs of short-term loans used by business in the course of normal operations but they burden the costs of long-term capital investment in plant and equipment. And they make up a large part of the cost of housing. Eventually, if money becomes very tight and very expensive, borrowers cut back, economic activity slows down, production is reduced, sales drop and a recession develops. The recessions of 1969-70 and 1973-75 were both preceded by rapid and severe escalations of interest rates.

FEDERAL RESERVE DISCOUNT RATES

The Federal Reserve Board, which directly influences interest rates through its role as "banker for the banks", jacked up its discount rate seven times during 1978, starting with its January 9 increase to 6½ percent (from 6 percent). On November 1, the rate was increased to an all-time record of 9½ percent -- 58 percent higher than the 6 percent rate at the beginning of 1978. The rate was still at this record level in mid-June 1979.

COMMERCIAL BANK PRIME RATES

The lending rates of commercial banks have risen in similar fashion. At the beginning of 1978, the big bank "prime rate", which is the minimum

lending rate to large businesses, was 7 3/4 percent. This rate successively increased during 1978 reaching a peak of 11 3/4 percent in December and remaining at that peak into June 1979.

BANK PROFITS

Rising interest rates on large lending volume have been highly profitable to the nation's largest banks.

Chase Manhattan reported a 78 percent profit gain -- from \$41.0 million in the 1978 first quarter to \$73.1 million in the 1979 first quarter.

Bank America reported income for the first quarter of 1979 at \$129.2 million, up 26 percent from the \$102.5 million in the same quarter a year earlier.

Citicorp reported \$125.3 million for the first quarter, and increase of 18 percent from the year earlier figure of 106.3 million.

MORTGAGE RATES

Home mortgage rates are now running over 10 percent. A common rate 10 years ago was 7 percent and 15 years ago 6 percent or less.

Even small rises in mortgage interest rates generate large increases in total interest to be repaid over a 30-year period. For example, a 30-year loan of \$30,000 at 6 percent requires total interest payments of \$34,750. At 7 percent the same loan costs \$41,850 -- an increase of \$7,100. At 10 percent, the loan costs \$64,780 -- an increase of more than \$30,000 (equal to the amount of original loan itself).

For larger loans the dollar hike is even more enormous. A 6 percent rate on a \$40,000 loan for 30 years costs \$46,340. At 10 percent the same loan costs \$86,370, an increase of \$40,000.

TABLE 8

Home Mortgage Interest

1. Interest on a \$30,000 loan for 30 years:

<u>Rate</u>	<u>Total Interest</u>
6%	\$ 34,752
7%	41,853
8%	49,248
9%	56,898
10%	64,779

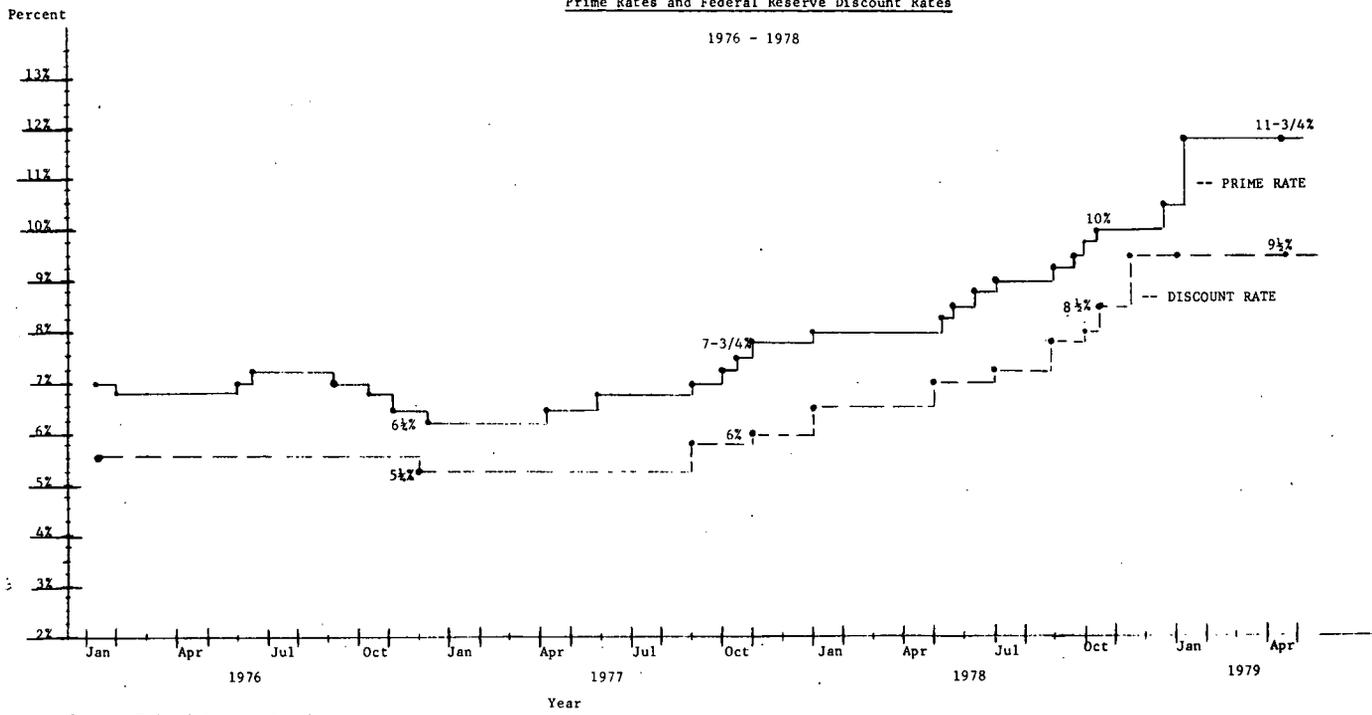
2. Interest on a \$40,000 loan for 30 years:

<u>Rate</u>	<u>Total Interest</u>
6%	\$ 46,336
7%	55,804
8%	65,664
9%	75,864
10%	86,372

CHART 3

Prime Rates and Federal Reserve Discount Rates

1976 - 1978



Source: Federal Reserve Board

IV. Profits

Various measures of corporate profits, including return on investment, profit on sales, and total cash flow show that U.S. corporations have had substantial profit gains in the fourth quarter of 1978, and in the first quarter of 1979. Corporate profits have risen to an historically high level and an above-average share of the nation's income.

A corporation's financial health is measured by its profits -- and also by its "cash flow." Cash flow includes profits and money set aside for depreciation. Depreciation allowances are the amounts that businessmen legitimately deduct from gross income to compensate for the wear and tear on plant and machinery and serve as replacement funds for such machinery. The sheer magnitude of depreciation allowances make them a vital factor in any corporate financial analysis.

Cash flow tells how well a company is doing and what its resources are -- resources from which it can pay dividends and expand investment in plant and equipment.

Between 1973 and 1978 cash flow of all corporations increased 65 percent to \$233 billion a year. The cash flow of corporations was 13.6 percent of the nation's income in 1978, a share as high or higher than in 19 of the previous 25 years. Cash flow rose to an annual rate of \$258 billion in the first quarter of 1979, a 14 percent share of national income. If continued through this year, this share will exceed all but two of the previous 25 years.

Profits alone were a high share of the nation's income in the last two years. Profits after tax rose from 4.6 percent of the national income in 1970 to 6.9 percent in 1978 and to 7.5 percent in the first 3 months of 1979. Both shares are well above the 6.6 percent average of the past 25 years.

A more complete measure of the return to capital includes not only profits (dividends to stockholders and undistributed profits) but interest payments to holders of corporate bonds and other corporate debt. Investors have been buying more corporate bonds in recent years -- in contrast to "equity" stock shares -- so bond interest has become more important than stock dividends as a source of income. This measure -- profits after tax plus net interest -- is available for all corporations except banks and insurance companies.

The combined return to corporate investors in 1978 was \$136 billion, or 8.0 percent of national income, a higher share of the nation's income than at any time in the past 25 years. In the first quarter of 1979 the return to corporate investors rose to an annual rate of \$156 billion or 8.4 percent of the nation's income.

Inflationary periods create measurement problems and there are differences of opinion regarding the measurement of profits. "Inventory profits," for example, result during periods of rapid inflation since firms buy goods at relatively low prices and sell them at higher prices.

Inflationary periods also make it more difficult to appropriately measure depreciation. Such periods also provide substantial opportunities for corporations to conceal "excessive" profits and thus avoid "excess profits" taxes and regulations.

Depreciation should be based on the actual cost of the equipment wearing out, since the relevant consideration is profits made on actual money invested. It is not possible to calculate accurately actual depreciation on any economy-wide scale, but, as the Commerce Department uses tax depreciation, its figures understate the return on investment in recent years.

Advocates of higher "replacement" cost depreciation accounting methods are quick to cite the higher cost of new plant and equipment, but they ignore the fact that inflation also reduces the real burden of corporate debt. Corporate prices and incomes are increasing but payments on debts remain the same. The declining debt burden offsets the higher cost of replacing plant and equipment. And the business tax reductions of recent years, such as the investment tax credit and accelerated depreciation, have also offset the effects of inflation. Studies show that the declining burden of debt and the tax reductions have more than offset the higher cost of replacing plant and equipment.

Corporate after-tax profits reached \$118.1 billion in 1978, a 15.7 percent increase over 1977. In the first 3 months of 1979, profits were at a seasonally adjusted annual rate of \$137.9 billion, a 35 percent increase over the first 3 months of 1978.

During the six months following the Administration's new Wage-Price Guideline program, profits have increased substantially. After-tax profits for the fourth quarter of 1978 were 25 percent higher than in the same quarter a year earlier, and in the first quarter of 1979 profits were up 35 percent over the corresponding quarter in 1978.

Profit Reports
(Seasonally Adjusted Annual Rates)

36.

Profits Before Tax
(Billions of Dollars)

<u>Quarter</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1977-1978</u> <u>Pct. Change</u>	<u>1978-1979</u> <u>Pct. Change</u>
Q1	\$164.8	\$172.1	\$226.9	4.4%	31.8%
Q2	175.1	205.5		17.4	
Q3	177.5	205.4		15.7	
Q4	178.3	224.9		26.1	

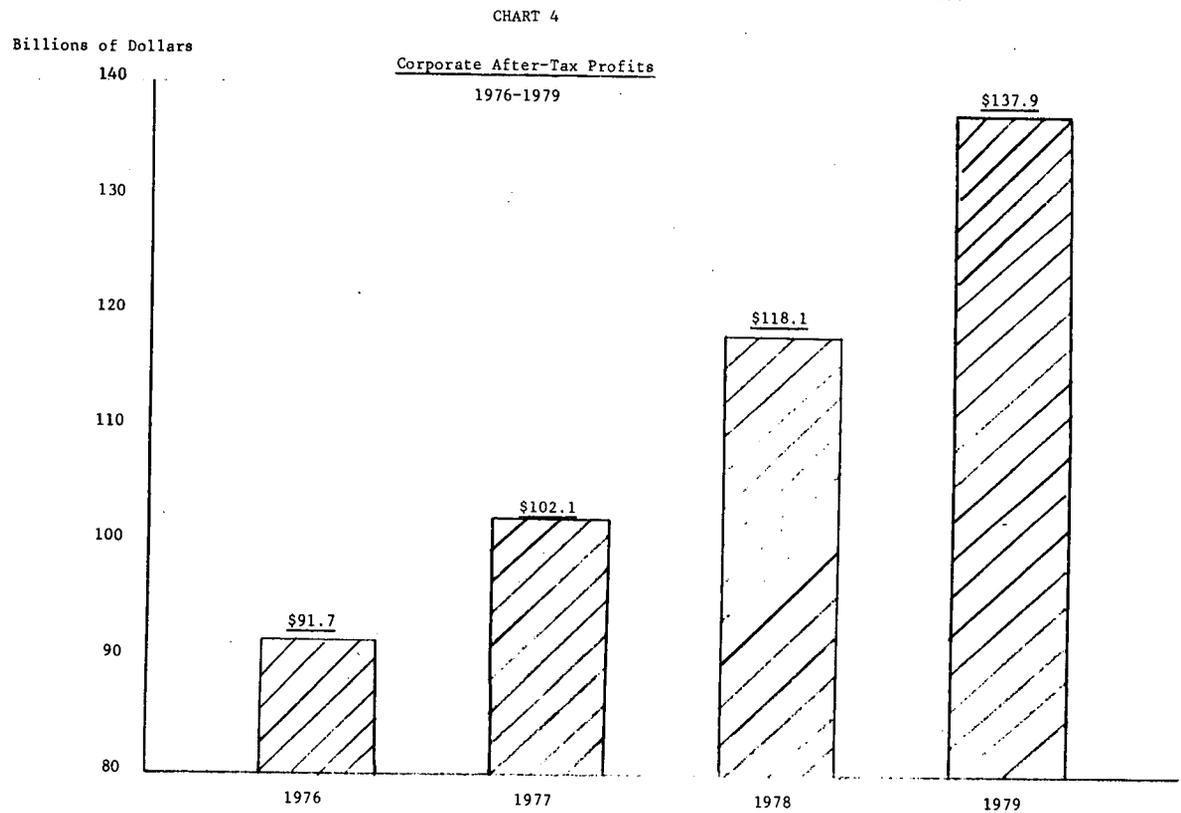
Profits After Tax
(Billions of Dollars)

<u>Quarter</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1977-1978</u> <u>Pct. Change</u>	<u>1978-1979</u> <u>Pct. Change</u>
Q1	\$ 96.5	\$102.1	\$137.9	5.8%	35.1%
Q2	102.8	120.5		17.2	
Q3	104.8	119.2		13.7	
Q4	104.4	130.5		25.0	

SOURCE: U.S. Department of Commerce

Profits for many individual companies showed substantial gains in late 1978 and early 1979. For example, Aluminum Company of America indicated a spectacular 137 percent increase in first quarter of 1979 profits over the same period last year. Kaiser Aluminum increased profits by 129 percent. International Harvester increased profits by an unbelievable 457 percent. Other big corporations with an enormous increase in profits included Paine Webber with a 421 percent increase, Zenith Radio 236 percent, Lockheed 130 percent and Hilton Hotels 55 percent.

Particularly large increases were reported by major oil companies, with Amerada Hess having a 258 percent increase in first quarter 1979 profits over the same period last year, Atlantic Richfield 61 percent, Exxon 37 percent, Gulf Oil 61 percent, Mobil 81 percent, Quaker State Oil Refining 253 percent, Standard Oil of Ohio 309 percent and Texaco 81 percent.



Corporate Profits after taxes in billions of dollars
Source: Commerce Department, Bureau of Economic Analysis

TABLE 9

Oil Company Profits
First Quarter 1979

<u>Corporation</u>	<u>Profits</u> <u>Percent Change From</u> <u>First Quarter 1978</u>
<u>Industry Composite</u>	+ 54%
Amerada Hess	+ 258%
Ashland Oil ^{1/}	75
Atlantic Richfield	61
Belco Petroleum	- 30
Charter	116
Cities Service	42
Continental Oil	343
Earth Resources ^{2/}	73
Exxon	37
Getty Oil	42
Gulf Oil	61
Houston Natural Gas ^{3/}	- 7
Kerr-McGee	89
Louisiana Land & Exploration	52
MAPCO	- 25
Marathon Oil	61
Mitchell Energy & Development ^{4/}	4
Mobil	81
Murphy Oil	49
Natomas	11
Occidental Petroleum	174
Pennzoil	95
Phillips Petroleum	4
Quaker State Oil Refining	253
Shell Oil	16
Standard Oil (Indiana)	28
Standard Oil (Ohio)	309
Standard Oil Co. of California	43
Suburban Propane Gas ^{1/}	19
Sun	43
Tesoro Petroleum ^{1/}	14
Texaco	81
Texaco Oil & Gas ^{2/}	15
Union Oil Co. of California	44
United Refining	142
Witco Chemical	44

^{1/} Second quarter ending Mar. 31.

^{2/} Second quarter ending Feb. 28.

^{3/} Second quarter ending Jan. 31.

^{4/} Fourth quarter ending Feb. 28.

SOURCE: Business Week, Corporate Scoreboard, May 21, 1979.

V. PRODUCTIVITY

Although overall productivity measures show a slowdown this is not true of the basic manufacturing sector. In fact, since manufactured goods make up a declining share of total output, there is a serious question about the validity of productivity measurement for the total private economy which also includes construction, finance, insurance, real estate and personal and business services.

The reliability of the productivity figures vary widely for different sectors of the economy. Manufacturing is one of the most reliable because there's normally an end product which can be counted or measured. In contrast, productivity measures are rather unreliable for services, construction, and finance, insurance and real estate. The measures for wholesale and retail trade are also less reliable than for manufacturing. And those sectors in which the measures are less reliable are the big growth areas of the U.S. economy in recent years -- raising questions about the validity of overall U.S. productivity figures. The manufacturing sector, for instance, has declined, until today it accounts for only about 29 percent of the hours worked in the private U.S. economy.

The widely bemoaned "slowdown" in productivity for the 1970s may be largely if not entirely produced by the poor measurement of output for most sectors -- and the measurement of output is much more difficult during inflationary periods when the measure of output must be adjusted for price increases.

Although the overall U.S. productivity measure shows a slowdown, there is no slowdown in the basic manufacturing sector. Manufacturing productivity increased 4.2 percent over the year ending in the first three months of 1978. For all of the 1970s, manufacturing productivity increased an average of 2.4 percent per year -- less than the 3.0 percent average of the 1960s, but the same as the 2.4 percent average yearly growth of the 1950s.

The respectable rate of manufacturing productivity growth during the 1970s came despite two back-to-back recessions and an underutilization of plant and equipment during most of the 1970s. The 1973-75 recession was so severe that it caused a 5.2 percent drop in productivity, the largest drop for any year since World War II. The recession of 1970 also caused a drop in productivity.

The decade of the 1950s also had two recessions, but neither was as severe as the 1973-75 recession. The decade of the 1960s was a long period of continuous expansion of output with only a slight slowing of growth in 1967.

Plant, equipment and manpower were seriously underutilized during the 1970s and this lessened the need for expansion, thereby slowing productivity growth. Plant and equipment utilization in manufacturing average only 81 percent in the 1970s compared to 85 percent in the 1960s and 84 percent in the 1950s.

So the recessions and low utilization rates of the 1970s make it remarkable that productivity growth in manufacturing did as well then as in the 1950s. And considering the marked difference in the economic climate, it is even more remarkable that the 1970s growth rate came so close to that of the 1960s.

In the private business sector of the U.S. economy and in the manufacturing sector, productivity growth has been as follows:

<u>Year</u>	<u>Private Business Sector</u>	<u>Manufacturing Sector</u>
1970	0.7%	- .4%
1971	3.4	5.4
1972	3.4	5.1
1973	1.9	2.7
1974	- 3.0	- 5.2
1975	2.1	4.9
1976	3.5	4.3
1977	1.6	2.3
1978	0.3	2.5
1979 (first quarter)	0.4	4.2

American workers are the most productive workers in the world. But two recessions in 1969-70 and in 1973-75, followed by excessively slow economic recoveries have sharply affected productivity growth. High unemployment and idle machines, plant, and equipment have resulted in higher unit labor costs and lower productivity.

However, the productivity of American workers is still higher than the productivity of workers in other industrial nations. And unit labor costs in the U.S.A. have gone up much less than unit labor costs in other nations.

The American worker produces 24 percent more than the German worker and 32 percent more than the Japanese worker, according to a study by the Dresdner Bank. And from 1967 to 1977, unit labor costs went up much more slowly in the U.S.A. than in such other major industrial nations as England, France, Sweden, Italy, Germany and Japan.

According to a recent Bureau of Labor Statistics study as of mid-year 1978, workers in manufacturing in four other nations were getting higher compensation per hour worked than workers in the United States. There are real problems in translating earnings in foreign countries into U.S. dollar equivalent earnings, but the BLS study shows manufacturing workers in Germany earning 11 percent more than U.S. manufacturing workers, in the Netherlands 16 percent more, and in Belgium and Sweden 20 percent more.

TABLE 10

Productivity Growth by Industry¹
1949 - 1977

	<u>Percent Change Per Year</u>		
	<u>1949-59</u>	<u>1959-69</u>	<u>1969-77</u>
Manufacturing	2.4%	3.0%	2.4% (includes 1978)
Transportation	2.9	3.6	2.3
Communication	4.8	5.0	6.2
Agriculture	6.2	5.5	4.9
Electric Gas and Sanitary Services	6.6	4.7	1.7
Services	1.3	1.9	1.2*
Finance, Insurance and Real Estate	1.6	1.2	1.2*
Retail Trade	1.8	3.0	1.3
Construction	3.0	1.9	-1.9*
Mining	4.1	4.3	-3.2

¹Data for manufacturing and agriculture are from yearly indexes. All others are from least squares trend lines.

*BLS does not consider these data to be of sufficient quality to be published separately. The data are released only as a means to aid in understanding the movements in productivity measures.

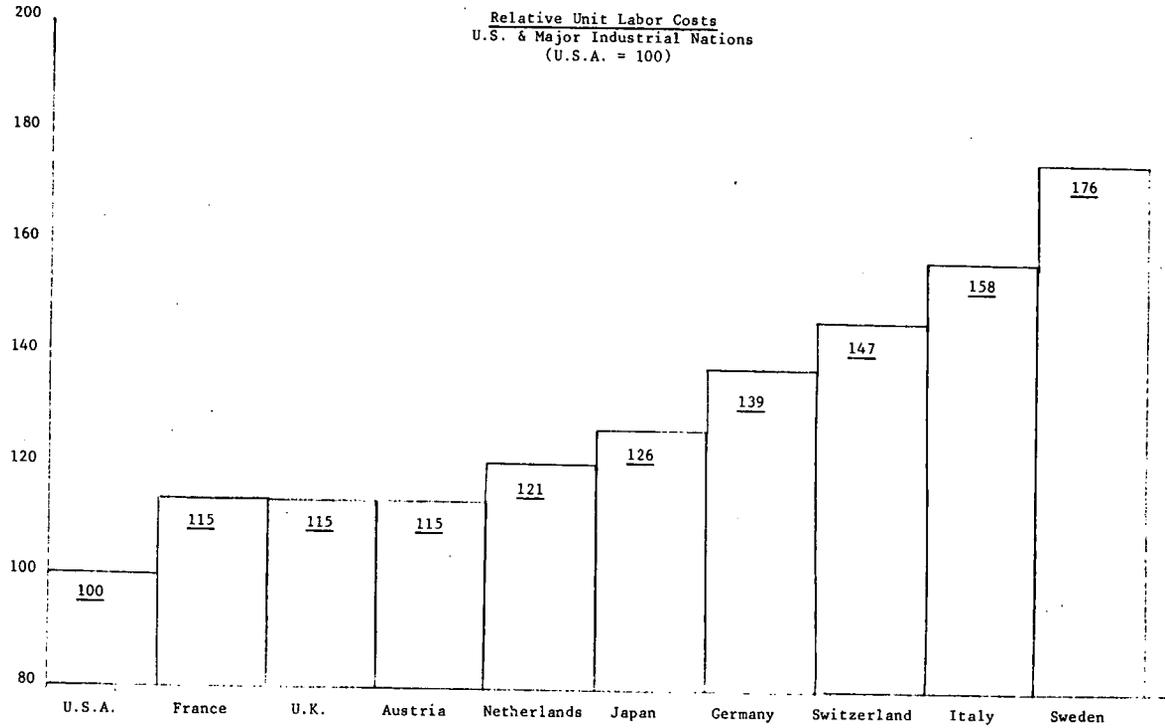
Source: Bureau of Labor Statistics

Labor Costs
Relative to U.S.
Labor Costs

44.

CHART 5

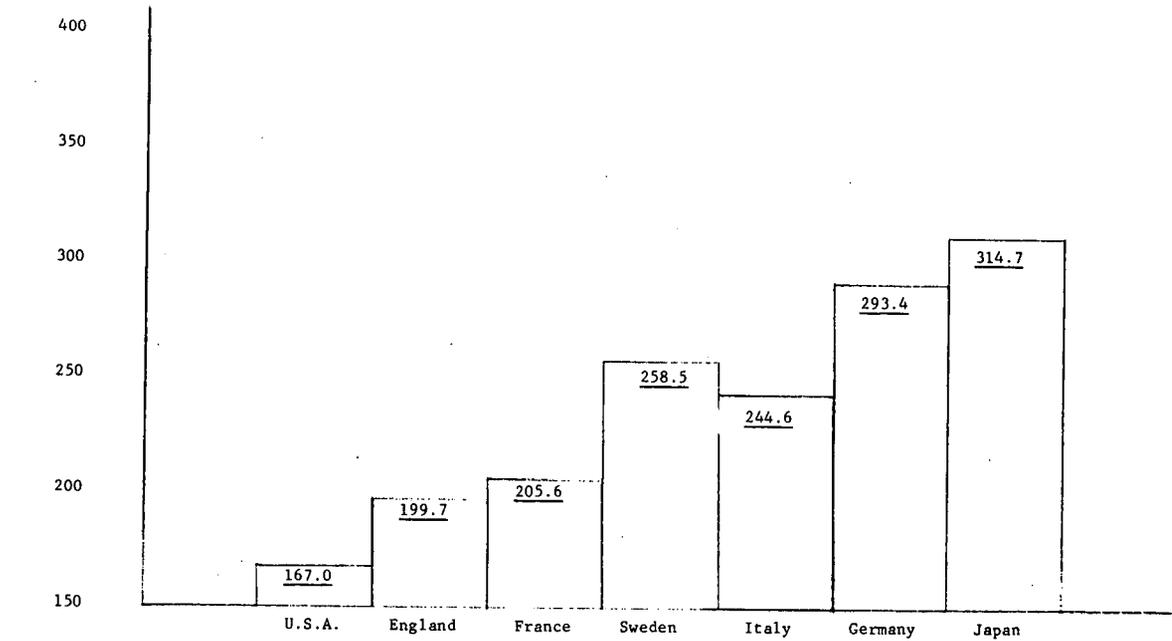
Relative Unit Labor Costs
U.S. & Major Industrial Nations
(U.S.A. = 100)



Source: Dresdner Bank
Economic Quarterly, August 1978

CHART 6

Changes in Unit Labor Costs
1967 to 1977
U.S. & Major Industrial Nations



Source: Bureau of Labor Statistics. 1967 = 100.

VI. WAGES

Wages have borne the brunt of the Administration's Wage-Price program. The policy results in substantial cuts in real earnings, with some workers suffering more than others.

No single statistic shows what is happening to wages because general wage changes in our society reflect wage changes of many different people and many different groups, but increases of corporate executives have averaged more than double that of the average worker.

In 1978 wage controls held wages substantially below the rate of price increases. The average wage rate change during 1978 in major collective bargaining settlements was 8.2 percent. This was the first year in the past four and only the third time since 1968 where the effective wage increase was less than the price increase.

Broad measures of wage and salary changes imply that more groups are receiving larger increases. The wage, salary, and other compensation gains for nonfarm employees in private industry have averaged an 8.7 percent increase in average hourly compensation in 1976, 8.1 percent in 1977, and 9.3 percent in 1978, according to the Commerce Department. This average for approximately 70 million workers includes executives, professionals, and all private blue collar and white collar employees.

When executive and supervisory employees are excluded, the rates of wage increases are substantially lower -- a 7.2 percent increase in average hourly earnings in 1976, 7.5 percent in 1977, and 8.0 percent in 1978. In April 1979, these wages were 7.8 percent above those of a year earlier. These figures represent the average hourly earnings of approximately 57

million blue collar workers, service workers, and nonsupervisory white collar workers. Their average hourly earnings amounted to \$6.04 in April 1979.

Chief executive officers received total compensation increases of 16.7 percent in 1978, according to Business Week magazine. These are chief executives of the top 800 firms and their compensation averages \$300,000 -- so a 16 percent increase was about \$48,000 for the year.

Salaries of professional employees rose more rapidly in 1978 than in earlier years. The rates for professionals rose 6.7 percent in 1976 and 7.1 percent in 1977 and 8.3 percent in 1978.

Unions that negotiated in 1978 generally settled for lower wage increases than in the two previous years. Unions negotiating major agreements in 1976 had first year average increases of 8.4 percent. In 1977 the first year average increase amounted to 7.8 percent and in 1978 it was 7.6 percent. Contracts negotiated during the first three months of 1979 had first year increases of 4.8 percent.

Union building trades' changes have been particularly modest in the last three years. During this period, wage and benefit increases amounted to 8.8 percent in 1976, 7.0 percent in 1977, 6.4 percent in 1978 and 6.4 percent in the first quarter of 1979, according to a special Labor Department survey of wages and benefits in seven basic crafts in 153 different cities.

Public employee unions have had particularly small increases. Federal employees were made the scapegoat of the Administration's fight on inflation by being held to a 5.5 percent increase in 1978 and the same 5.5 percent increase is proposed again for 1979.

Unions not negotiating in 1979 have deferred wage increases averaging 5.1 percent, identical to the 1978 level and below the average deferred wage increase of 5.9 percent in 1977.

The Squeeze on the Worker

In spite of dollar gains in the paycheck, the American worker has been losing real buying power as inflation erodes the value of increased earnings.

While the buying power of an average wage and salary worker's earnings improved modestly between 1967 and 1972, there has been a net loss since 1972.

Between 1967 and 1972, the buying power of the average nonsupervisory worker's weekly pay, after deduction of federal income and social security taxes, rose 6.4 percent. But in 1977, the average worker's pay after these deductions and after adjustment for inflation was down 2.9 percent from 1972. In 1978, a further decline of 1.4 percent took place. This downward trend worsened following the imposition of controls. By April 1979 real spendable earnings had decreased 4.5 percent from the year earlier levels.

In dollars of constant buying power (1967 dollars), takehome pay after federal taxes for an average worker with three dependents was:

Average Spendable Weekly Earnings

	<u>1967 Dollars</u>	<u>Percentage Change From Previous Time Period</u>
1967	\$90.86	
1972	96.64	+ 6.4%
1977	93.85	- 2.9
1978	92.53	- 1.4
April 1979	89.58	- 4.5 (Change from April 1978)

Source: Bureau of Labor Statistics

VII. INCOME DISTRIBUTION

Current economic policymaking ignores the fundamental need to reduce some of the sharp differences that exist in income shares. The tax bill approved by Congress in October 1978 is in direct contradiction to the notion of a fairer distribution of income and highlights the need for government policies based on fair play. According to Census Bureau figures:

- * The median income of U.S. families in 1977 was \$16,009, an amount \$1,099 below the Labor Department's Urban Wage Earner Intermediate Family Budget.

- * 80 percent of families received incomes of \$26,000 or less.

- * 60 percent of U.S. families were in the income range of \$7,903 to \$26,000.

- * The lowest 20 percent of families were in income brackets of \$7,903 and under and received only 5.2 percent of total income.

- * The middle 60 percent of all families were at income levels of between \$7,903 and \$26,000 and received 53.3 percent of total income.

- * The highest 20 percent of families were at income levels of \$26,000 and over and received 41.5 percent of total income.

- * The top 5 percent of families were at income levels of \$40,493 and over and received 15.7 percent of total income.

The Revenue Act of 1978 cuts taxes by \$21.4 billion. Of this amount, 60 percent or \$12 billion will go to corporations and individuals with incomes of over \$30,000 a year. The vast majority of the nation's taxpayers -- the 88 percent with incomes of \$30,000 and under will receive less than \$9 billion -- an average cut of less than \$150.

After paying for the Social Security tax increases scheduled for 1979, most workers will be paying more taxes, or their reductions will amount to only \$1 or \$2 per week.

The following highlights the grossly inequitable manner in which the tax cut is distributed:

<u>Income Class</u>	<u>% of Taxpayers</u>	<u>% of Tax Cut</u>	<u>Average Cut Per Taxpayer</u>
0-\$10,000	33.7%	13.2%	\$ 77
10-20,000	36.1	19.4	105
20-30,000	18.9	23.1	240
30-50,000	8.6	20.0	458
50-100,000	2.1	12.3	1,150
100 and over	.5	12.0	4,230

AFL-CIO Research Department
Based on Joint Committee on
Taxation Data

The corporate contribution to financing the federal government has dropped substantially over the past 15 years. In 1965 corporate income taxes accounted for 21.8 percent of total budget receipts and 34.3 percent of the total income taxes. Official estimates for 1979 show a drop to only 13.6 percent of total budget receipts and 23.3 percent of income tax receipts.

This means that individuals are paying a higher share of the costs of government.

Much of the fall in the corporate share is due to the addition and enlargement of tax preferences such as depreciation speed-ups, investment credits, and rate cuts. The Investment Tax Credit, for example, just made permanent in the 1978 tax law, cuts business taxes by about \$15 billion annually and is equivalent to over 20 percent of total corporate income tax.

The corporate share has also dropped because of the huge amount of tax revenue lost under the tax preferences (tax loopholes) available to U.S.-based multinational corporations.

The following table shows how the corporate share of the total income tax burden has dropped.

<u>Fiscal Year</u>	<u>Total Federal Budget Receipts (billions)</u>	<u>Total Income Tax Receipts (Corp. & Indv.) (billions)</u>	<u>Corporate Income Tax</u>	
			<u>% of Total Budget Receipts</u>	<u>% of Income Tax Receipts</u>
1965	\$116.8	\$ 74.3	21.8%	34.3%
1970	193.7	123.2	16.9	26.6
1975	281.0	163.0	14.5	24.9
1976	300.0	173.0	13.8	23.9
1977	357.8	212.5	15.3	25.8
1978	402.0	241.0	14.9	24.9
1979(e)	456.0	273.9	15.4	25.7
1980(e)	502.6	298.3	14.1	23.8

Source: The Budget of U.S., various years.

Note: 1965-1978 actual; 1979-1980 Office of Management and Budget estimates

Significantly, because of the adverse effect of the 1978 tax cut on income distribution, much of the potential job creating stimulus that would have been gained through increased consumer purchasing power will be lost. As a result, the key element in fighting inflation -- a balanced and fully employed economy -- is thwarted.

VIII. PRICE AND WAGE GUIDELINES, AN UNFAIR PROGRAM

The Administration's wage and price program is a one-sided wage control program with no appropriate procedures for redress of injury to workers, and with many workers harmed by the wage standards themselves. It proceeds from the mistaken notion that wages are the cause of the current inflation. It fails to deal with many of the major factors influencing inflation, particularly price inflation in the necessities of life -- food, energy, medical care, housing and interest rates.

The Administration's program exempts many types of price changes. It sets a precise measure for wage changes, but a vague standard for prices. It basically ignores profits, dividends, rents and interest.

The price guidelines do not even cover all items -- and indeed they do not even pretend to control the major causes of inflation. Additionally, the basic price deceleration guidelines allow those who raised prices the most in the past two years to profit further from that conduct.

For wages there is a single 7 percent number, easily remembered, widely publicized, applicable across-the-board, enforced by every employer in the country, from multi-billion dollar corporations to the individual firm employing only a single worker.

The 7 percent is a maximum applicable to every employee unit. Not every unit will receive as much as 7 percent, but none may get more. The wage controls are self-enforcing -- through the mechanism of employers anxious to cooperate with the government in holding down their employees' pay. There is no flexibility as far as wages are concerned.

The price guidelines are a striking contrast. There is no single number. Coverage is not universal. There is no self-enforcing mechanism of organized resistance to price raises. Enforcement mechanisms are partial at best, and largely dependent on government's ability and willingness to dispense or withhold favors through regulatory and procurement contract mechanisms. This machinery has no basis in law and, in fact, constitutes a control program by indirection in the face of congressional action denying the Executive Branch the authority to institute controls.

The general public has no way of knowing whether particular price increases -- no matter how large -- are in compliance or not. Because allowable rates of price increase are computed on the basis of individual company price histories, never before compiled and not on the public record, the individual citizen has no means of making an independent check on compliance. Wide latitude is allowed for price increases on particular product lines and particular products, and there are alternative methods of testing compliance other than through price deceleration.

There are actually several price guidelines in addition to the originally announced "price deceleration" guideline, and there are a number of important exclusions even from the price deceleration guidelines. Additionally, companies are allowed considerable flexibility in the choice of their accounting methods and in whether to report as a single company or as separate units within a single company.

Finally, and perhaps most importantly, there are certain situations in which no restraint applies. Essentially excluded, for all practical purposes, are the four basic necessities of life for the average family -- food, housing, energy and medical costs. Thus there is little or no attempt to hold down prices on the items no family can do without.

The 7 percent wage control figure lacks any conceptual basis. It is simply an arbitrary number.

Wage increases are normally based on many factors -- increases in the cost of living including increased tax burdens, securing an appropriate share of productivity gains, maintenance of comparability with other workers, the employers' profitability, and other factors.

In one way or another, all previous U.S. mandatory wage control programs took these elements into consideration. The present program does not.

The 7 percent wage guideline produces a reduction in real wages under the current inflation rates of 11 to 12 percent. No previous control figure or guideline under earlier programs required a reduction in real earnings. In fact, earlier programs established wage guidelines well above the rate of inflation, taking into account productivity gains as well. During World War II and the Korean War control periods, wages were permitted to increase in line with changes in the cost-of-living. During the Kennedy era, a wage guideline of 3.2 percent was established when the rate of inflation was 0.7 percent. The Kennedy era guideline gave full recognition to productivity increases. During the Nixon controls, the 5.5 percent wage standard was set when the rate of inflation was 4.0 percent, and that guideline allowed an extra 0.7 percent increase for fringe benefits. This guideline took into account both the rate of inflation and the growth in productivity. Previous programs allowed special consideration for improving fringe benefits. This program does not.

This program ignores many of the recognized equitable exceptions granted under earlier control programs. It is a rigid plan that fails to recognize the realities of the wage and salary determination process.

Worst of all is the heavy burden placed upon low-income workers. The exemption level of \$4.00 an hour leaves most low-income workers restricted to a 7 percent increase even though the prices of necessities on which they must expend nearly all their meager income are rising at a rate nearly double the allowable wage increase.

IX. PRICE AND WAGE IMPACT OF THE WAGE/PRICE GUIDELINES

The wage and price guidelines have not reduced the rate of price inflation or the level of profit increases during the six-month period since this program was announced in October 1978. On the contrary, both the rate of price and profit increases have accelerated. However, wage increases have been effectively held to the previous rates of increase. The result is that the real buying power of wages has been reduced.

A. Consumer prices are rising substantially faster since last October than they did in the immediate previous period. In the past six months (October to April 1979), the Consumer Price Index rose 11.9 percent at an annual rate, in contrast to the 9.4 percent annual rate of inflation in the six months ending in October 1978.

Consumer Price Index
for Urban Wage Earners and Clerical Workers

Seasonally adjusted annual rates of change:

Six months ended October 1978	9.4%
Six months ended April 1979	11.9%

Source: Bureau of Labor Statistics

B. Wholesale prices (Producer Price Index: Finished Goods) are increasing faster now than prior to October 1978. In the latest six months (October to April 1979) the Producer Price Index rose at a 12.2 percent annual rate. In the six months ending in October 1978, this same index showed wholesale prices rising at an 8.4 percent annual rate.

Producer Price Indexes
(Seasonally Adjusted Annual Rates of Change)

<u>Finished Goods</u>	<u>Annual Rate</u>
Six months ended October 1978	8.4%
Six months ended April 1979	12.2%

Source: Bureau of Labor Statistics

C. Profits are also rising at a very rapid rate, with profits before taxes increasing 26 percent in the fourth quarter of last year, compared with the same quarter in 1977. This compares to profit increases of 4 to 17 percent earlier in the year. In the first quarter of 1979 profits were 32 percent above the level of the first quarter of 1978. After tax profits rose even more rapidly in the six months following the guidelines. In the six months prior to the guidelines, after tax profits showed a year-to-year change of 14 to 17 percent. But in the last six months, after tax profits had year-to-year gains of 25 percent in the fourth quarter of 1978, and a 35 percent gain in the first quarter of 1979.

Corporate Profits
(Seasonally Adjusted Annual Rates)

	<u>Profits Before Tax</u> (Billions of Dollars)			<u>Percent Change</u> <u>1977 to 1978</u>	<u>Percent Change</u> <u>1978 to 1979</u>
	<u>1977</u>	<u>1978</u>	<u>1979</u>		
Q 1	\$164.8	\$172.1	\$226.9	4.4%	31.8%
Q 2	175.1	205.5		17.4	
Q 3	177.5	205.4		15.7	
Q 4	178.3	224.9		26.1	

	<u>Profits After Tax</u> (Billions of Dollars)			<u>Percent Change</u> <u>1977 to 1978</u>	<u>Percent Change</u> <u>1978 to 1979</u>
	<u>1977</u>	<u>1978</u>	<u>1979</u>		
Q 1	\$ 96.5	\$102.1	\$137.9	5.8%	35.1%
Q 2	102.8	120.5		17.2	
Q 3	104.8	119.2		13.7	
Q 4	104.4	130.5		25.0	

Source: U.S. Department of Commerce

D. Average weekly earnings of some 58 million production and non-supervisory workers in private industry (nonfarm) increased at an annual rate of 4.7 percent in the latest six-month period (October to April 1979) substantially slower than the 6.5 percent rate during the six months ending in October 1978. Since hours worked per week have dropped, weekly wages have increased less rapidly than average hourly earnings. Average hourly earnings show little increase in the rate of change as hourly earnings

are rising at a 7.7 percent annual rate during the last six months in comparison to a 7.5 percent rate of change in the six months ended October 1978. After adjustments for inflation, the real buying power of a worker's wages are being eroded sharply as consumer prices are rising at an 11.9 percent rate.

Wages of Production Workers on Private Payrolls

Seasonally adjusted annual rates of change:

Average hourly earnings:

Six months ended October 1978	7.5%
Six months ended April 1979	7.7%

Average weekly earnings:

Six months ended October 1978	6.5%
Six months ended April 1979	4.7%

Source: Bureau of Labor Statistics

E. Union-negotiated wage settlements have not accelerated during the two quarters since the Administration's new program was announced. The wage increases average less than 7 percent in major contracts covering 1,000 or more workers. Increases in wages and benefits combined are less than 6 percent in contracts covering 5,000 or more workers.

Quarterly Wage and Wage and Benefit Adjustments,
First Quarter 1978 to Date (In Percent)

	1978				Average, or	1979
	I	II	III	IV	Total ^{a/}	I

Settlements:

Wage-rate settlements
(1,000 or more workers):

First-year adjustment	9.2%	6.9%	7.5%	7.4%	7.6%	4.8%
Average annual change over life of contract	7.1	6.2	6.4	5.9	6.4	6.6

Wage and benefit settlements
(5,000 or more workers):

First-year adjustment	13.2	6.8	7.2	6.1	8.3	2.5
Average annual change over life of contract	8.2	6.0	5.9	5.2	6.3	5.2

a/ Wage and wage and benefit settlements are annual averages.

Source: Bureau of Labor Statistics

F. Real Spendable Weekly Earnings are falling much more rapidly during the last six months than they had in the six months prior to October. While the average production worker's weekly wage was being eroded prior to the guideline program, the situation worsened substantially during the last half year. The average weekly earnings of production or nonsupervisory workers adjusted for the effects of inflation and taxes was dropping at a $\frac{3.6}{3.2}$ percent annual rate in the six months ending in October 1978. By April 1979 the six month rate of loss in real earnings amounted to $\frac{7.3}{5.5}$ percent.

Real Spendable Average Weekly Earnings

Seasonally Adjusted Annual rates of change:

Six months ended October 1978

$\frac{3.6}{3.2}\%$

Six months ended April 1979

$\frac{7.3}{5.5}\%$

Source: Bureau of Labor Statistics

Senator MCGOVERN. Mr. Alperovitz, who is next?
Mr. ALPEROVITZ. I am.

STATEMENT OF GAR ALPEROVITZ, CODIRECTOR, NATIONAL CENTER FOR ECONOMIC ALTERNATIVES, WASHINGTON, D.C.

Mr. ALPEROVITZ. Senator McGovern, yesterday some 2,000 or 3,000 people met in a national teach-in, bringing together the leadership of some 70 organizations representing virtually all the major consumer groups, most of major labor, senior citizen, environmental, and minority groups, to discuss this issue. I think the one fundamental conclusion that we can state—and we think it's the essential beginning point—is the same position we took in a meeting with President Carter in late December and in several meetings with Alfred Kahn, Mr. Bosworth, Charlie Schultze, and Mr. Eizenstat.

It is that unless the problem of sectoral inflation is addressed directly, there will not be relief from inflation. I want to repeat that: Unless we deal with these sectors, inflation will not be controlled. This is a position which I believe Secretary Marshall enunciated over 2 years ago within the administration. The President, 1 year ago in April, said he would address sectoral inflation. He said the same thing in August—that he would do something on this subject. Very little has been done.

Let me underscore why we believe this must be the starting point, and go on to the solutions we think make sense.

First, I want to take the unadjusted data this year, and look at what the family actually experiences in America. In focusing on the prices of foods, energy, housing, and health care, we are talking about 60 to 70 percent of the expenditures of four out of five families. The data for those at the bottom of the income ladder are too poor to tell precisely what this portion spends its money on, but we know it's mostly food, housing, drive-to-work gas and heating oil, and medical care.

In the first 5 months of this year, the annualized rates of inflation were: Food, 17.1 percent; shelter, 14.1; medical care, 9.2; and energy, 37.1 percent. Those four sectors taken together, as Mr. Oswald said, run somewhere in the range of 17 to 17½ percent. They were fully 10 points ahead of the rest of the economy. In other words, there was a 10-point spread between those sectors and the remainder of the economy.

In each of the sectors, there are specific problems causing inflation. We are not in an excessive demand-pull inflation in general. We are not in a situation where wages are pushing up energy prices. There are specific, long-term sectoral problems that will not go away unless we address them. These sectors are fueling the ongoing inflation and have been for almost a decade. Moreover, the pressures which will build up, in our judgment, will continue unless we deal with them directly.

For this reason, unless the specific sectors are addressed, there is no way to solve the general inflation problem. Another way to underscore that is to consider the variety of traditional, widely discussed approaches to curing inflation to see whether they have any prospect of giving relief to American families.

First, cutting the budget, the most popularly discussed proposal. The Congressional Budget Office calculated, in January of this year, that if all of the Carter administration's proposed budget cuts were approved, the change in inflation would be a mere one-tenth of 1 percent over 2 full years. That is, absent further OPEC problems, absent further food problems. They have a very marginal effect.

Cutting the health, safety, and environmental regulations is another much discussed proposal. Mr. Bosworth reckons that 0.7 percent of the overall CPI is the total effect of all the regulations. So, if you got rid of all of them, which is patently absurd in the days where Three Mile Island and DC-10's are exploding, the best you could have would be a marginal effect on our 13.8 percent inflation.

Finally, a major proposal—and I'm frightened to say it's a growing consensus in the country—is to slow the economy and produce a recession. We are in a recession. We are going deeper into it. But whether that will cure the new sectoral inflation is extremely questionable.

Arthur Okun surveyed a variety of studies on this subject. His broad conclusion about the impact of a recession on the current kind of inflation could be summed up in the following way: 1-percent drop in employment sustained for 3 full years is roughly what it takes to knock 1 percent off the underlying inflation rate. Three full years of a 1-percent increase in unemployment to knock a point off the underlying rate.

I remind you we are experiencing a 13.8-percent rate of inflation. Consider what sort of depression it would require to cut down some of the inflationary pressure off that high a rate. It won't work. In my judgment, what is required is so far beyond the pale, politically, as to make the proposal irrelevant as a serious solution to the new kind of inflation problem. It is obvious why this is so when you consider the key sectors.

Cutting the budget will do virtually nothing to change skyrocketing energy prices when our own Government is aiding and abetting and furthering the rise in energy costs. Moreover, there is virtually no significant labor cost in most of the energy price increases we have seen. You can cut wages drastically in energy, and as long as current policy continues to raise prices, we will continue to see sky-rocketing prices in energy.

I won't go further into that sort of illustration, but it does suggest that the key issue is the specific nature of the problem in each sector. Unless it is addressed directly, there can be very little hope for relief in these sectors.

The COIN organization, which brought together these 60 to 70 groups, recently issued this report entitled "There Are Alternatives." Our major premise is, if the Government wished to take action, it can, in fact, deal with both the short- and long-term problems in these sectors.

There is no mystery about what needs to happen, and there is a great deal of expert research available on this, and on other aspects of food, energy, housing, and health care programs. We have brought together a compilation of proposals in this area which we believe make sense, and we will talk about them briefly and submit testimony at great length on them. But I think the answers are evident.

We need to deal differently with the energy policy—to bring down prices, and expand alternative sources, and free ourselves from OPEC. We need to expand the supply of housing to deal with the fact that the baby boom is now a family boom. We need to bring rationality and cost-cutting into the medical care and distribution system. Finally, we need both to bring rationality into many parts of the distribution, processing, and production parts of the agricultural and food industry, and above all to prevent another Russian wheat deal from jolting the economy.

These are long-term programs. We are realists in the sense that we see none of this can change the fundamental rates of inflation unless we deal with the problems over time. Therefore, we have offered some temporary transitional proposals with a view to breaking the momentum of the current inflation.

They make sense to us, because of the mess we are in, as a way to halt some of the current inflation. But they are only transitional to the fundamental reforms. They might give us some relief and some time to move on to the longer-term work.

In this context, the four major proposals we have isolated which we think could bring around 2½ to 3½ percent change in the CPI over an 18-month period; depending upon how far they are implemented are: First, maintaining basic controls on energy prices; second, hospital cost containment; third, proposals, which we believe are within the President's authority, to lower the interest rate component of moderate- and low-income housing, this would also significantly impact the consumer price index and help break the momentum; and finally, a series of proposals for selective short-term, anti-inflationary rebates in the food sector, which might bring some relief to jolt food prices down in the short term; and, as we go into the recession, this could also help stimulate the economy by providing consumers with additional spending power.

We will be happy to explain these proposals and to answer questions. They are taken up at some length in our proposals.

The final thing I would like to say by way of introduction is that in meetings with the President in December, and more recently with Mr. Eizenstat, we suggested the following scenario: Over the next 3 or 4 months, the economy will slide, in our judgment, into a severe beginning point for a major recession. It will also—and OPEC will tell us more about this today—be likely to experience increased energy inflationary pressures—with the prospect also of further food inflation in the early 1980's, if what seems to be happening on the international grain markets is an accurate indication.

So we have a prospect of deepening recession and ongoing inflation, as we approach to a primary and election year. In that context, we believe the current stalemate within the administration and within the country, the essentially do-nothing failure of this administration, will be broken, one way or another.

The current direction is further recession and further holding back on major proposals. We believe there is a vast moral and economic constituency which favors giving priority to new methods of controlling inflation in the things that matter most to most families—the necessities of life.

So we think that in that context, some of the proposals here discussed will make sense both economically, to break the momentum, and politically and morally, as a way that we can stop the wondering dynamics in the inflationary spiral—and thereby open the way to more growth in the economy. So it's in that context that we believe there may be a very real possibility over the next few months for some of the more innovative proposals.

Mr. Mohn is with us today. He has taken time from the senior citizens conference which hosted us yesterday, and must be back there, so we would first like him to talk about the health-care problem.

STATEMENT OF EINAR MOHN, FOURTH VICE PRESIDENT, NATIONAL COUNCIL OF SENIOR CITIZENS, WASHINGTON, D.C.

Mr. MOHN. Thank you.

I'm a Californian and have been an active trade unionist all my life; retired now. I joined the most active group of citizens in the country; that is, the senior citizens.

I'm talking about health care and some of the problems that are not new. They have been with us for many, many years. I can remember negotiating the first agreement with the employers that carried with it an insurance policy for health care. I think we paid at that time about something like \$3.50 or \$4 a week for that policy. Today we are paying \$125 to \$130 or \$140 a month for a health-care policy which at the very best provides for 50 percent of the cost to the family that is insured of what it costs them for health care.

I have not been a strong believer that the Federal Government is the cure-all for all our problems. I still don't believe that that is so. It shouldn't be so. I fought very hard to try to get some cooperation between the various segments of the health-care industry, the doctors, the hospitals, and certainly the insurance carriers who had a very selfish, perhaps, and big stake in the problem of health care, and that didn't work.

We have tried now in California for the last 6 years specifically to pass some legislation, and we are noted for having a rather liberal legislature in California. Every health bill that has been presented of any consequence has been defeated.

Now, I don't know if that is because the people who represent the health-care industry and the insurance carriers are so much smarter than we are, or whether they have so much more money than we have, that they get these results, but anyway, we have been defeated. So I had to give up, very reluctantly, the idea that we have to turn over to the Federal Government the operation of some system, some cover-all system of health care in order to take care of the problems that surround it.

Because health care is something that is not a luxury; it is a basic item. And as you get older, unfortunately, you need more and more health care. Medicare was a big step in the right direction, but that has some serious faults, and some of those faults are really beginning to hurt.

The question of drugs today, sustaining drugs for elderly citizens, is a very serious and very costly question. One of the biggest disgraces we

have in this country is long-term care for the elderly. It ought to be something the Federal and State Governments ought to really get into in a very active, serious way to correct. The costs have gone up and up.

The cost of health care far exceeds the inflationary factor that is dealt with in all the other sectors of our economy. There should be no real good reason for this.

In this country we are overbedded at least by 40 percent of hospital beds. You don't save any money by shutting down a ward or a floor in a hospital. You have to find some way, some means of converting excess hospitals into some other useful purpose. That is not an easy thing to do, either economically and, we have discovered, practically impossible to do politically, in the community.

So those are just some of the factors. It's hard to get people aroused over this question. Maybe what we should do is hold hearings on this question of health care in some of the inpatient and outpatient parts of a large hospital in an inner city. Here in Washington, really, you don't have to go very far to see the effects of the lack of good health care.

The environment is certainly one of the big factors. The needs of the people, as far as nutrition is concerned, is a big factor. You could practically look out the window out of this very comfortable room we are meeting in and see some of the very bad effects of a health care system that does not take care of the needs of its people.

We don't have an easy solution for this. We are supporting, as the National Council of Senior Citizens—and I think, the general public—a survey taken in 1974 by the Harris poll showed that overwhelmingly—by at least 50 percent or more—the citizens of this country were ready to accept a national health care system, in spite of all the hue and cry of the medical profession that this was something that was going to lead us down the road to socialism or some other thing that was bad for our country.

You see, this is one of the places where the consumer has nothing in the world to say about what it's going to cost him. In some situations, the consumer may withhold his purchasing and have some effect—perhaps not great, but some effect on any choices he makes. Once you come under the care of a physician, from that point on, they determine what is going to be done with you, how it will be done, and what it is going to cost. There is no limit to what that can entail.

The cost containment bill that is now here in the Congress deals with hospitals. You can't control the costs of health care if you leave out the most important factor of all, and that is the physician, because the physician determines what you cost is going to be in the hospital. The balance of the cost is relatively not too great. It's all the procedures and drugs he requires that will make it a costly item.

We certainly urge that one of the things this Congress has to seriously consider and come to grips with is a universal health care system that is going to take care of all of its people without becoming a class system that gives to those that have plenty, more, and takes away from those that have little, more.

We senior citizens are going to really get out on the campaign trail. We are not going to be concerned about whether people are Democrats or Republicans. We will try to find out, if we can, from people

how they will stand on this issue. It's a big issue, this whole fight against inflation; a tremendous issue, and it's going up faster than any other segment of the costs to our people, is health care. That is our problem, Senator McGovern.

I would like to have an invitation to come back, and I would be willing to sit still and not say anything for 10 minutes, to hear a report from the Congress that you have solved at least some of these problems.

Thank you.

Senator McGovern. Thank you.

[The prepared statement of Mr. Mohn, together with a report entitled "There Are Alternatives," follows:]

PREPARED STATEMENT OF EINAR MOHN

Senator and Members of the Committee, good morning. I am Einar Mohn, a Vice President of the National Council of Senior Citizens, and recently retired 1st Vice President and Director of the Western Conference of Teamsters. I am presently serving as Chairman of the Advisory Council of the California Commission on Health Facilities and have been involved in health issues both in my own State of California and nationally for decades.

Today, I am testifying on behalf of the National Council of Senior Citizens. The National Council is a nonprofit, nonpartisan organization, made up of over 3,800 senior citizens' clubs across the Nation, representing more than three million members. I am also testifying on behalf of Consumers Opposed to Inflation in the Necessities (COIN).

My friends, the savage consequences of inflation on the quality of life of the average American family is nowhere so well exemplified as in the area of health. Not only is health care a basic necessity, but it is also a basic human right which is increasingly being denied to people because of the enormous barrier to access created by medical inflation.

The health care system actually accounted for over \$200 billion last year, making it the Nation's third largest industry. The more money available to it, the more it will gobble up. Controls are nearly nonexistent.

Inflation in the health care sector is not new, nor is it, as is often cited, the product of the large increase in the number of third-party payers, including the enactment of Medicare in 1966. The fact is, for the decade prior to Medicare and symbolizing the need for Medicare, inflation in the health care sector of our economy outstripped general inflation by nearly three to one. Nor is inflation in the cost of health care the product of increased demand for services.

To understand the health care system, one must understand the major economic forces at play in this sector. Unlike the typical marketplace transaction, where decisions are made by the consumer in the medical marketplace, once the consumer makes the initial decision to enter the delivery system, all subsequent decisions are made almost exclusively by the provider of care.

Indeed, our current health care delivery system is governed the providers of medical care. The consumer of health care, upon entering this system, is passive. Diagnosis, prognosis and prescriptions are not negotiable items, nor is price.

Long past due is the need for the health care sector of the American economy to conform to the performance of the rest of the economy. A government which asks its people to tighten their belts cannot at the same time tolerate an entire sector of the economy operating without any constraint. The facts and figures are clear. Inflation in the health care sector far out-strips and has consistently out-paced general inflation in the economy as a whole. Indeed, general inflation is being pushed by health care inflation.

Any doctor who would diagnose medical inflation in any other way confirms the need for second opinions. Similarly, a prescription which would phase-in national health insurance contingent on the health of the rest of the economy is surely bad medicine and its authors prime candidates for malpractice.

The financing system based on cost plus accounting is nothing other than a blank check reimbursement policy. Retrospective budgeting by the medical establishment does nothing to encourage efficiency. If you and I were reimbursed by this method for all our personal health care expenses, the cost of health care

would be of concern only to the insurers, not to the consumers of health. As it is, nearly all private and public health insurance pays only a portion of the charges.

These gaps in health insurance coverage tend to encourage high intensity expensive medical and discourage preventive health care by creating financial incentives toward inappropriate utilization of services. The system today ultimately protects providers, not consumers.

Catastrophic health insurance, providing incremental additions to existing health insurance, even if sweetened by measly improvements in Medicare, will increase inflation in this sector and do little to protect those persons most in need of protection.

Catastrophic health insurance:

Does not cover long-term care in health related facilities or intermediate care facilities, the primary "catastrophies" for the elderly and disabled.

It does not cover out-patient prescription drugs, dental care, mental health or medical appliances or devices.

It does not control costs nor encourage efficiency.

It does not remove barriers to health care.

It does not cover preventive care—it provides incentives toward expensive, high technology and institutional care.

It does not limit the amount of out-of-pocket health care expenses, i.e., it does not limit liability.

It does not improve existing quality controls.

It does not improve availability of care in the inner cities or rural areas.

It does not deal with the problems of excessive hospital bed capacity, unnecessary surgery, maldistribution of physicians by specialty and geography, and duplication of equipment.

It does not support or encourage Health Maintenance Organizations. In fact, it will disadvantage HMO's.

It does not improve or encourage utilization controls.

It does not help the ten million people living below the poverty line who are not on Medicaid. In short, it does not take into consideration the ability to pay, and offers no protection" for those who need it most.

And, finally, catastrophic health insurance would virtually end chances for a truly universal and comprehensive health care program. And that, my friends, would be the biggest catastrophe of all. For only a proposal which addresses these problems and only a proposal which addresses the desperate need to control health care costs is worthy of support. Not until a universal comprehensive national health insurance program is in place will this nation be able to afford good quality health care for all its people. And not until a universal comprehensive national health insurance program is in place will the American people be assured, as a matter of right, that good quality health care will be both available and accessible to all, regardless of the ability to pay.

There Are Alternatives

A Program for Controlling Inflation
in the Necessities of Life

COIN

Consumers Opposed to Inflation in the Necessities
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THE COIN CAMPAIGN

Public Citizen
 Consumer Federation of America
 National Council of Senior Citizens
 Explanatory Project for Economic
 Alternatives
 Environmental Action
 International Association of
 Machinists
 International Union of Operating
 Engineers
 National Consumers League
 Community Nutrition Institute

Acan
 Actor's Equity League
 AFL-CIO
 Alabama Consumers' Association
 All Indian Pueblo Council
 Americans for Democratic Action
 California Public Policy Center
 Campaign for Economic
 Democracy
 Center for Auto Safety
 Center for Science in the Public
 Interest
 Citizen Action Coalition
 Citizen Action League
 Coalition of American Public
 Employees
 Commission for Racial Justice,
 United Church of Christ
 Committee for National Health
 Insurance
 Connecticut Citizen Action Group
 Consumer Action Now
 Consumer Coalition for Health
 Consumer Energy Council of
 America
 Democratic Socialist Organizing
 Committee
 Energy Action
 Environmentalists for Full
 Employment
 Food Research Action Council
 Friends of the Earth
 International Chemical Workers
 Union
 Maryland Citizens Consumer
 Council
 Massachusetts Public Interest
 Research Group
 Missouri Citizen Action
 Missouri Public Interest Research
 Group
 Movement for Economic Justice/
 Jobs and Justice
 National Center for Black Aged
 National Citizens Communication
 Lobby
 National Education Association
 National Gray Panthers
 National Urban Coalition
 National Urban League
 National Women's Political
 Caucus
 Network
 Newspaper Guild
 Oil, Chemical and Atomic Workers
 International Union
 Operation PUSH
 Rural America
 Senior Citizens Law Center
 Service Employees International
 Union
 Sheetmetal Workers International
 Association
 Shelterforce
 Union of American Hebrew
 Congregations
 United Association of Journeymen
 and Apprentices of the Plumbing
 and Pipefitting Industry
 United Auto Workers
 United States Catholic Conference
 Urban Bldg. Coalition
 Urban Environment Conference
 Virginia Citizens Consumer Council
 Women's Equity Action League

Rising prices for the necessities of life—food, energy, housing and health care—are seriously eroding the standard of living of most American families. The vast majority of all Americans spend nearly 70 per cent of their income on these four sectors—sectors that have suffered a 10.8 per cent annual inflation rate in 1978.

This silent tax devastates most consumers, but where is the consumer voice in the inflation debate?

The necessities of life are not just an economic issue, they are a moral issue.

That's why 60 consumer, environmental, senior citizen, racial minority, religious, women's, low-income and labor organizations have joined to create Consumers Opposed to Inflation in the Necessities (COIN). THE COIN CAMPAIGN will be a voice of consumers for all of us—housewives, small business representatives, professionals, white- and blue-collar workers, the jobless. It will be an ongoing effort to propose, discuss and put into practice significant economic reforms that can substantially stabilize the prices of the basic necessities of life—food, energy, housing and health care. We will study and publicize prices, issue studies, prod the government to take action, expose inflationary business practices, and seek public understanding of the true causes of inflation in the necessities.

And we will challenge self-serving business propaganda that for too long has distorted and dominated public debate on this issue. We have all heard the Big Business Catechism: Inflation is caused by government. Inflation is caused by health and safety regulations, social security, a jobs program, modest salary and wage increases aimed at catching up with prices. These formulations manage to confuse the victims of inflation with its causes.

But workers, consumers, environmentalists, the elderly, and minorities will not perform as convenient scapegoats for the special interests. THE COIN CAMPAIGN intends to end this monologue and begin a public dialogue—a dialogue on what to do about inflation and on what the role of government should be in the economy.

We will expose who is truly responsible for high food prices, rising utility and fuel bills, escalating hospital charges, and the unacceptably high interest rates and mortgage payments people now pay to achieve even minimal shelter for their families. The issues of corporate overcharges, extensive price-fixing, corporate subsidies and the long-run health savings of environmental standards—so crucial to the inflation debate yet so neglected—will be explored and exposed.

The groups that comprise this consumer campaign understand that we cannot solve the problem of inflation overnight. The effort will take the active participation of citizens, government and business. THE COIN CAMPAIGN intends to be a strong consumer voice in this ongoing process. In this context, we will try to be catalysts for solutions. The proposals we will discuss for curbing inflation are not exhaustive. And not every COIN participating group supports all of them. We expect to build upon the work of thousands of citizens and consumer groups around the country who are already working to reduce utility rates, establish less expensive ways of marketing food, provide good health at reasonable prices, and build, rebuild and prevent profiteering on housing. We will mobilize the vast majority of American people who are hurt by inflation to create an economic system that can supply the necessities of life to all our citizens at substantially stable prices.

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Introduction: The New Inflation

Consumers Opposed to Inflation in the Necessities (COIN) is a group of 69 organizations--representing consumers, senior citizens, labor, environmentalists, women, minority, religious groups and others--working together to fight rising prices of the basic necessities: food, housing, medical care and energy. We have chosen these areas as priorities for three specific reasons:

1) These are the most important areas for most families. Four out of five American families spend between 60 and 70 percent of their incomes on these four items alone.

2) It is in these areas that current inflation has been overwhelmingly concentrated: The annual rate of inflation in these four sectors taken together was 17.2 percent in the first four months of 1979, while the rest of the economy was at 7.1 percent.

3) Finally, and relatedly, it should be obvious that overall inflation cannot possibly be addressed unless inflation in the four sectors is stemmed directly.

Over the past nine months, task forces made up of COIN members have developed recommendations to control inflation in each of these four sectors of the economy. This report is designed to explain why targeted reforms in the necessity sectors are an appropriate response to the new inflation and to outline steps, both immediate and long-term, which can be taken to stabilize or bring prices down in the key areas. Although the policy options offered here do not necessarily reflect all the specific

positions of every member of COIN, they are consistent with COIN's statement of principles (see cover page). We regard this report as a beginning point for new policy, and look forward to additional suggestions to bring basic necessity inflation under control.

Like the overwhelming majority of Americans, COIN believes that inflation is one of the most serious problems facing the nation today. It is eroding the living standards of most families. The average worker's hourly wage bought less in 1978 than it did in 1972. It is creating even greater hardship for the poor and the elderly. They are forced by inflation to choose between food and heat, as government programs which could help them cope are slashed by politicians in the name of fighting inflation. Basic necessity inflation is both an economic and a moral problem in our nation. And it is undermining efforts to solve other pressing national problems, especially unemployment.

Last year the Consumer Price Index (CPI) rose 9.0 percent. In the first four months of this year, it was rising at a 13.3 percent annual rate. Current economic policies offer little prospect that these numbers will be reduced substantially in the foreseeable future.

These facts have led some policy-makers to virtually give up on government efforts to fight inflation. "As we look ahead for the next year or two," says Barry Bosworth, Director of the President's Council on Wage and Price Stability (COWPS), "all we see is that the real income of the factory worker is likely to decline." Presidential inflation advisor Alfred Kahn believes there is "not a hell of a lot" the government can do about rising prices. "There is no way we can avoid a decline in our standard of living," Kahn claims. "All we can do is try to adapt to it."

COIN rejects this viewpoint. It is a confession of impotence in the most powerful economy in the world. Self-evidently, the government's policies have failed to curb inflation. That hardly means that the fight should be abandoned. COIN believes that the American people, and their

government, have it within their capacity to slow the rising cost of living--but only if new policies are adopted which deal with the fundamental causes of the new inflation.

What's causing inflation?

Answering that question correctly is obviously at the heart of designing an effective anti-inflation program. The answer can be found by reviewing carefully which prices have risen faster and more consistently than the average, and why.

Looking at prices over the past six years, the period during which inflation has become a severe and seemingly intractable problem, four sectors of the economy stand out--food, housing, health care, and energy.

From 1973 through 1978, food prices rose an average of 9.7 percent each year. Housing costs rose an average of 8.3 percent. The costs of health care increased at a 9.2 percent average annual rate. And energy prices rose an average 11.9 percent per year. And in the first four months of this year, food prices rose at an annual rate of 18.7 percent, housing rose 13.8 percent, health care went up 9.9 percent, and energy prices rose at a 31.2 percent annual rate.

The critical role of the necessities in overall inflation is confirmed when we compare them to all the other goods and services that the average family buys. From 1973 through 1977, prices of the combined "non-necessities" rose an average of only 6.4 percent per year. In contrast, the prices of necessities rose 9.1 percent per year, over forty percent more rapidly.

The gap has been widening between these sectors and the rest of the economy. Last year, for example, necessity prices rose almost two-thirds faster than non-necessity prices. And in the first four months of 1979, necessities have been going up at well over twice the rate of non-necessities.

Clearly, rising prices for necessities are the "heart" of inflation. For four of every five American families the basic necessities take 60-70 cents of every budget dollar, and even more for the poor and the elderly. These are purchases that can't be postponed--when things get tight we can do without that new sofa but we get evicted if we don't pay the rent.

One conclusion is inescapable: The necessities are where inflation is really pinching and where it has to be stopped.

The fact that prices are rising at such disparate rates in separate parts of the economy suggests that inflation has different causes in different sectors. Common sense tells us that the four necessity sectors are very different from each other and from the rest of the economy. We export billions of dollars worth of food and import billions of dollars worth of energy. Houses are built by thousands of relatively small contractors; energy is controlled by a handful of huge multinational corporations. We pay for every food item we buy out of our own pocket, but we buy houses with borrowed money and the insurance company pays most of the hospital bill. Supermarkets advertise weekly specials--doctors don't put appendectomies on sale.

To bring rising prices of the basic necessities under control requires a "sectoral" anti-inflation strategy, one that is especially tailored to deal with the special nature and problems of each sector. Other approaches might help some, but only if the basic necessity problems are solved directly. Unless the key sectors are dealt with, moreover, even such a major change as the enactment of mandatory wage/price controls will not stem basic necessity inflation. The common sense notion that specific problems require specific solutions goes a long way toward explaining why traditional remedies for inflation aren't working.

The traditional solutions to inflation--and why they won't work

In the last decade, a wide range of anti-inflation measures have been tried--wage/price controls (1971-74), wage/price guidelines (1978-79), recessions (1969-70, 1973-75), budget cuts (1973, 1979), high interest rates (1973-74, 1978-79) and attacks on health and safety regulation (1975-79). Except for short periods, all these efforts have failed to have a significant impact on inflation. Since none of them is targeted to solve the new and special problems of the necessity sectors where inflation is concentrated, that is not surprising. What is surprising is that, despite their repeated failure, these approaches continue to be taken seriously as the relevant options.

* Budget cuts

No doubt there are times when inflation results from excess demand aggravated by large budget deficits. In such times, reducing the federal deficit by cutting government spending (or raising taxes) makes sense. However, today is not one of those times. "We do not have, today, an inflation problem that stems from excess demand placed on the economy by government deficits," observed the President's chief economic advisor, Charles Schultze, in mid-1978; more recently, a variety of leading economists have pointed out that the overall situation of the economy is not one of excess demand, but rather a strong possibility of a recession. In these circumstances there is no reason to believe that cutting social security benefits or laying off CETA jobholders will hold down natural gas prices or slow rising mortgage interest rates. Indeed, the Congressional Budget Office estimates that the cuts the Carter Administration proposed for the FY 1980 budget could, at best, reduce the rate of inflation by only one tenth of a percentage point by the end of 1980.

Ironically, many of the government programs now being cut in the name of fighting inflation are the very kinds of public investments we need to expand supply to bring down prices (housing and alternative energy, for example) or to provide public information and competition to reduce inflation (cooperatives, health programs, etc.). Many of the budget cuts would reduce essential services--or economic rights, like social security benefits--which help the poor and the elderly barely survive the impact of inflation.

* Weaker environmental and health and safety regulation

This approach has long been a favorite of large corporations. In the 1950's their antigovernment rhetoric was "creeping socialism"; today it is "over-regulation." While of course the reduction of nitpicking rules is to be welcomed, cutting regulations as an anti-inflation strategy has at least two major limitations. First, the total effect on the CPI of regulation is relatively small. A Data Resources study for the Environmental Protection Agency, for example, estimates that air and water pollution control costs contribute only three-tenths of a point

to the inflation rate each year. COWPS Director Bosworth estimates that all environmental, health, and safety regulations contribute three-fourths of a percentage point. Grossly cutting regulatory costs by a quarter-- a very drastic and unrealistic proposal--would then, at best, only cut two-tenths of one point off an overall inflation rate in the 9-13 percent range.

More importantly, reducing such protections can be counterproductive in the fight against inflation. For example, if the grocery manufacturers successfully block regulations requiring more informative food labeling, consumers will be less likely to be able to shop intelligently, leading to less cost-effective purchasing decisions. The relaxation of EPA controls on utilities or of USDA efforts to remove cancer-causing substances from food can only lead to higher medical costs. As we have seen this year in the accidents of the DC-10 and most dramatically at Three Mile Island, the potential direct human and financial costs of lax regulation can be staggering. The Three Mile Island disaster alone will cost hundreds of millions, perhaps billions of dollars. (Federal spending and government regulation will be discussed in more detail in Chapter V.)

* A recession, tight money

Twice before in this decade, policy-makers have concluded that the only answer to inflation was to slow down the economy. The results were recessions in 1969-70 and 1973-75, the latter being the worst economic downturn since the Great Depression.

The Carter Administration, admitting that it wants to slow economic growth, believes it can avoid a recession. The Congressional Budget Office and many leading economists believe this is impossible given current policies. Whether Administration or Congressional economists are correct, a recession is unlikely to cure inflation. The experiences in 1969 and 1973 demonstrated that while the government could create a recession, close down the housing industry, and increase unemployment, it could not "wring inflation out of the economy." COWPS Director Barry Bosworth has estimated "it would require about one million additional unemployed and a loss of \$100 billion in output to lower the rate of inflation by one

percentage point." This is obviously a tremendous price to pay for such a small impact. Moreover, after each recession, inflation increased when the economy recovered. In other words, only a permanent recession would be a permanent solution to inflation.

In many ways slow growth policies in fact make inflation worse. Higher interest rates directly raise the monthly cost of home ownership. In 1978, the disproportionate rise in mortgage interest costs boosted what would have been an 8.2 percent inflation rate up to 9.0 percent. Rising interest rates add to the cost of everything purchased on credit, such as cars and appliances, and are a major cost to highly credit-dependent businesses, like homebuilders, utilities, and hospitals (all three in basic necessity sectors). These businesses must pass on higher interest costs in prices.

High interest rates and low consumer demand brought about by slow economic growth also discourage productive business investment in new, more efficient plant and equipment. This contributes to low labor productivity and leads to inadequate production capacity and supply bottlenecks in the future, both of which are potential causes of inflation.

Most importantly, these policies won't do anything about most of the special causes of the new inflation in the basic necessities. As G. William Miller, Federal Reserve Chairman, recently stated: "Pushing interest rates up won't help bring down either food prices or energy prices."

Why the voluntary wage/price guidelines can't work

It's no secret that the Carter Administration's wage/price guidelines aren't working. When they were announced in October 1978, the CPI was rising at a rate of 8.4 percent a year. By April 1979, inflation had jumped to a 14.0 percent annual rate. In the necessities sectors, the increase was even more dramatic--from 9.7 to 17.4 percent.

The reason for their failure is fairly clear. According to the Congressional Budget Office, about 60 percent of the items that make up the Consumer Price Index are either formally or informally exempt from the guidelines. More importantly, most of the major cost components of price increases in the necessities are exempt. For instance, the

guidelines do not cover:

- key energy sources, such as natural gas, crude oil, coal, uranium, all of which in turn are major components of electricity, food and transportation costs;
- interest rates, including those paid to finance housing development and purchases;
- food prices at the farm.

Informally exempt, because enforcement of the guidelines is limited to large corporations, are:

- sales of new and existing houses;
- rents;
- health services, including virtually all hospital rates and doctor's fees.

By excluding many of the most inflationary sectors of the economy, the price guidelines are a predetermined and continuing failure. Assuming even that there were full compliance by all those covered by the guidelines (a most optimistic assumption), and assuming that exempt prices rose no faster than last year and that price hikes were to drop .5 percent, the CPI would go up fully 8.7 percent in 1979, according to the CBO. Moreover, the severe inequities of allowing massive price increases in some sectors, while trying to hold down others, undermine public support for voluntary guidelines.

Restraining wages won't solve the problem

Pay increases, especially for unionized workers, have always been a tempting target for inflation fighters. Nationwide contract negotiations such as the recent Teamster talks draw intense media attention. But it would require drastic and immoral cutbacks in workers' real wages to have even a minor impact on prices. Neither wage increases nor minimum wage laws are the primary cause of basic necessity inflation. Moreover, as the Council of Economic Advisers has observed, many current pay increases are the result of attempting to catch up with previous price rises in the necessity sectors. COWPS Director Bosworth acknowledges that "housing, food, and energy prices will be going up much more than anything else even if there are zero wage increases."

This observation is borne out by several significant facts:

- * In housing, labor's share of the cost of building a new house dropped from 31 percent in 1949 to 17 percent in 1977 as land and interest went from 16 to 36 percent. Indeed, in 1978 the prices of old houses rose faster than the prices of new ones. Wages paid this year to construction workers can't explain that. As every homeowner knows, moreover, the biggest factor in the monthly mortgage payment is the interest rate.
- * In energy, labor expenses are a relatively minor part of the cost of production and marketing. Refinery workers, for example, whose contract negotiations were subjected to intense government pressure in early 1979, get less than a cent for every gallon of gasoline bought at the pump.
- * In health, the share of daily hospital charges going to labor fell from 62 percent in 1955 to 53 percent in 1975.
- * In food, the farmers' share of the food dollar fell from 32.9 percent in 1972 to 30.8 percent in 1977. In the same period, hourly earnings of food industry workers rose less than the overall rise in food prices.

It is increasingly recognized that the non-labor components of prices--especially in the basic necessities--have been jarring the economy regularly for the last several years. Consequently, it is all but impossible to expect rigid guidelines to hold wages down when the family budget is under tremendous pressure, particularly in the necessity areas.

Controlling the new inflation at its source: Reforms to curb corporate power in the necessity sectors

Our current policies seem to amount to an odd mixture of attempting to slow the economy--which risks a recession; of raising some key prices (e.g., energy); of making symbolic but largely ineffectual cuts in the federal budget and necessary regulations; and of hoping somehow to muddle through.

The old solutions to inflation aren't working because the inflation we are experiencing is a new inflation, rooted in fundamental problems in the necessity sectors. Many of these problems are linked to major shifts in the world economy. The ability of OPEC and the oil industry to raise prices is only a symptom of the increasing cartelization and corporate control of energy sources. Likewise, the international food "jolt" of 1973-74, together with the Russian wheat deal, is a harbinger of rising world demand for U. S. grain that will inevitably come with increasing population and affluence. Without major new policy initiatives the domestic economy will continue to be vulnerable to such international shocks, with even higher inflation the result.

Many problems are also related to domestic conditions in the new economic era we have entered. The baby boom is now a family boom, and the drop in housing construction that used to slow inflation now makes our housing shortage worse, driving up prices. Suburban housing increasingly competes with agriculture for land, driving up the price of both. Blocking the development of renewable energy resources, the energy industry has instead developed more costly but more profitable Alaskan and offshore oil. The basic dynamic of the medical industry has taken us to a point where we devote far too many resources to wasteful, high-technology medical treatment and not enough to prevention.

The difficult economic era we have entered obviously requires bold new solutions, tailored to deal with the new conditions which are forcing prices up in each sector. In each of the necessity sectors, however, we are up against powerful corporations and economic forces that profit from their ability to manipulate the market and from their power to influence government decisions and policy.

The COIN recommendations which follow include a diverse array of targeted government actions designed to plan for price stability: developing new energy sources, allocating credit to necessity housing, preventing manipulation of food exports, planning a better system of financing health care, promoting competition and creating new institutions where competition has failed.

There is, however, a common thrust that unites most of COIN's proposals. That is the need to restrict the ability of powerful corporate institutions to block reforms that would curb rising prices.

The pressures that fuel the new inflation are not going to go away. They will be managed either by the special interests seeking private gain or by prudent government policies in the public interest.

If recent history is a guide to what more corporate influence will mean, inflation is unlikely to be slowed. American consumers will pay sharply higher food prices as the grain giants manipulate world food shortages. The major oil companies will continue to profit from restricted OPEC production and to block development of alternative energy sources. The fee-for-service system will push up health costs, while doctors, drug companies and the makers of exotic hospital equipment thrive. And the cost of owning or renting a home will rise as speculators, bankers and realtors profit from the supply shortage and high interest rates.

The alternative is a series of reforms in government policy that will promote price stability by curbing corporate power. Most of the reforms suggested in this program can be grouped in three broad categories:

- o Putting a direct lid on selected prices - Hospital cost containment legislation and extension of price controls in oil are good examples of this approach. While not necessarily ultimate goals in themselves, they promise short-term relief from inflation and monopoly pricing that none of the traditional remedies can, and they can help break the momentum of the price/wage spiral. They block or counteract the inflationary effects of corporate power and permit time for the kinds of longer term reforms that are required.

- o Expanding supply and conservation - Obviously, conserving energy and expanding the supply of renewable sources is a key to holding down energy prices. But a similar analysis applies to the housing and food sectors. Measures to maintain the production of necessity housing by insulating it from restrictive monetary policy and policies to prevent short-term world grain shortages from jolting the domestic economy by giving domestic use priority over exports can slow inflation significantly.

o New policies/institutions to increase competition - From breaking up monopolies to divesting the large oil companies of competing energy resources to strengthening the family farmer, increasing competition is a key strategy. Where competition is possible (as in trucking and milk marketing), it will mean restoring it. At other times it may mean setting up new institutions, such as health maintenance organizations (HMO's), consumer co-ops, or a government energy corporation, to compete with existing producers.

The COIN Agenda

In each of the necessity sectors--food, energy, housing and health care--COIN Task Forces have developed a set of proposals which could, over time, control corporate power, expand supply and create new institutions to foster competition and plan for price stability. This agenda is long-term because it deals with the underlying structural causes of rising prices. The solutions COIN proposes will not be easy to achieve. They will require the building of a citizens' movement able to contest the corporations and special interests which oppose our agenda. But unless we can achieve public control over the engines of inflation in each of these key sectors, prices will continue to rise, with a devastating impact on our economy and our society.

A brief summary of the COIN program in each sector follows:

* Energy

In energy the long-term priority must be a planned transition from an economy based on depletable fossil fuels to one based on a variety of renewable--mostly solar--energy sources. In order to prevent inflationary shocks which damage our entire economy and make the transition more difficult, we must maintain and strengthen price controls on domestically produced oil, gas and other petroleum products, based on cost of production rather than the inflated OPEC price.

We must also take strong steps to break the horizontal monopoly which the oil companies now operate over competing energy sources--such as coal, uranium and solar. We must cut the cozy relationship between the big oil companies and OPEC which encourages price increases by instituting some

form of public authority to require arms-length bidding for lowest possible price between domestic buyers and foreign sellers. Finally, we must pursue an aggressive spectrum of actions designed to gain independence from high-priced OPEC oil. These include: active development of alternative energy sources; aid to encourage proliferation of international oil production; a federal oil and gas corporation; and import reduction targets tied to planned energy conservation measures.

* Food

Over the short term, the Carter Administration, the Congress and many state legislatures have clear opportunities to stem the rising tide of food prices. These opportunities include: (1) the additional importation of beef during times of severely reduced production, (2) the removal of the discriminatory pricing restrictions on reconstituted milk, (3) maintaining the authority of the Secretary of Agriculture to set milk support prices at a level chosen from the full 75 percent to 90 percent range guaranteed him by permanent legislation (instead of unjustly raising the minimum to 80 percent), (4) repealing the food sales taxes maintained by many states, (5) blocking further increases in sugar support prices, and (6) allowing the continued importation of fresh Mexican vegetables. All of these initiatives will work to lower and stabilize food prices. What is more, these steps can and should be taken in the immediate future.

Over the longer term, COIN places greatest priority on the restoration of genuine and active competition in the food production, distribution, processing and retailing industries. In addition, we feel it is critically important to implement an equitable and responsible mechanism for the management of domestic food and feed grain supplies. Taken together, these two programs would largely ensure adequate food supplies at affordable prices.

COIN also urges that steps be taken to solidify the gradually eroding foundation of family farms--a foundation which historically has supported a strong agricultural sector in America.

In addition, steps should be taken to reform the regulations governing (1) the transport of food, (2) the production and cooperative control of

dairy products, fruits and vegetables and (3) food and nutrition labeling. Of paramount importance, moreover, is the need to completely restructure the system by which meat, the centerpiece of the modern American diet, is traded.

* Housing

In order to reduce housing inflation, federal, state and local governments must take action to expand the supply of moderate priced housing. Required steps include eliminating cutbacks and expanding federal subsidies for new construction and rehabilitation of low to moderate income housing and a major national homesteading plan that would rescue housing from abandonment and encourage low-cost self-rehabilitation. Cooperative housing has construction and maintenance costs well below typical rental housing and also shields low and moderate income families from escalating real estate prices. Technical assistance to organizations seeking to establish and operate cooperative housing should be increased and a major share of federal housing subsidies should be directed to housing organized on a cooperative basis.

In order to stabilize housing production and avoid cyclical escalation of interest rates, selective credit controls should be used when the economy becomes overheated and less reliance placed on restrictive monetary policy. Selective credit controls would curb corporate borrowing, mortgage credit for luxury housing, and excessive expansion of consumer credit without resort to higher interest rates. Real estate brokerage and closing costs should be lowered by establishing municipally sponsored or other nonprofit, low-cost brokerage services and by requiring mortgage lenders to bear the cost of title insurance and legal fees. Elimination of the federal income tax deduction for mortgage interest and property tax payments would lower home prices, increase the supply of rental housing, and eliminate a wasteful and inequitable tax subsidy that fails to expand home ownership opportunities.

* Health Care

Controlling inflation in the health care sector will require a reorganization of the health care system to ensure: universal and comprehensive treatment and services; development of alternatives to fee-for-service reimbursement; a publicly controlled financing system which places ceilings on health care spending and doctors' fees, and discourages duplication of facilities and unneeded procedures; an emphasis on preventive medicine; and continued tough regulation to reduce occupational and environmental causes of disease.

Hospital cost containment is needed to slow the rate of health care inflation in the short term, but only a comprehensive national health insurance program with built-in requirements for containment of spending and doctors' fees and measures to promote a variety of consumer controlled health maintenance organizations can really put a lid on escalating costs.

We must gradually move away from a "health care industry" based on profit to a community based health system which prevents disease and ensures that all people receive the care they need.

Four steps to break the momentum of inflation

Inflation in the necessities is a long-term problem that will be solved only by reforms that will take time, in some cases years. Nonetheless, there are some initiatives that can be taken now to significantly reduce inflation in food, energy, health, and housing.

To illustrate what a short-term agenda could include, only one step has been selected for each sector below. Each could reduce the rate of inflation significantly over the next 18 months. The goal is twofold: to break the momentum of the ongoing price/wage spiral and to allow time to begin the needed longer term reforms.

1. Energy: Continue and strengthen oil price controls

In April, President Carter announced his plan for rapid decontrol of crude oil prices. By 1982, according to the Administration's own estimates, decontrol will cost American consumers

an additional \$18.5 billion. Should OPEC continue to raise prices faster than the rate of inflation, the cost will be far higher.

The most direct and immediate way to moderate energy price increases would be to continue and strengthen oil price control. Together with some other, more limited efforts to hold down energy prices, such a decision could reduce expected increases in the CPI by up to one full percentage point. (For a more detailed discussion of oil price decontrol, see p. 21).

2. Health: Hospital cost containment

Since 1977, Congress and the Administration have been grappling with hospital cost containment legislation that would put a cap on increases in hospital expenditures. Such a cap would have an immediate constraining effect on inflation in the health care sector because hospitals account for such a large (40 percent) proportion of the health care dollar.

Nevertheless, just as retaining price controls on domestically produced oil is not the long-term solution to inflation in energy, hospital cost containment is not the final answer to inflation in the health care sector in the long run. Only a universal and comprehensive National Health Insurance plan including systemwide reforms in reimbursement can solve inflation in this sector.

Hospital cost containment legislation would be a direct means of restraining price increases in one of the most inflationary sectors of the economy, and could reduce the rate of hospital inflation by at least one full percentage point.

3. Food: Temporary anti-inflationary consumer price rebates and/or subsidies

Most food prices cannot be effectively held down in the short run by direct restraints. The volatility of farm commodity prices make the model of oil price decontrols or hospital costs containment inappropriate.

In this situation, we believe urgent exploration of fast-hitting anti-inflationary rebates or subsidies in the food sector should be an immediate priority. A range of potential options is available, including selective subsidies or rebates on key food items of special significance to the majority of families, temporary across-the-board reductions of food prices (applied at the wholesale and/or retail level), etc. Specially focussed Tax Incentive Programs (TIPs) or direct subsidies could be given to achieve immediate reductions in food prices, allowing time for the implementation of more basic reforms. We believe it possible through these and other short term measures to reduce the food component of inflation sufficiently to reduce the overall consumer index by 1 to 1.5 percentage points in an 18-month period. (See Page 49.)

4. Housing: Reducing interest rates for necessity housing

The Credit Control Act of 1969 provides the President with authority to take immediate action to lower mortgage rates for 75 percent of home buyers, stimulate the production of moderately priced homes, and dampen the demand for luxury homes. Pursuant to that Act, the President and the Federal Reserve Board should direct the Federal Home Loan Bank Board to establish a system of reserve requirements for mortgage loans that would lower the mortgage rate for necessity housing--moderately priced homes which represent 80 percent of existing home sales and 70 percent of new home sales--and raise the mortgage rate for luxury housing. Lowering the necessity mortgage rate by one percent--from 10.5 percent to 9.5 percent--and raising the luxury mortgage rate by one percent--from 10.5 percent to 11.5 percent--would immediately reduce the CPI by .73 percentage points.

Taken together, these four short-term initiatives could break the momentum of rising prices and take up to three percentage points off the inflation rate. This would allow time to launch basic reforms in the necessity sectors. We believe, moreover, that a very broad and powerful constituency exists for Presidential leadership to control inflation in "the basic necessities of life."

Energy

In recent years, energy prices have continually led the inflationary spiral. From 1973 through 1978, energy prices jumped 96.2 percent, compared to the CPI, which increased 59.4 percent. Increases in energy prices have been so dramatic that the share of the Gross National Product going for energy more than doubled between 1970 and 1977.

As anyone who has recently bought gasoline or heating oil knows, prices have not stopped rising. In the first four months of 1979, energy prices rose at a 31.2 percent annual rate, more than twice as fast as the rest of the CPI. They will rise even more sharply in the next few months as recent OPEC price increases begin to be reflected in the prices of petroleum products, as OPEC continues to raise its prices far in excess of inflation, and as natural gas deregulation and the first steps of oil decontrol take hold.

Why are energy prices going up?

Until 1973, American energy prices were held reasonably stable primarily by the low cost of imported oil and the regulated price of natural gas. When the OPEC cartel quadrupled the average price of its crude oil, the lid came off. Not only did the price of imported oil rise dramatically, but the prices of substitute fuels--coal, uranium, unregulated natural gas--jumped, too. And, with every subsequent OPEC price increase, other fuel prices have risen as well.

The two partial exceptions to this pattern have been the prices of regulated domestic crude oil and natural gas. Under controls that originated in the Nixon Administration's wage/price freeze, most domestic crude oil prices (as well as retail gasoline prices) have been limited by federal

ceilings. Interstate natural gas sales have been subject to cost-based price regulation by the federal government since the early 1950's. (Even with these controls, natural gas rose from less than 20 cents per million cubic feet to \$1.42, and average oil prices nearly tripled.)

With the support of the Carter Administration, the major oil companies that dominate the foreign and domestic markets for oil and natural gas have pushed for an end to government price ceilings. Last year, at their urging, Congress passed the Natural Gas Policy Act, providing phased decontrol of natural gas prices. This year, they are supporting the President's decision to decontrol domestic crude oil prices.

The OPEC cartel is able to exert such a powerful influence on American energy prices in part because the major energy companies have successfully blocked efforts to develop lower cost, alternative energy sources and conservation. These include oil and gas deposits in non-OPEC nations, mass transit, fuel efficiency standards, and other conservation measures, and renewable domestic resources such as solar power. Using both its economic and political power, the energy industry has helped maintain a world-wide and domestic energy shortage that keeps prices rising. The intimate business ties and vested interests of the major U. S. oil producers with OPEC itself, and worse, the integrated structure of the oil giants, have made "arms-length" bargaining impossible with the cartel.

American consumers pay most of the costs for this situation directly when they buy gasoline, fuel oil, or natural gas. In the cases of coal, natural gas, uranium, and oil used to generate electricity, the inflationary impact of fuel price increases is compounded by lax regulation of privately owned utilities. With billions of dollars in rate increases resting on the choice of fuels, building programs, and other management decisions, corporate domination of the regulatory process means rising electric rates.

Short-term solutions* Continuation and strengthening of oil price controls

As indicated at the outset, COIN believes that stopping decontrol of oil prices is important in its own right, and as part of a four sector strategy to immediately break the momentum of current inflation. (See above, pp. 15-16.

The President began to remove price controls from domestic crude oil on June 1, 1979 with the aim of total decontrol accomplished by October 1, 1981. Under the President's plan, according to the Treasury Department, the additional costs to consumers between now and 1985 will be an astounding \$86 billion. The CBO has indicated that the cost of living would be pushed up by about one full percentage point by the end of 1982 as a result of the President's decontrol plan, more if OPEC continues to raise prices. Decontrol will not only raise gasoline and fuel oil prices, but petroleum-based products like fertilizer, chemicals, plastic, and synthetics will also become more expensive, as will everything we buy that depends on transportation to get to the marketplace. Decontrol will cost the average family of four over \$300 a year assuming no additional large OPEC price rises. In fact, Americans' fuel bills will rise by more than \$600 a year if price increases for natural gas and imported oil are included.

By his decision to give the oil companies higher prices through decontrol, President Carter has reversed the position he took as a candidate when he told the Democratic Platform Committee: "There is no need to, and I oppose efforts to, deregulate the price of old oil." The Democratic Platform, entitled "The Party's Contract with the People", adopted his perspective and stated that "beyond certain levels, increasing energy prices simply produce high cost energy--without producing any additional supplies" and that:

Republican energy policy had failed because it is based on illusions; the illusion of a free market in energy that does not exist, the illusion that ever increasing energy prices will not harm the economy.

Now is not the time to base our energy policy on illusions.

The argument for "decontrol" is that it will stimulate additional domestic production of oil. But the amount of that additional production, if any, is small in relation to total production. The White House, for example, claims that its "decontrol" plan will elicit about 200,000 "extra" barrels a day in 1980 and about 400,00 barrels a day in 1981. The effective cost to the economy of each of these extra barrels will be \$255 per barrel in 1980 and \$196 per barrel in 1981. In fact, rapidly increasing prices are more likely to cause producers to hold back on production than to produce at the current year's lower price.

Decontrol will not significantly encourage conservation. Prices are already high enough to do whatever price alone can do efficiently to persuade Americans to adjust their use of gasoline and heating oil. Gasoline and heating oil prices have doubled since 1972, yet fuel oil consumption actually rose 18 percent and average gasoline consumption rose 16 percent from 1972 to 1978. Direct conservation measures are much more cost-efficient.

The CBO study estimates that the President's decontrol plan will cause an optimistic saving of 215,000 barrels a day by 1985. This figure represents a reduction of projected demand of only one percent. By contrast, strict enforcement of the 55-mile-an-hour speed limit would save 250,000 barrels per day; mandatory thermostat settings could save 380,000 barrels per day; and the wheeling (trading) of electricity between systems during peak demand could save 200,000. And none of these mandatory conservation measures cost anywhere near the billions of dollars decontrol will cost our economy.

Since it will significantly increase inflation without seriously encouraging either production or conservation, domestic crude oil prices should continue to be regulated on the basis of cost of production plus a reasonable return. The Department of Energy, which lately has been loosely interpreting controls, allowing prices to rise even while under regulation, must be required to aggressively enforce oil and gasoline price controls and to prosecute violators. Congress should give the Executive Branch the power to open up oil company books to get the facts on profits, costs of production and overcharges to consumers. (According to the industry's own information filed with the Securities and Exchange Commission, 1978 average, per barrel, production costs for 16 major oil companies was

\$1.83 per barrel. These same companies received an average price for those same barrels of \$8.94 per barrel!) Without full public information the companies will continue to claim they need a larger return.

* Reimposition of petroleum product controls

Continuing controls on crude oil is not sufficient: price controls on petroleum products which already have been decontrolled must be reimposed, controls on gasoline must be continued and enforced with renewed vigor. The most important petroleum products which have been decontrolled are home heating oil, diesel fuel, jet fuel and residual oil. The effects of controls, even when laxly enforced and liberally written as they have been in the case of gasoline, is dramatic. Since home heating oil controls were removed, the price of gasoline has increased by 19 percent, while the price of home heating oil has increased at nearly twice that rate--35 percent.

* Reforming offshore oil and gas leasing arrangements

On behalf of the public, the federal government leases offshore Outer Continental Shelf oil (OCS) and gas lands to private companies for exploration and development. Almost all of the leases entered into with the oil companies are of the low fixed royalty cash bonus variety. This system of leasing restricts competition, concentrates oil and gas resources in the hands of a few large companies, encourages delays in development and fails to provide the public with fair market value for its non-renewable resources. By forcing companies to bid millions of dollars in cash bonuses, the government restricts access to oil and gas resources to only the largest companies and at the same time misdirects capital away from exploration and development. This system of leasing also contributes to inflation, because the large companies can delay exploration and development in anticipation of higher prices--a delay which results in less supply which in turn puts upward pressure on prices.

OCS leasing can be made to work--to increase the revenue to the public, to increase competition, to increase exploration and development and to lower oil and gas prices. The government now has statutory authority to lease OCS lands under superior leasing systems, and to force companies to develop their tracts. It also has the authority to contract with companies to do pre-lease

exploration in order to improve the government's knowledge of the public's resources. What can be done? The public can put pressure on Congress and the Secretary of Interior to use the existing authority to improve the leasing system, and the Congress can pass legislation to set up a federal corporation to compete with the private companies in OCS exploration and development providing a yardstick against which to measure the performance of the private companies. Finally, the Secretary can end the use of the low fixed royalty cash bonus bidding system.

Long-term structural reform

Energy prices increasing at two to three times the general inflation rate, long gas lines, severe economic dislocation and a continuously declining standard of living for most Americans will continue until the government reverses its commitment to the high price energy future cherished by the major oil companies. It must instead commit itself to the development of low-cost, cost-effective, humane alternative energy sources and to reduction of the market power currently enjoyed by the major oil companies.

Instead of blithely telling us that we will have to pay more and get less energy in return, the Administration should be aggressively identifying those energy policies which meet the goal of providing enough energy to satisfy basic human needs and run the economy at a reasonable price. This means a ranking of energy alternatives based on their cost-effectiveness. With a limited amount of resources available to fund and support energy projects each dollar spent pursuing one policy is a dollar which will not be spent on another policy. Thus it is imperative that every policy is evaluated not just for its own internal cost-effectiveness, but for its merit in comparison to all other alternatives. When this is done, it becomes painfully obvious that conservation and renewable energy are not only more cost-effective than the high price, high profit exotic fuels the oil industry would have us invest in, but that these alternatives also possess only a fraction of the potential for inflation of the oil industry's high priced alternatives.

* Promoting renewable energy sources

A strong commitment to the development of solar energy can ensure that future generations are not plagued by intensification of the energy inflation we have experienced since 1972. If a strong solar commitment is made, one-fourth of the energy consumed in the United States by the year 2000 could come from renewable sources. The anti-inflationary benefits of meeting this commitment would include:

- o Providing a non-inflationary source of energy for those living in solar homes--by the year 2000, 90 percent of new buildings would need 80 percent less conventional energy than those built in 1975. Solar energy could fulfill a majority of energy needs in 30 percent of existing homes.
- o Moderating the inflation experienced by those still dependent on conventional fuels--an increasing reliance on solar energy would greatly reduce the demand for conventional fuels.
- o Moderating the inflation in energy intensive goods ranging from food to plastics--by the year 2000, 30 percent of all new energy used by industry could come from renewable sources, and 15 percent from existing plants.
- o Reducing U. S. reliance on high cost foreign sources of crude oil.

To meet the goal of deriving 25 percent of the nation's energy supply in the year 2000 from renewable sources, a program is necessary that effectively removes current barriers, includes incentives for production and consumption, and encourages development of markets and more cost-effective technologies. The following are the most important initiatives that can be taken:

- o Creation of an independent solar development bank. This bank would make long-term low-interest loans to homeowners, commercial

building owners and builders to install solar energy systems. Also, long-term, low-interest loans would be made to manufacturers of solar equipment. It is estimated that creation of this bank with adequate funding to provide loan subsidies would yield approximately 2.4 quadrillion BTU's by the year 2000.

- o Incorporation of solar energy in existing homeowner assistance programs.
- o Incorporation of solar energy in existing commercial, agricultural and industrial assistance programs.
- o Allowing solar tax credits to apply to those who purchase solar equipment to lease as well as to those who purchase for their own use. This would greatly expand the residential solar market, particularly for renters.
- o Direct assistance in bringing solar to low-income consumers to meet all or part of the costs of installing solar equipment. Likewise, HUD should embark on an aggressive program to install solar equipment in public housing units.
- o Underwriting a solar insurance pool for warranties. This will encourage small businesses involvement in solar production.
- o Federal buildings should be retrofitted wherever cost-effective, and new construction should incorporate solar energy.
- o Direct purchase by the federal government of large quantities of photovoltaic cells for producing electricity in federal installation, thus providing economies of scale in production sufficient to bring down costs into competitive range in the private market.
- o Substantial increase in research, development and demonstration spending by the government for FY '80. This would mean authority in excess of \$16 billion, and over the next decade approximately \$30 billion. Government distribution of solar R&D funds should be done in a pro-competitive manner that stimulates solar development by small businesses and non-profit institutions, rather than by large corporate interests.

* Diluting OPEC's power to set excessive world prices

American consumers would hope that their bargaining agents in negotiations with the OPEC cartel would be as vigorous as possible in demanding the lowest possible price. Yet, rather than being confronted with buyers who are interested in the lowest possible price, OPEC is assisted by its buyers, the major oil companies, who are also its partners, consultants, distributors, etc. The fact that there are so few buyers greatly reduces the effort necessary to police the cartel. And the efforts to police are made even simpler as sales are made a part of a public record. Consequently, the way the majors do business with OPEC greatly reduces one of the biggest potential threats to a cartel.

The majors do not simply tolerate OPEC, they benefit from it. Indeed, in many ways, the majors' financial security is tied to OPEC's continued existence. The high OPEC price guarantees the market for various high priced alternative fuels they have invested in, and raises the price they can receive for domestically produced oil and natural gas.

There are various ways to restore a true arms' length buyer-seller relationship in our foreign oil purchases. One solution to the problem would be the establishment of a federal government agency which would be the sole legal importer of oil. The agency would receive secret bids to meet the U. S.'s import needs. This plan makes it easier for individual OPEC nations to compete, to sell at prices below the "official" OPEC cartel level. In addition to the secrecy of the bids, detection would be made difficult, as the bid price would not be for just the oil, but for delivery as well. The invitation to compete could be quite attractive to several OPEC members--those short on cash, burdened with large underdeveloped populations and currently producing well below capacity.

The major oil companies are further encouraged to import foreign oil by IRS tax rulings which allow them to treat royalty payments as income taxes, thus making them eligible for over \$1 billion in tax credits against foreign profits.

Other strategies should include active measures to encourage the proliferation of petroleum production around the world--for example, development aid and long-term purchase contracts and mutually beneficial relationships with countries such as Mexico.

* Making the oil industry competitive

The American oil industry is unique in the degree to which its members--the 26 major oil companies--own and control every aspect of the energy process, from producing the crude, through transporting and refining, to marketing. The major oil companies wield enormous economic power--the top eight earned one-third of all profits reported by the top 1800 U. S. corporations in 1974; last year, these companies accounted for 72 percent of the \$163 billion in cash holdings attributed to the fuel industry. Moreover, these eight firms accounted for about 15 percent of the \$77.81 billion cash holdings held by the top 35 major U. S. industries.

Federal enforcement of the U. S. anti-trust laws prohibiting unfair competition and monopolistic structure--even including the pending Federal Trade Commission case against major oil firms--have not altered the industry's concentrated structure. It is clear that case-by-case, piecemeal attempts to restore competition are wholly insufficient, as they do not address the fundamental problems of the industry, problems which require structural reform.

Only a legislative divestiture of the production, refining and transportation, and marketing operations of the major oil companies will achieve the goals of a more efficient industry and cheaper energy. Requiring separation of the key components of the major oil companies would restore competition and reduce consumer expenditures on gasoline and other oil products by billions of dollars a year.

Traditionally, independent gasoline marketers have been able to undersell the majors by 3-6 cents a gallon. These savings result from the superior efficiency of the independents, who sell a higher volume at a lower margin and avoid the costs of non-price competition such as image advertising. Vertical integration allows the majors both to subsidize inefficiency in their refining and marketing operations and to limit the independents' access to crude oil. After divestiture, no segment of the previously integrated major companies would be able to be subsidized by any other. Thus, Exxon Marketing, for example, would have to compete on equal terms with independent marketers and would be forced to increase efficiency to meet the lower price of the independents. And the independents would have unrestricted access to crude oil supplies, increasing their ability to compete with the majors.

By creating a competitive market for crude oil and opening up the pipelines to all producers and refiners, divestiture would increase efficiency and squeeze monopoly profits at every level of the industry. Divestiture would ensure that the structure of the industry does not add to other causes of rising energy prices. And, to the extent that divestiture increases the incentive for American refiners to behave more competitively by seeking cheaper crude oil, it would weaken the OPEC cartel.

* Preserving competition among fuels

Following the oil shortage of 1973, and the quadrupling of the price of imported oil, oil companies have enjoyed enormous increases in cash flow. Much of this windfall is being spent to acquire early control of potentially competitive sources of energy. In 1977, 13 oil companies, including such giants as Exxon, Mobil and Texaco, owned 20 percent of all outstanding federal coal leases, containing 46 percent of the recoverable coal in the United States. Five major oil companies controlled 51 percent of uranium reserves and 62 percent of domestic uranium milling capacity. Four of those five are among the top 20 in coal. Less conventional, but potentially competitive sources of alternative energy have also attracted the interest of big oil. Ninety percent of The Geysers geothermal field in California--the only full-scale commercial geothermal plant in the country--is owned by Union Oil, Burma, Shell and Occidental Petroleum.

Promising new solar enterprises are being bought out by the large oil companies. Recently, Atlantic Richfield bought Solar Technology International, Mobil bought Tyco Laboratories, and Shell has acquired a major interest in Solar Energy Systems. In addition, oil companies currently control 37 percent of domestic copper production, a key element in solar collectors. It has been estimated that the equivalent of 33 percent of 1974 U. S. copper production would be required to reach President Carter's goal of 2.5 million solar homes in 1985.

Oil companies argue that their expansion into competing fuel production and distribution is necessary to meet national energy production goals. Yet, their acquisition of coal reserves has not led to increased production.

In 1977, only eight of 24 petroleum companies with significant reserves were actually producing. El Paso, Mobil, Shell and Texaco had produced no coal. In 1975, Exxon had produced only one-third of one percent of its reserves. Their acquisition of operating companies shows an even more disturbing pattern. After Occidental purchased Island Creek, production dropped from 30 million tons to less than 20 million tons in seven years. Declines in production also occurred following the purchase of operating companies by Standard Oil, Sunoco and Gulf.

Steps to prevent big oil from gaining direct control over competing fuels include:

- o legislation to prevent major oil companies from controlling assets in coal, uranium, geothermal, solar or other competing fuel industries.
- o disclosure by energy companies of data showing ownership or control of competing fuel assets (information which must be available to federal antitrust enforcement agencies and to Congress, as well as the Department of Energy).
- o creation of an Office of Competition at the Assistant Secretary level within the Department of Energy.
- o Department of Energy promotion of interfuel competition in managing research, demonstration and development funds. (Major oil and gas companies, for example, should not be the primary recipients of funds for research and development of synthetic fuels.)

* Conservation.

Conservation, as President Carter has acknowledged is "our cheapest and cleanest energy source." The possibilities for dramatic reductions in energy consumption in the near and long term are tremendous, and indeed, it is probably impossible to find a politician on record against conservation. But conservation is not only sound energy policy, it is strong anti-inflation and economic policy. Effective conservation policy attacks inflation from two directions. First, it reduces the cost of using energy even if the cost

of energy is rising; and second, by reducing the total demand for non-renewable fuels weakens the ability of the major oil companies to charge exorbitant prices. The Administration's conservation policy fails because it is built on the faulty proposition that high energy prices reduce consumption; it fails because it short-sightedly views conservation in terms of personal sacrifice rather than increasing the efficiency of the energy we use and overcoming the institutional barriers to reduced consumption; and it fails because its rhetoric is not backed by action--the budget for FY '80 dramatically reduces conservation spending at a time when it is one of the most cost effective, socially useful investments the government can make.

Buildings.

The largest area for improvement in the residential sector is the structural integrity and thermal efficiency of dwellings. An effective, comprehensive residential energy conservation strategy must address the current housing stock as well as new buildings, address renters as well as homeowners, and recognize the particular disadvantages of the poor. Programs to increase the efficiency of the current housing stock include increasing the homeowners' awareness of the potential of retrofitting through consumer education, tax credits, loan guarantees and/or extensions of mortgages to include the costs of improvements. Vigorous and comprehensive implementation and enforcement of the Building Energy Performance Standards required by the Energy Conservation and Production Act will ensure that new construction will be maximally efficient. Increasing the energy efficiency of the dwellings of the poor is particularly desirable, as the inefficiencies, the costs to the government and the possibility for redressing an inequitable situation are the greatest. Funding for the low-income weatherization program should be greatly increased, and the program should be expanded to include low-income renters. Estimates are that at the current funding level, it would take more than 40 years to weatherize all the low-income homes that currently need it. However, for many of the poor, structural defects are so overwhelming that weatherization is premature. Accordingly, HUD funding for structural rehabilitation should be increased. Finally, HUD should take steps to eliminate the huge inefficiencies in federally subsidized housing. Implementing these policies could reduce residential energy consumption by more than 20%. Another 20% could be saved by replacing

electric resistance heating with heat pumps (for example by making heat pumps eligible for conservation tax credits), by increasing appliance energy efficiency standards, and by reducing water heating requirements through reduced settings and recovery from other appliances.

Many of the same problems of thermal efficiency apply to the commercial sector as well, and many of the same approaches will work. In addition, mandatory temperature settings offer great potential. Most buildings use too much lighting which directly wastes electricity and indirectly increases the need for air conditioning as the lights give off wasted heat. Finally, buildings should be built out of materials which are least energy intensive. For example, steel is less energy intensive than aluminum which in turn is less energy intensive than glass.

The thermal efficiency of government buildings must also be improved. The federal government should be setting the example in this area; and indeed, to the extent the federal government commits itself to strong energy conservation, operating costs will be reduced, and the "market" for construction will be greatly increased. The federal government should also work very closely with state and local governments providing technical information and incentives, for example through the revenue sharing program.

Transportation.

Policies to reduce energy consumption in the transportation sector must increase the energy efficiency of the vehicles used as well as alter the current institutional foundations of wasteful energy use. The Department of Transportation and the Congress must remain committed to the 27.5 mpg standard for 1985, and should set even higher standards for the following years. Other improvements in the design of the automobile could also greatly reduce energy requirements including increased use of radial tires which each could save 10%, weight reduction, as each 100 pounds of weight loss would save 2.8%, improved ignition systems as idling wastes 7%, and the vigorous search for alternatives to the internal combustion engine. Federal, state and local policies should encourage the wise use of automobiles through car and van pooling, parking limitations, auto free zones, differential tolls, elimination of parking subsidies particularly for government employees. In the long run, urban planners should utilize land use planning to encourage transportation efficiency and rigorously review highway construction plans.

Finally, a strong commitment to mass transit at the federal and state levels is necessary to reduce the nation's dependence on automobiles.

This could be accomplished by increasing the diversion of monies from The Federal Highway Trust Fund to intra- and inter-city public transportation. In particular, the modernization and expansion of rail transportation should be accorded high priority.

A national intermodal freight policy is desperately needed. Current regulatory policy has created a bias in favor of trucks, yet trucks haul less than one-fifth of all freight, although they consume one-half of all fuel. The government should encourage greater use of trains to haul freight. Finally, all backhaul restrictions should be eliminated.

Utilities.

The generation of electricity consumes 25% of the U.S. fuel budget and costs three times as much as other energy sources--the equivalent of a \$35 barrel of oil. Yet despite its high cost, electric powerplants over generate electricity an average of 60% of the time, and two-thirds of the energy used to produce electricity is wasted. Waste heat recapturing systems could recoup one-third of this loss, and reduce total U.S. fuel demand by several percent.

Rate reform is the number one starting place. Private utilities and their shareholders profit from increased energy use, and have accordingly promulgated rate structures rewarding large users while charging homeowners the highest prices for electricity.

Industry.

U.S. industry accounts for more than a third of America's energy consumption. While industry has made greater progress than other portions of the nation in energy conservation, approximately one third of the energy now utilized by the industrial sector could be saved by mandatory nationwide implementation of waste recycling, heat recuperation and industrial cogeneration technologies, in addition to more efficient industrial maintenance and housekeeping. When the necessary capital expenditures are

beyond the means of the small businessman, federal assistance would be appropriate. Additionally, strict performance standards for common industrial equipment should be implemented.

* Developing public energy sources through a federal oil and gas corporation

One of the surest ways to introduce competition into the oil industry would be to set up a competitor with economic resources comparable to those of the large oil companies. It is clear that no existing smaller firm in the private sector is capable of mounting significant competition against the majors; only the federal government, which owns between 50 and 70 percent of all U. S. oil and gas reserves, could offer such a challenge.

A federal corporation set up by Congress to explore, develop and market oil and gas could have a dramatic competitive effect upon the marketplace. Such a corporation could:

- o Serve as a cost "yardstick," providing information which would assist the public and the government in determining the fairness of energy prices.
- o Ensure the efficient use of fuel resources belonging to the American people while fully protecting the environment. Federal parks and other restricted or preserved areas would be exempt from any exploration and development.
- o Undertake the development of new, environmentally sound techniques.
- o Participate in research and development on a joint or cooperative basis with private, independent producers, stimulating further competition with the majors.
- o Give supply preferences to the needs of individual states or regions which are particularly dependent upon, or short of, energy.
- o Assist third world nations in the exploration, development, management and sale of their energy resources.

Governed by a Board composed of experts, government officials, private businessmen and consumers, a self-supporting TVA for oil and gas could serve as a strong force for competition in the oil industry, resulting in greater energy supplies at a lower cost to the American consumer.

* Reforming utility rate structures

The consequences of inflation in energy are no where so dramatic as in the increased cost of household utilities. Electricity rates have risen 55 percent over the last five years while natural gas rates for home heating have risen 107 percent over the same period. The cost of maintaining a livable temperature in residential housing has forced many families--especially elderly households--to make desperate choices between heating and eating. Failure to hold down the inflation rate in this sector will result in untold tragedy.

Rising fuel costs explain only part of utility rate increases. Rate structures which give discounts to large users of electricity, who are, in effect, subsidized by small users, encourage wasteful consumption of energy and long-term increases in energy costs. Residential users pay 64 percent more per kilowatt hour than do industrial users.

Among the specific utility regulation reforms that could hold down rates for consumers are:

- o Ending automatic fuel adjustment clauses. They allow utilities to pass on to consumers directly increases in fuel prices--without a rate hearing. They eliminate any incentive a utility may have for shopping around for the least expensive fuel. Vertically integrated utility companies can charge themselves higher than market rate prices for fuel, knowing that the fuel adjustment clause will allow them to pass that price right on to consumers.
- o Prohibiting inclusion of "Construction Work in Progress" in utility rate bases. CWIP allows utilities to charge consumers for the costs of plants even before the plants are operational. In other words, CWIP makes today's consumer pay for tomorrow's power today. In 1976, the Federal Power Commission estimated that if CWIP were allowed nationwide \$5 billion would be added to the nation's utility bill. Since CWIP greatly facilitates new construction, its effect is to lead utilities to over-expand, which in turn is inflationary and diverts capital from other important sectors of the economy.
- o Passing on to consumers savings from "phantom taxes." "Phantom taxes" describes the utility practice, sanctioned by federal law,

of charging consumers higher taxes than the utility actually paid. For example, in 1976 the top 100 investor-owned utility companies charged their consumers approximately \$2.5 billion in federal taxes while actually paying only \$374 million--an overcharge of \$2.1 billion. Local utility commissions are constrained by a Catch-22 in the Internal Revenue law that states that if the savings from the loopholes are passed on to consumers, the utility is ineligible for them.

- o Ending declining block and other discriminatory rates. Declining block rates charge large volume users less per unit than small volume users--the more you use the less you pay. This encourages excessive consumption. It forces low and middle income residential consumers to pay more for energy than other members of society.

In 1976, the top 100 investor-owned utilities charged their residential consumers 1.7 times as much per unit as their industrial consumers. Life line rates provide consumers their first 300-500 kwh at a rate no higher than any other rate. This standard allows consumers to obtain necessity power at reasonable rates. Life line rates can be combined with "zero inflation rates" which prevents the rate for the first 300-500 kwh from increasing until the other blocks have increased 25 percent.

- o Setting up RUCAGs. One of the significant inflationary biases in the system of utility regulation is the under-representation of consumers in the rate-making processes. Utility rates are set by regulatory agencies in adversary proceedings in which the utilities are well represented by legal and economic specialists. As a result, their views (generally for higher rates) tend to receive disproportionate acceptance by regulators. To help counteract this inflationary bias, Residential Utility Consumer Action Groups (RUCAGs) should be set up at the state and federal levels to represent the interests of small consumers before regulatory agencies. RUCAGs would be financed by voluntary check-offs of contributions by consumers on their utility bills. Governed by a board representing contributing members, the RUCAG would hire staff and other experts to represent residential consumers.

The above proposals to reduce energy inflation are only a beginning. COIN is convinced that an all-out effort to expand conservation and renewable sources, to reduce U. S. dependence on OPEC and to increase competition can be successful. Over the longer haul we believe careful consideration should be given to sharpening the distinction between necessity users of energy (e.g., home heating oil, agriculture) and non-necessity (e.g., yacht fuel, private jet aircraft). In general, the prices of the former should be substantially stabilized, and the latter increased.

FoodThe sources of inflation in food

Both the Council of Economic Advisors and the Council on Wage and Price Stability have regularly documented the obvious fact that overall inflation is significantly fueled by food inflation. Yet only the most modest attempts to develop a serious strategy to control price problems in this primary sector have been undertaken.

Food costs take a major share of the consumer dollar--an average of about 25 percent for four out of five American families. For the poorest fifth, moreover, food expenditures require nearly 40 percent of disposable personal income.

Between 1970 and 1977, food prices increased 67 percent, and total food expenditures increased from \$106 billion to \$182 billion annually. Seventy percent of that increase occurred in the marketing sector (processing, transportation, packaging, etc.). Of the 25 percent increase for raw commodities, nearly half occurred in just one year--1973. From 1974 through 1977 nearly 90 percent of the increase in retail food prices was attributable to increased marketing costs.

In 1978, retail food prices increased by 11.8 percent. In contrast to the 1974-1977 period, nearly half of the increase came from raw commodity cost hikes--particularly for beef, poultry, pork, dairy products, and fresh vegetables. Approximately 40 percent of the increase was due to greater expenses in the marketing sector (the remaining 13 percent resulted from rising fish and imported food costs).

In the first four months of 1979, food prices increased at an annual rate of 18.7 percent.

Of primary concern is the growing level of concentration in the food production, processing and retailing industries. In the food manufacturing sector, for example, just one percent of the more than 20,000 firms now control more than four-fifths of total food manufacturing assets. These firms are extremely diversified and possess tremendous power and influence over nearly every aspect of the American diet--from nutrition to pricing to the actual shaping of consumer demand.

The acceleration of food prices in the 1970's is also related to the new economic era that we have entered, an era of tighter world demand for U. S. food supplies. In 1972 and 1973 world-wide crop failures combined with large purchases of U. S. wheat by the Soviet Union and other countries jolted the domestic food economy, increasing food prices by 32 percent in 1973-74. Higher grain costs increased the production costs for beef, pork, and poultry and--when coupled with what seemed at that time to be a very elastic demand--also accelerated the liquidation of cattle herds. Five years later we are suffering the consequences, in the form of sharply reduced supply and rapidly increasing prices. What is more, as farm income increased from higher grain prices, land prices were ratcheted upward, making it extremely costly for smaller farmers to buy land to increase production--and leading to increases in farm support prices, which pushed up food prices even further. As higher food prices were passed into wages, the costs of machinery and other farm inputs were also driven up.

The events of 1972-74 are symptomatic of a new vulnerability of the U. S. food economy to world shortages. Absent fundamental changes in U. S. export policy, increasing population and affluence abroad will steadily pull U. S. food prices upward, with the additional possibility of severe jolts brought on by crop failures. These jolts will ricochet throughout the food economy as before and then ratchet all consumer prices upward. Farmers will borrow to purchase land and machinery to increase production and then be over-extended when farm prices fall.

At the same time, the handful of private corporations which dominate the grain trade will reap enormous windfalls. And when farm prices drop, increasing concentration in both the food production and processing sectors

will assure that already large profits are further enlarged. These developments portend grave inflationary consequences for the consumer and threaten the very existence of the family farmer. The importance of this last point cannot be emphasized enough--to weaken the family farm would severely jeopardize the long-term security and adequacy of the American and world diets.

The sources of the new inflation in the food sector are deeply ingrained in the industry. They will not go away unless new policies, appropriate to the special sectoral problems, are adopted.

Why the wage/price guidelines aren't holding down food prices

In the food sector, the Carter Administration's wage and price guidelines can do little to stop rapidly rising prices.

First, the guidelines do not and cannot apply to farm level commodities. Given the cyclical and largely uncontrollable nature of food production, arbitrary price guidelines have been demonstrated in the past to do more harm than good in achieving long-term food price stability.

Second, at the processing and manufacturing level, the guidelines are maintained on a firm-by-firm basis, rather than a product-by-product basis. The Administration requests only that parent firms hold aggregate price increases to 6.5 percent or lower. Hence, a firm that does not need to increase its price for a particular product (or because the level of competition in that one area did not permit a price increase) can raise the price of other goods (perhaps in less competitive areas) by any margin--as long as the aggregate increase in terms of dollar volume does not exceed 6.5 percent.

Finally, at the retail level, the Administration has only requested that a "percentage margin" be maintained by individual firms. At a time when raw commodity and wholesale prices are increasing dramatically, this strategy will likely prove to aggravate, not moderate, inflation. In fact, in recent weeks both the Council on Wage and Price Stability and the Department of Agriculture have stated publicly that "farm to retail margins" have been increasing "too sharply"--that is, greater than known costs warrant--especially for meats.

During the first five months of 1979, producer food prices increased at a 12 percent annual rate. The Administration's program, in effect, allows a comparable increase in retailer margins--regardless of whether or not such increases are warranted. In a sense, processor increases are actually to the advantage of the retailer. As the Council on Wage and Price Stability has stated, "During 1978, the increase in spread appears to have exceeded cost increases and, as a result, profit margins of processors and retailers widened."

Short-term priorities

* Increasing the supply of beef

Easily the largest inflationary stimulus in the food sector during the last year has been the skyrocketing cost of beef. At the retail level, most "cuts" of beef have risen by about a third over last year and for some beef--particularly hamburger--costs have risen by 50 to 70 percent. Continued, though slower, price hikes are likely at least through 1980, due to shortages, especially of non-fed and culled cattle.

Legislation should be sought this year which will:

- (a) allow increased shipment of lean beef to the U. S. during times of reduced production, and
- (b) lend some degree of stability to the beef-production sector (as well as a sense of certainty to cattlemen).

For these purposes, the use of a counter-cyclical formula in determining beef import levels would be desirable. Legislation should include Presidential authority to amend quotas in the event a significant domestic shortage should occur.

* Permitting the sale of lower-cost reconstituted milk

An important measure which would quickly cut costs and provide nutritional benefits to the poor is the removal of the implicit price restrictions on the marketing of reconstituted milk products.

Presently, non-fat dry milk can be produced from manufacturing grade milk in efficient dairying regions, shipped to inefficient areas, and

reprocessed with water, milk solids and even butterfat and finally sold to consumers at a cost much lower than that for which skim or low-fat fluid products can be purchased. The reprocessed product, when manufactured by a commercial facility, is virtually identical to other milk.

The milk-order system requires that handlers pay into regional "milk pools" the difference between the class III manufacturing price (for which non-fat dry milk can be purchased) and the class I fluid price (for which regulations require expensive fluid differentials be paid). This requirement effectively keeps the reconstituted product off the market because it eliminates the incentive for the handler to reconstitute powdered milk and undermines the consumer's financial motivation to purchase it. This highly inflationary regulatory structure was designed solely to protect artificially high prices.

* Defeating proposed legislation requiring the President to set high dairy support prices

Legislation presently allows the Secretary of Agriculture to set milk support prices between 75 percent and 90 percent of parity, depending on supply, demand and production cost conditions. Legislators are currently considering measures that would restrict the USDA to a support minimum of 80 percent over the next two years.

The 1977 Food and Agricultural Act contained a similar provision and, because of the grossly inappropriate and inflationary nature of the index used to set milk supports (the parity index) combined with the higher minimum, support prices have skyrocketed. COIN has calculated, moreover, that if both the parity index and the 80 percent minimum are maintained, support prices on October 1, 1979 (the date of the next semi-annual adjustment) will be fully 19 percent above those set October 1, 1978. What is more, next October's support price will be over 15 percent higher than the actual average cost of producing milk in the United States (which already includes a return on investment and labor).

This obviously inflationary special interest legislation must be defeated--the Administration must retain its ability to set support prices at a level below 80 percent when economic conditions warrant that action. Allowing the passage of such restrictive legislation would prohibit the Administration from setting supports at levels between 75 percent and 80 percent of parity even if, over the next two years, Treasury expenditures to buoy the high support price become excessive. Prohibiting the Administration from using such an effective and useful tool in the inflation fight is imprudent and irresponsible.

* Repealing sales taxes on food

Twenty-three states still impose a tax on food, even though such taxation directly penalizes those least able to afford such a tax--the poor and the elderly, who spend almost 40 percent of their total disposable incomes on food purchases. It has been estimated these taxes add at least \$1 billion to annual food costs. In those states where food sales taxes exist, legislation should be sought that would eliminate their use.

* Blocking sugar price increases

The world price of sugar is approximately eight cents per pound. As a result of current statutes and regulation, import fees and duties bring the price up to approximately 15 cents per pound. A proposal now before the Congress would raise the price of sugar to 15.8 cents in the first year and a Senate bill would go one cent more--16.8 cents. Both proposals would continue to escalate the price of sugar over the next few years. In addition, the increased cost of such sugar substitutes as corn syrup (which historically jumps as a direct result of increased sugar prices) could well result in hundreds of millions of dollars of additional consumer costs. COIN does not support a termination of the domestic sugar support program. We feel strongly, however, that further increases in support prices are both unnecessary and inflationary.

* Allowing continued imports of Mexican vegetables

At the instigation of Florida vegetable growers, the Treasury Department is currently investigating whether Mexican vegetable farmers are "dumping" produce in American markets.

COIN feels that the shipment of Mexican vegetables should continue unrestricted because the law on which Treasury will rule--the Antidumping Act of 1921--was devised primarily to protect against the subsidized "unloading" of foreign durable goods in U. S. markets and not unsubsidized sale of perishable products. Thus, the fact that a grower may be unable to recoup expenses on each shipment of produce cannot be construed to necessarily indicate dumping.

If Treasury does rule against Mexican vegetable growers, the supply of fresh winter vegetables could become extremely tight and prices could increase dramatically for U. S. consumers. What is more, the same dumping standard could be applied to all fruits and vegetables which are imported--an act which would have immeasurable inflationary consequences. Just as important, application of this inappropriate standard would virtually eliminate the competition given domestic growers, thus allowing further, possibly unjustified, price hikes. It must be noted, however, that COIN feels strongly that imported produce meet the same health and safety standards required of domestic produce.

*Reforming transportation regulations

Although it is not readily apparent to most consumers, freight costs account for an average five cents out of every food dollar spent. Truckers, the keystone in the transportation system, are regulated by the Interstate Commerce Commission, but such regulation discriminates in favor of haulers and against all those who must pay for a non-competitive service.

Current regulatory structure in the trucking industry is founded on control over price and control over entry. Such ICC regulation is often indistinguishable from a private cartel and has been estimated by economist Thomas Moore to cost consumers up to \$1 billion annually.

Legislation should abolish price-setting and anticompetitive rate bureaus and should both encourage greater degrees of competition along trucking routes and eliminate the restrictions on trucking agricultural commodities. The Federal Trade Commission, in reviewing the Robinson-Patman Amendment to the Clayton Act, should clarify and eliminate the implicit restrictions on "backhauling" food products.

* Meat pricing reform

Most bulk quantities of meat today are bought and sold on the basis of a "formula pricing system." Ninety percent of the industry today uses one pricing source--the "Yellow Sheet." Investigations by USDA, FTC, and particularly the House Small Business Committee have found that prices are manipulated and altered almost daily, and in most cases those that actually appear on the Yellow Sheet do not in any way represent the market conditions. The inflationary ramifications of this situation are staggering. Even a one cent per pound price boost on a week's supply of the nation's beef could result in packer-to-retailer overcharges amounting to \$4 million.

Legislation from the Small Business Committee requiring (a) the use of more than one reporting sheet in all meat transactions, (b) mandatory reporting of each transaction, and (c) USDA licensing of reporting agencies should be supported. In addition, legislation should be enacted to establish a computerized national beef pricing reporting service--monitored jointly by the FTC and USDA.

*Reforming marketing orders

The federal market order system, when combined with the legalized immunity from anti-trust litigation afforded producer cooperatives, serves to artificially inflate the prices of many products. The regulatory/price support mechanism for milk, for example, is both inflationary and potentially detrimental to consumer health as the consumption of nutritious dairy products is curtailed.

Moreover, today's dairy support program has not even helped the dairy farmers who are in greatest need. In fact, the Federal Trade Commission has reported that "as a vehicle for aiding the small and probably non-affluent farmer, the milk program appears to be ineffective and inefficient." While the largest 15% of all dairy farms receive 50% of the subsidy benefit, the poorest 45% receive only 6% of the subsidy dollars. What is more, since about 25% of dairy production is conducted by non-owner farmers and since these producers receive no benefit from higher subsidies because they are merely charged higher rents, as much as one quarter of all subsidy dollars do not even go to dairy producers. Since approximately 90% of all dairy

landlords are not farmers, as much as 22.5% of all federal dairy benefits do not even go to farmers. Needless to say, this situation greatly aggravates the support price/land price spiral, which further inflates food costs and makes it extremely difficult for young farmers to enter dairy production.

A number of steps can be taken to reduce the inflationary impact of market regulation. The class I differential--which is added to the price of Grade A milk used for fluid purposes, even though there is no difference between that milk and the Grade A milk used for manufacturing purposes--could be reduced significantly. The Federal Trade Commission and the Department of Justice should review the production and supply conditions of each of the federal orders--including the incidence of over-order prices and the state of cooperative control and merger activity. Legislation should be sought which would require the use of an appropriate dairy-specific price index to adjust price support levels.

In addition, policymakers must actively pursue dairy policy changes that will address the problems of program inequity and misdirection cited earlier. For example, a system based on income support or deficiency payments might be developed which is keyed to smaller but efficient dairy producers.

Similar problems apply to fruit and vegetable marketing orders. Since the 1930's, USDA has issued marketing orders for more than 30 fruits and vegetables. A marketing order restricts the flow of a commodity from the farm to the retail market by limiting supply. Currently, there are 26 fruit, 12 vegetable, and seven dried fruit and nuts marketing orders in various regions of the country. The production and marketing of many of these commodities are under the complete control of one producer cooperative.

Consumers pay more for commodities regulated by marketing orders, according to a GAO study. Marketing orders create scarcities which result in higher prices for consumers. And farmers, especially small ones, are denied full access to the lucrative retail market when their produce does not meet size or appearance specifications, and they are forced to sell to a processor who pays them relatively little for produce to be made into juice, jam, and other processed foods.

Officials should investigate whether a system of price supports and commodity reserves should replace the market order system. Furthermore, marketing cooperatives should be made subject to the same antitrust requirements as ordinary business concerns, as recently recommended by the President's Commission on Antitrust Laws and Procedures.

*Better food labeling

As Americans eat more processed foods, and as the link between diet and health becomes more apparent, it becomes increasingly important for those foods to be well labeled. Consumers must be given the information necessary to make prudent buying decisions.

Effective labeling proposals by the FDA and Congress should be supported-- stressing those aspects of food which most directly affect health. The higher costs of extreme scientific precision are unnecessary; what is essential is that the average consumer be able to understand and use the label and that the nutrition information contained guide the consumer to cost-efficient, nutritious foods.

*Coops and other low-cost food marketing alternatives

Since two cents of every food dollar pays for advertising, five cents for transportation and nine cents for packaging, an effective alternative marketing network could directly achieve significant cost savings and also add competition to the existing system. For example, one source estimates that home gardeners produced the equivalent of \$14 billion worth of retail foods in 1977. Furthermore, about one percent of total grocery store sales were accounted for by increasingly popular warehouse stores--stores with limited choice, little decor and service, but lower prices than regular grocery stores. A 1976 USDA survey reported that approximately 38 percent of respondents have purchased food at a roadside stand or farm.

Most significantly, consumer cooperatives--enterprises owned by their patrons rather than investors-- have provided vigorous competition with local food retailers. When the Fort Greene Co-op opened in one of the poorest Brooklyn neighborhoods, two of its competitors immediately reduced their prices and cleaned up their stores. Chicago's Self-Help Action Center saves its members about 33 percent--an example that is not atypical.

More support for alternative marketing could take several forms: adequate financing and outreach for the program enacted by the Cooperative Bank Bill; legislative support for Title 5 of the Family Farm Development Act (Farm Marketing Programs); active consumer education on food marketing alternatives--including food buying clubs and community gardening; federal encouragement of state and local feeding programs to purchase foods directly from local farmers.

*Temporary anti-inflationary food price rebates

Most food prices cannot be effectively held down in the short run by direct restraints. The volatility of farm commodity prices makes the model of oil price controls or hospital cost containment inappropriate.

In this situation, we believe urgent exploration of fast-hitting anti-inflationary rebates or subsidies in the food sector should be an immediate priority. A range of potential options is available, including selective subsidies or rebates on key food items of special significance to the majority of families, temporary across-the-board reductions of food prices (applied at the wholesaler and/or retail level), etc. Specially focused Tax Incentive Programs (TIPS) or direct subsidies could be given to achieve immediate reductions in food prices, allowing time for the implementation of more basic reforms.

Direct rebate programs for food would be hard-hitting and immediate. Shortly after implementation, the consumer would actually see a significant change in prices at the grocery store. In this, they have a tremendous advantage over other anti-inflationary programs, which are often slow-moving and difficult to discern. Such efforts, perhaps extended for an 18-month period, could form part of the previously discussed package of short-term measures to break the current momentum of inflation. (See pp. 15-17.)

If the economy goes into recession this year, as predicted by the Congressional Budget Office, we believe there will inevitably be proposals

from both the Administration and the Congress for immediate fast-hitting stimulus programs involving tax cuts. A strategy which uses tax incentives to reduce food prices combines the advantages of controlling a key part of inflation and leaving more money in consumer hands--thus stimulating the economy.

Some members of COIN believe that a specific form of "Consumer TIP" applied directly at the retail level by what is in effect a negative tax on food items could be effective. Retailers would be given a tax credit of, say, 7 percent of gross sales, if they certified that they passed this savings on in reductions in prices of 7 percent. If applied at the more competitive retail end of the system, and safeguarded by certification that processors and wholesalers were not inflating their margins, this particular form of anti-inflationary Tax Incentive Program could be an important way of translating tax incentives into final price reductions. TIPs applied at earlier stages of production contain significant dangers of "leakages" between primary costs and final retail prices. A consumer based monitoring system, together with regular audits, could help insure that the benefits of a Consumer TIP are fully passed through in price reductions.

Long-term structural reforms* Restoring competition to food production, processing and retailing

Over the past three decades, competition in American food industries has been declining rapidly. Market shares, sales concentration, advertising and profits are currently at all-time peaks and are still increasing.

Processing and marketing of food products is currently being conducted by a relative handful of large companies with large market shares. In 1963, the 50 largest food concerns controlled 42 percent of manufacturers' assets--a figure which rose to 64 percent by 1978. Concentration of profits and advertising expenditures was substantially higher, reaching the 90 percent mark for the top 50 firms in 1975. Recent research by FTC economist Russell Parker shows that concentration in the food manufacturing industries adds on the order of \$15 billion to annual consumer expenditures for food. This figure represents as much as seven percent of what the national as a whole actually spends on food in one year.

Food retailing is largely concentrated in terms of region. For example, in Denver two supermarket chains hold 80 percent of the market; in Washington, D. C., two firms control 63 percent of all grocery sales; in Milwaukee, the figure for the top two firms is 61 percent. A 1977 Congressional Joint Economic Committee study of food retailers concluded that "in many markets, consumers are paying large dollar overcharges due to their market power." This estimate of national monopoly overcharges ranged to \$662 million in 1974.

Thus the total cost of concentration in the food manufacturing and retailing industries for an average American family of four is at least \$313 annually.

A number of steps should be taken to slow and ultimately to reverse the trend toward increasing concentration in the food industry. Two antitrust reforms that would especially benefit the food sector are reversal of the Illinois Brick decision and passage of restrictions on giant conglomerate mergers (both are discussed in Chapter V).

Very important in this context is the practice of exclusive territorial allocation. Franchising among processors, wholesalers and retailers should be severely restricted. Tighter rules concerning the application of antitrust law to subsidiaries, as well as more sophisticated criteria for the establishment of harm to competition, must be developed. Closer regulation and reporting of intrafirm income sources and transfers--necessary to limit firms in reimbursing subsidiaries for predatory pricing, for example--is needed to achieve more strict business income accountability. The information would serve to facilitate FTC and Justice Department investigations into anticompetitive practices and structure. Restructuring the tax code as it applies to expenses incurred for advertising should also be actively investigated. FTC might be able to develop a mechanism for evaluating advertising strategies in different industries based on the degree of intrafirm competition present.

* Protecting the family farm

Since 1945, an average of 130,000 farmers have gone out of business every year. During this time, average farm size has more than doubled. As the General Accounting Office reported in 1978, "when comparing business receipts to cost of sales and operation, the most efficient farms--regardless of organizational structure--were farms receiving between \$10,000 and \$49,000 in business receipts." Yet, the Congressional Budget Office concludes that "on the whole, federal policy has discouraged small farm operations and led to greater concentration in farming."

COIN feels this policy is misdirected and will lead to both decreasing competition and diminishing agricultural stability over the long run. In fact, the GAO has said that "society has come to depend on the smaller and medium sized farms as an ideal combination of resource control and ability to bounce back from adversity. Although a resilient agriculture does not insure economic stability, it does maintain reasonable food supply stability...."

The following initiatives should be undertaken:

Commodity program benefits paid out of the U. S. Treasury should be targeted to small and moderate sized family farmers for whom farming is

their largest source of income. Special credit programs should be implemented to reduce the cost of capital for new farmers and for those with limited resources, and to insure that young farmers can enter agricultural production.

Tax laws should be changed to prohibit the use of farm losses to offset nonfarm income by nonagricultural corporate owners and to prevent the use of farm land for speculation purposes. Also, the capital gains tax should be increased. In addition, the tax code should be altered to require the use of accrual accounting methods by farmers with annual gross sales of over \$100,000.

Publicly supported research at land grant institutions should focus on farm production and marketing techniques which benefit small to moderate sized family farmers rather than large-scale, industrialized agriculture.

* Stabilizing domestic food and feed grain prices

If the American consumer is to be protected from the shocks of future world food shortages, a comprehensive and consistent federal policy is needed to administer food and feed crop production and exports. Rising world food prices are inherent in the new economic period we are entering. Even now another explosion of grain prices threatens the whole food economy.

If nothing is done to avoid the irrationalities of the 1972-74 period, public response to excessive price increases could also be disastrous for the farmer. Short-term controls, for instance, on beef prices might well be reimposed, and the costs of longer term programs to support farm income might easily be rejected. A new strategy is needed to help both the consumer and the farmer.

The primary objective of a new approach must be to stabilize domestic commodity prices on a long-term basis. Farm level stability could be expected to stabilize retail food prices--to the extent that raw food costs influence finished food prices. Steady feed grain costs would make more predictable the most important cost of meat production.

A second objective of a sound production and export strategy would be to guarantee total real net farm income. A third would be to ensure the viability of a diverse, competitive and ecologically sound production sector composed of efficient small and medium-sized farmers.

These goals could be achieved through a set of food and agricultural policies that would (1) stabilize farm prices through prudent management of supplies available for domestic use and export, (2) use government payments to achieve desired farm income levels, and (3) use an incomes policy (based on both production and income criteria) to improve the relative income position of smaller farmers.

These policies could be carried out primarily through a commodity export strategy designed to give first priority to the domestic needs that exist for domestic grain supplies. U. S. purchasers would pay a predetermined price--which is relatively stable from year to year and which is initially set at a level commensurate with historical supply and demand equilibria. What stocks remain after domestic needs are satisfied would be sold on the world market at the prevailing market price. In years of reduced production the difference between the higher global price and the domestic price would be accumulated in a "cash reserve" and would be used to support farm income in surplus years. Part of these proceeds would also be used to help third world nations expand productive capacity in agriculture.

Such a policy could prevent jolts to the food economy (and profiteering by large grain dealers), achieve substantial stabilization of consumer prices, and provide a supplemental source of farm income, especially for years of low world grain prices. The proposed system could be implemented through either a public export corporation--a U. S. grain board--or a system of quantitative controls and export licensing. Expanded grain reserves could also help stabilize prices.

Housing

Between 25 and 30 cents of every consumer dollar spent by the average family goes for shelter. From 1973 through 1978, housing costs have risen 61.5 percent. And in the first four months of 1979, the annual inflation rate in this sector was 13.8 percent. Obviously, unless this major component of overall inflation can be controlled, general price rises will be difficult to bring under control.

The sources of inflation in housing

The underlying cause of the new inflation in housing is the strong demand for housing generated by the high rate of growth in the number of households. The household growth rate has been stimulated by the maturation of the post-World War II baby boom--the peak birth period was 1954-1965--and a rising incidence of household formation by single, divorced, separated, and widowed persons. From 1974 to 1978 the number of households increased at an historically high annual rate of 1.55 million, a rate 50 percent above the one million rate that prevailed from 1950 to 1970. This rapid growth will continue. The Census Bureau estimates that from 1978 to 1983 households will increase at an annual rate of 1.58 million.

During the 1970's, annual production of at least 2.3 million new housing units was necessary to avoid a housing shortage. Yet from 1974 to 1976 the average annual rate of housing production was only 1.6 million units. The number of additional housing units squeezed out of the existing housing stock rose dramatically from an annual rate of only 60,000 units from 1970 to 1973 to an annual rate of 650,000 households from 1974 to 1976. Nonetheless, a housing shortage developed, particularly in low and moderate income units. The average annual increase in the median sales price of existing homes from 1974 to 1976 was ten percent. The number of doubled-up families increased by 300,000 during the same period.

Although housing production rose to an annual rate of 2.3 million units in 1977 and 1978, this has not alleviated the shortage. For example, the national rental vacancy rate, a good indicator of housing market conditions, which was 6.2% in 1974, fell to an historical low of 5.0% in 1978. The housing market will tighten further in 1979 as higher interest rates are expected to lower housing production below 2 million units.

The overall shortage has generated a rapid increase in existing home prices. From November 1976 to November 1978, the median sales price of existing homes rose 30.7 percent, while the median sales price of new homes rose 28.2 percent. New home production designed for upper income families has priced an increasing number of middle income families out of the new home market. The percent of families able to afford a median priced new home has fallen dramatically from 46.2% in 1970 to about 25% in 1978.

To avoid a continuing shortage and further rapid price escalation, at least 2.4 million new housing units (including mobile homes) should be produced each year. Yet, it is unlikely that housing production will meet this demand, unless new policies are adopted. Current problems include: rising interest rates and mortgage market instability, a reduction in government subsidized housing starts, a diminishing capacity to squeeze additional units out of the existing housing stock, impediments to increased multi-family rental construction, special problems in certain local markets, and the inability of new single family home construction to respond to the demand of a growing share of middle income families.

A major cause of the new inflation in the monthly cost of housing has been the sharp rise in interest rates on mortgage and construction loans. During 1978 interest rates on housing construction loans rose from a 8½%-9½% range to a 13%-14% range, a 50% increase. Since during 1978 the cost of construction financing represented 14% of the cost of a new home, the 50% increase in construction financing costs is alone responsible for a 7% increase in the price of new homes.

The escalation of mortgage and construction loan rates in 1978 caused a 1.3% increase in the Consumer Price Index. Although a strong demand for credit and general inflation exerted upward pressure on interest rates, the primary cause of the sharp interest rate escalation in 1978 was the restrictive monetary policy pursued by the Federal Reserve Board. Had the Federal Reserve held interest rates stable during 1978 and used selective credit

controls instead of restrictive monetary policy, the CPI would have increased by only 7.6% instead of 9.3%

The housing construction industry suffers from extreme cyclical changes in the level of production. In the 1974-75 recession, housing starts (excluding mobile homes) fell from an annual rate of 2.4 million units in 1972 to a rate of 1.2 million units in 1975.

This instability arises because the level of residential construction is very sensitive to the availability and cost of mortgage credit. In the past housing downturns have occurred when strong credit demand and restrictive monetary policy have triggered deposit withdrawals from thrift institutions, thereby choking off the supply of mortgage credit. In addition to contributing to the housing shortage, cyclical instability has direct cost-push effects. Unpredictable, sharp production declines result in idle plant and equipment in both the residential construction and building materials industries, raising production costs. Residential construction workers are compelled to seek higher wages to offset the extended unemployment. Instability results in a high rate of homebuilder bankruptcies, leading homebuilders to include a risk premium in their profit margins. On the other hand, sharp production upturns result in supply bottlenecks and high prices for building materials. Sharp cyclical fluctuations also result in inefficient production techniques as homebuilders and building material producers seek to minimize their investment in fixed capital. Overall it is likely that cyclical instability has increased the cost of home production by 15% to 20%.

Additional inflationary factors include:

1) Federal income tax deduction for mortgage interest and property tax payments. This tax subsidy inflates home prices, fails to expand supply, and depresses the rental housing market.

2) Growing shortage of developable land.

In a growing number of metropolitan areas, developable land is in short supply and its price has been escalating. From 1950 to 1977, the cost of developed land--land acquisition and site improvement--rose from 10% to 25% of the cost of new homes. In many areas, supply limitations have been

further aggravated by restrictive land use controls. For example, 99.2% of all developable land in the New York City area is restricted to single family homes.

3) Lack of effective competition in setting real estate settlement fees--brokerage commissions, attorneys' fees, title insurance fees. These closing costs on average are equal to 10% of the sale price and clearly exorbitant.

4) Lack of adequate incentives for cost effective construction and maintenance of federally subsidized rental housing.

5) Escalating state and local property taxes. Property taxes increased by 353% from 1965-1976.

6) Rapid turnover of residential properties by real estate speculators. Such turnovers often result in higher purchase prices and rents but no significant building improvements.

7) High property insurance premiums in older urban neighborhoods that are not justified by loss rates, particularly where insurance redlining has necessitated reliance on FAIR Plan coverage.

8) Unnecessarily restrictive building codes promulgated by some local jurisdictions and imposed by HUD on some federally subsidized residential construction.

Short-term solutions

* Lower mortgage rates for necessity housing and higher mortgage rates for luxury housing

Since January interest rates on mortgage loans to purchase existing homes have risen from a national average of 9.15% to a record high of 10.54%, and rates currently exceed 11% in many localities. A rise in mortgage rates from 9% to 11% (a 22% increase) results in a 20% increase in monthly mortgage payments. For most homeowners monthly mortgage payments represent from 60%-70% of the cost of home ownership.

The President should take immediate action to reduce housing inflation by directing the Federal Home Loan Bank Board (FHLBB) to establish a system of reserve requirements for mortgage loans that would lower mortgage rates for necessity housing and raise mortgage rates for luxury housing. The Credit Control Act of 1969 provides authority for the FHLBB, upon authorization from the President and the Federal Reserve Board, to require all insti-

tutional mortgage lenders to maintain special reserves for mortgage loans. Such mortgage reserves would be entirely separate from the demand and savings deposit reserves that commercial banks maintain with the Federal Reserve Board. By paying interest on necessity mortgage reserves and no interest on luxury mortgage reserves or by imposing mortgage reserve requirements only on luxury mortgages and giving lenders a reserve credit for necessity mortgages, the FHLBB can shift the relative yield to lenders of necessity and luxury mortgages. This yield shift will lower the market interest rate for necessity mortgages and raise the rate for luxury mortgages. The FHLBB should use the mortgage reserve system to lower the necessity mortgage rate by 1% (100 basis points) and raise the luxury mortgage rate by 1% (100 basis points). The FHLBB should reinvest the mortgage reserve balances in necessity mortgage loans in order to avoid any decline in the overall supply of mortgage credit.

Necessity housing should be defined as single family homes priced at \$75,000 or less and low, moderate, and middle income cooperative housing. The \$75,000 standard can be adjusted upward in the several SMSA's where home prices are far above the national average. Luxury housing should be defined as single family homes priced above \$75,000 and all second homes. The reserve requirements would not apply to multi-family housing, other than low, moderate, and middle income cooperative housing. In 1978, 80% of existing homes sold and 70% of new homes had purchase prices of \$75,000 or less. Thus, roughly 75% of home purchasers would benefit from lower mortgage rates. A 1% reduction in the mortgage rate for necessity housing will lower the CPI by 0.73%.

Aside from lower mortgage payments for most home buyers and the beneficial impact on the CPI, lowering the necessity rate by 1% and raising the luxury rate by 1% will expand housing production and, thereby, moderate the housing supply shortage. Due to the mortgage interest tax deduction and less budget constraints, upper income persons are less sensitive to high

mortgage rates than moderate income persons. Thus, the demand for necessity housing is more interest rate elastic than the demand for luxury housing. Lowering necessity mortgage rates by 1% should result in the production of roughly an additional 130,000 homes per year, while raising the luxury mortgage rate should only reduce luxury production by roughly 30,000 units. This would be a net gain of 100,000 units per year.

Introduction of a necessity-luxury mortgage rate spread will also reduce inflation in the housing sector by shifting the distribution of new production toward necessity housing. In recent years a major cause of housing inflation has been the increasing orientation of new home production toward luxury homes.

Raising the mortgage rate for luxury housing will by itself have an important anti-inflation effect. The higher rate will moderate the demand for luxury housing. A powerful demand for luxury housing has fueled inflation in many housing markets as escalating prices for luxury homes have spilled over and exerted upward pressure on necessity housing prices.

Although mortgage reserve requirements are authorized by the Credit Control Act of 1969, they should be distinguished from selective credit controls. Selective credit controls are curbs on credit users imposed to avoid escalation of interest rates and a housing downturn during cyclical booms of the economy. By contrast, use of mortgage reserve requirements to establish a necessity-luxury mortgage rate spread is a useful tool to fight inflation in the housing sector under any macroeconomic condition--i.e., stagflation or recession, as well as boom. A mortgage reserve system is a cross subsidy within the mortgage sector that runs from luxury home purchasers to necessity home purchasers. It is not a program to insulate the mortgage sector as a whole from the adverse effects of a credit crunch.

Longer-term solutions

* Selective credit controls

In recent years monetary policy has been the primary tool by which government has sought to curb aggregate demand when the economy has become overheated. In such circumstances the Federal Reserve Board has attempted

to curb credit extensions, which stimulate aggregate demand, by raising interest rates. Selective credit controls provide an alternate method for curbing credit extensions during cyclical booms of the economy. They involve the imposition of restrictive loan terms--high down payment and short maturity requirements--on certain credit extensions and imposition of borrowing ceilings for certain types of borrowers. Selective credit controls limit credit extensions directly, rather than relying on higher interest rates to dampen credit demand.

Such controls avoid the highly undesirable cost-push inflationary impact of high interest rates resulting from restrictive monetary policy. Because interest cost is a key determinant of housing costs, the cost-push impact of restrictive monetary policy is born primarily by the housing sector. During 1978, raising interest rates added 1.7% to the CPI, with 1.3% of this resulting from higher rates on mortgage loans and residential construction loans.

Use of selective credit controls and less reliance on restrictive monetary policy can eliminate the extreme cyclical fluctuations in housing production; stabilizing housing production could lower the cost of housing by as much as 15% to 20%. Selective credit controls would facilitate housing stabilization by curbing credit extensions in all major economic sectors--business, consumer durables, housing--rather than in just the housing sector. In contrast, the high interest rates associated with restrictive monetary policy primarily affect the housing sector.

Aside from lowering housing production costs, stabilizing the housing sector will increase the supply of housing. Sharp cyclical downturns in housing output, such as occurred in 1974-1975, result in a production shortfall that is difficult to make up in later years. Also, when it is necessary to limit aggregate demand, selective credit controls provide a means to curb non-essential residential production--high priced, luxury homes and second homes. High interest rates for the most part curb the production of more essential, moderately priced housing, since the housing demand of moderate income persons is more sensitive to high interest rates than that of upper income persons.

During cyclical booms of the economy, the President should invoke the authority conferred by the Credit Control Act of 1969 and direct the Federal Reserve Board to impose selective credit controls. When authorizing

selective credit controls, the President should establish a housing production target for the next 12 months and direct the Federal Reserve Board to implement the credit controls in a manner that will facilitate reaching the target. Investment by large corporations and construction of luxury housing should be curbed by the following credit controls:

- o Borrowing by each of the 500 largest corporations should be limited to a fixed percentage of the corporation's borrowing in the previous year. In applying the borrowing ceilings, all types of credit should be included--i.e., bank loans, commercial paper, corporate bonds. To provide flexibility, large corporations subject to the controls should be able to purchase additional borrowing rights from other large corporations which have not used their full borrowing authority under the ceilings.
- o Restrictive downpayment and maturity requirements should be imposed on mortgage loans for the purchase of luxury housing--high priced homes and second homes.
- o Restrictive maturity periods should be imposed on consumer installment loans and maximum lines of credit on credit cards should be limited.

* Government programs to expand the supply of moderate priced housing

Increased government action to expand the supply of moderate priced housing is necessary because the private housing market is not generating enough housing units for lower and moderate income persons. Aside from the general housing shortage, several other factors add to the severity of the shortages in the moderate priced home market. First, new residential construction has become increasingly luxury oriented and the units produced are not easily filtered down to middle income persons. Second, production of new rental housing is very limited. In 1978 the nation's rental housing stock actually declined as rental unit losses exceeded rental unit production by roughly 20,000 units. Among income groups low and moderate income persons are the most dependent on rental housing--roughly 45% of low and moderate income families are renters versus only 15% for upper income families.

Government housing subsidies for new construction, substantial rehabilitation, and in some cases moderate rehabilitation expand the supply of

moderate priced housing. Government subsidies are particularly important to the supply of rental housing, since roughly two-thirds of all new rental units involve subsidy programs. Rehabilitation--whether substantial or moderate--has the same supply expanding effects as new construction whenever it restores abandoned housing units or prevents impending abandonment.

Certain strategies will increase the supply expanding effect on government housing subsidies. Moderate rehabilitation requires less subsidy per unit than substantial rehabilitation, while new construction involves the greatest subsidy. Thus, the supply expanding effect of subsidies can be maximized by giving moderate rehabilitation units facing likely abandonment priority over substantial rehabilitation and substantial rehabilitation priority over new construction.

The primary federal housing subsidy problem--Sec. 8 rental assistance--provides rent subsidies for existing units requiring no rehabilitation, as well as rehabilitated units and new units. Although subsidies are smaller for existing units which do not require rehabilitation and are not in danger of abandonment, they do not expand the supply of housing. Thus, where rental markets are tight, subsidies should be concentrated on rehabilitation or new construction. On the other hand, high cost subsidies for new construction should not be used in a housing market where a short supply is not an underlying problem. Federal housing subsidies will have the greatest impact on supply if the higher cost supply-expanding subsidies are channeled to tight housing markets and the low cost subsidies with no supply effect are channeled to relatively loose housing markets.

Rehabilitation costs in subsidy programs can be significantly reduced by encouraging home purchasers or co-operative members to undertake some of the rehabilitation. Self-rehabilitation, known as sweat equity, can be particularly cost effective in multi-family buildings. In New York City, self-rehabilitation has lowered the cost of rehabilitating multi-family buildings by as much as 50%.

Abandonment losses can be minimized and self-rehabilitation opportunities vastly increased by a large scale expansion of Urban Homesteading Programs. Under such programs abandoned housing owned by HUD or local governments is sold at a nominal price to low and moderate income persons who participate in the rehabilitation process. Although the amount of HUD owned housing suitable for homesteading is modest--less than 28,000 single

family homes and less than 46,000 multi-family units--the volume of abandoned housing units which local governments could acquire by tax foreclosure is substantial, as many as 3 million units. New York City predicts that by 1981 it will own 250,000 multi-family units.

- o The federal subsidy for Sec. 8 and public housing should be expanded by establishing an annual target of 400,000 supply expansion units (rehabilitation and construction) for each of the next five years. In FY 1979 the Sec. 8 and public housing subsidy provided for 230,000 rehabilitation and new construction units and 130,000 existing units.
- o In allocating Sec. 8 and public housing, priority should be given to lower cost subsidies--i.e., in order of priority: existing units without rehabilitation, moderate rehabilitation, substantial rehabilitation, new construction.
- o In allocating Sec. 8 and public subsidies, the higher cost subsidies that expand supply (rehabilitation and new construction) should be concentrated on tight rental markets.
- o A national homesteading plan should be adopted with a goal of homesteading 100,000 abandoned units every year and employing self-rehabilitation to the greatest extent possible. Key elements of the plan would be: (1) federal monitoring of the number and condition of abandoned units; (2) federal encouragement for local governments to aggressively take title to abandoned units and devise and expand homesteading programs; (3) homesteading of both single family and multi-family units; (4) increased federal funds to cover the cost of acquiring abandoned homes for homesteading, to provide technical assistance to homesteaders, and to finance rehabilitation at low interest rates. Overall, homesteading programs should be directed toward low and moderate income persons.

* Federal income tax deduction for mortgage interest and property taxes

Federal income tax law provides a \$12 billion tax subsidy to homeowners by allowing them to take a federal income tax deduction for mortgage interest payments and state and local property taxes. Almost all of it goes to upper income and upper middle income persons because, relative to moderate and lower income persons, they are more likely to be homeowners, more likely

to hold mortgage debt, hold mortgage debt in larger amounts, and receive a greater tax savings from the deductions due to their higher tax brackets. Taxpayers in the upper third of the income distribution receive more than 90% of the tax subsidy.

This tax break has a strong inflationary impact on home prices. Most of the tax savings are capitalized in the form of higher home prices. This inflationary effect can be seen in the much higher market value for condominium units than comparable rental units, which reflects the fact that renters do not receive the tax break. Elimination of the tax deduction would most likely lower home prices by 10% to 15% and at the same time greatly strengthen the private rental market.

The tax subsidy provides only modest real benefit to homeowners, because most of the tax savings is lost due to the induced increase in home prices. Even worse, what little benefit is conferred does not extend to moderate income homeowners. Moderate income homeowners generally do not itemize deductions and thus do not use the mortgage interest and property tax deduction. About 1/3 of all homeowners with mortgage debt take the standard deduction rather than itemize deductions and this group is predominantly moderate or lower middle income homeowners. IRS data shows that very few taxpayers with incomes below \$18,000 itemize deductions. Thus, even if the tax deduction does confer some real benefit, it does not expand home ownership opportunities, because it does not reach moderate income home buyers.

The subsidy is also in large measure responsible for the rash of conversion of multi-family buildings from rental to condominium tenure, contributing to growing shortages in rental markets. Due to the tax subsidy, multi-family buildings have a higher market value as condominiums than as rentals. Landlords can capture this capital gain by converting. Aside from triggering conversions, the tax subsidy has more generally contributed to the depressed state of non-subsidized rental housing production.

A \$12 billion federal tax subsidy that greatly inflates home prices, depresses the rental housing market, fails to expand home ownership opportunities, and primarily benefits upper income persons should be eliminated. Unlike the federal subsidies for low and moderate income housing--about \$7 billion for fiscal year 1980--which stimulates production of housing units that would otherwise not be built, the \$12 billion mortgage interest and

property tax subsidy does not expand supply and has a major inflationary impact.

* Cooperative housing

Cooperative housing provides a vehicle for low cost, good quality housing. Cooperative and other non-profit organizations can construct or rehabilitate housing units at lower costs than private developers. Cost savings result from elimination of developer profit and lower priced professional fees. Long term maintenance and operating costs are also lower for cooperative housing, because cooperative developers, unlike private developers, have an incentive to construct buildings that are energy efficient and require minimum maintenance. For example, Cooperative Services of Detroit, a large cooperative housing organization that undertakes its own construction, has constructed and now manages housing units that cost 25% less to build and now rent for 33% less than comparable private developer units.

The cost savings of cooperative housing are even greater when self-help rehabilitation is involved. As indicated in the section on homesteading, in New York City abandoned multi-family buildings have been rehabilitated by cooperative organizations for only 50% of the cost of comparable rehabilitation by private developers. Cooperative tenure is a prerequisite to homesteading and self-rehabilitation of multi-family buildings.

Housing cooperatives can be organized along one of several alternative ownership structures. In non-equity co-ops an incoming family pays a fixed sum, possibly \$300, to become a residential member. When the family leaves the cooperative this sum is returned, but there is no equity build up. In full-equity co-ops, resident members purchase and sell their units at market rates and thus there is equity build up just as with condominium units. Limited equity co-ops allow for a limited build up of equity. Non-equity or limited-equity co-ops represent a highly desirable, low cost alternative to rental housing for low, moderate, and some middle income persons. Such co-ops insulate their resident members from the rent increases and displacement that result when real estate prices begin to escalate in the local housing market. Additionally, cooperatives provide a strong incentive for proper building maintenance--an incentive that is sadly lacking in many rental projects. At least three proposals would relieve this problem:

- o Pursue large scale expansion of federal, state, and local technical assistance for cooperative housing. Such technical assistance should include advice concerning project feasibility, financing, and legal matters and cooperative management training. Housing and Community Development Act Sec. 106(b), Sec. 810, and Community Development Block Grant funds should be used to support technical assistance.
- o Establish as a target for the Sec. 8 subsidy program that, within five years, 30% of the additional Sec. 8 housing units each must be in cooperative or other non-profit projects.
- o Establish within HUD an Office of Assistant Secretary for Cooperative Housing and require GAO to identify the administrative changes that must be made in HUD local offices to facilitate greater HUD staff support for tenant and community organizations seeking to establish cooperative housing.

* Brokerage and settlement fees

Brokerage commissions, attorney's fees, and title insurance are on average equal to 10% of the selling price of a home. Brokerage commissions range from 5% to 7% of the price, while attorney's fees range from 3% to 5%. As home prices escalate, so have these fees which are paid on a percentage basis. The fees vastly exceed the value of the services provided. There are alternatives:

- o Local governments should establish low cost brokerage services or provide technical assistance to non-profit organizations seeking to provide such services. Low cost services could reduce brokerage commissions by as much as 50%.
- o HUD should prepare and disseminate educational pamphlets for homeowners on "How to Sell Your Home Without a Broker."
- o The Real Estate Settlement Producers Act should be amended to require mortgage lenders to bear settlement costs--i.e., title insurance and legal fees--and to prohibit mortgage lenders from requiring borrowers to use an attorney to conduct settlement. Since there is considerable competition in the mortgage market, absorbing settlement costs into mortgage rates would encourage mortgage lenders

to shop for low rate title insurance and to eliminate unnecessary and high priced attorneys from the settlement process. In cases where borrowers desired to be represented by an attorney, they would arrange for and pay the attorney themselves.

* Variable rate mortgages

With variable rate mortgages (VRM), the size of a homeowner's monthly mortgage payment fluctuates according to changes in money market interest rates. If VRMs become widespread, the great majority of homeowners will face higher monthly mortgage payments whenever interest rates rise. With the standard fixed rate mortgage, the monthly mortgage payment of homeowners remain constant. A shift from fixed rate mortgages to VRMs would result in much faster cost of living increases during periods of rising inflation and severely aggravate the cyclical instability of the economy. The Federal Home Loan Bank Board recently committed a grave error in authorizing VRMs for federal S&L's in all states. Federal and state savings and loans and savings banks should be prohibited from offering VRMs.

* Elimination of Overly Restrictive Land Use Controls, Site Development Regulations and Building Codes

Major factors limiting the supply of developable land are failure to expand sewage treatment capacity and restrictive zoning. Removal of these artificial restraints will moderate escalating land costs in many communities. GAO estimates that unnecessarily expensive site development requirements -- i.e., requirements for streets, sidewalks, driveways, storm and sanitary sewers, and water systems -- have increased the cost of homes on average by \$1,300 and in some communities by as much as \$2,655. Similarly, in many jurisdictions building codes require unnecessarily expensive material and techniques.

o HUD should prepare an annual report that identifies local jurisdictions in which overly restrictive controls, regulations or codes are significantly increasing the cost of land, site development, or construction.

* Rent Controls

A short supply of rental housing in a growing number of cities has provided landlords with the economic power to raise rents far in excess of any increases in operating costs. For example, in March 1979 a large San Francisco landlord who owned 1,100 rental units announced rent increases for all his apartments ranging from 20 to 60%. The resulting tenant outrage was so great that by June it had triggered enactment of a city rent control law. Rent arbitration--establishing an arbitration procedure to set a fair rent in cases where tenants protest a rent increase--or rent control can prevent landlord price gouging and curb displacement of low to moderate income tenants. However, rent control does not address the underlying problem of an inadequate supply of rental units. Thus, it should be viewed as only a short term solution and should be accompanied by immediate action to expand housing supply and to establish subsidy programs that will enable low and moderate income residents to continue to reside in neighborhoods undergoing revitalization.

- o Local governments should enact rent controls in situations where a short supply of rental units in the local housing market is causing rents to increase rapidly. In order to avoid undermining efforts to expand supply, rent controls should not apply to new rental units, whether new construction or substantial rehabilitation.

* Strengthening Tenants Organizations

A strong city-wide tenants organization can provide the following services which collectively will have a major impact on holding down the cost of housing for tenants: (1) educate tenants as to rights which if exercised could reduce costs--i.e., right to refuse to pay rent if the landlord fails to maintain the apartment, right to set off the cost of repairs against rent, limitations on security deposits, landlords liability for damages; (2) represent tenants in administrative and judicial proceedings; (3) assist tenants seeking to organize cooperative housing and to undertake self rehabilitation; (4) seek local and state legislation that expands tenants rights; (5) encourage local governments to take action to expand

the supply of moderate priced housing and minimize displacement. In order to provide all these services city-wide a tenants organization must have a large and stable supply of funds.

o Local governments should enact legislation that would establish a mechanism for collecting tenant membership contributions to a Tenant Resource and Advocacy Center (TRAC). The contributions would be collected by landlords, turned over to the city government and then passed on to TRAC. TRAC would be governed by a Board of Directors, elected by tenants. Depending on the type of legislation enacted, tenant contributions to TRAC could either be voluntary--allowing a rebate for tenants who do not wish to contribute--or mandatory--in essence, a rental excise tax. In either case the economic benefits received by tenants would be for greater than the cost of their contributions. TRAC could charge a fee for some services, using a sliding scale geared to income level.

* Property Insurance Redlining

HUD has found that homeowners in many older neighborhoods are forced to pay homeowner property and liability insurance premiums that are as much as 10 times greater than rates paid in other neighborhoods. Only a small portion of these higher rates are justified by higher loss ratios.

o State governments should enact legislation that prohibits insurance redlining and requires insurance companies to justify higher premiums with data documenting higher loss rates.

o HUD should vigorously implement the Holtzman Admendment which requires that FAIR plan premiums be no higher than comparable coverage in the voluntary market.

Health Care

In recent years the prices of medical care have consistently risen faster than the cost of living, and, in fact, have been a significant contributor to the overall average rate of inflation. From 1973 through 1978, they increased 69.5 percent, compared to 59.4 percent for all prices. And in the first four months of 1979, medical costs rose at an annual rate of nearly 10 percent. Slowing medical price increases is important in its own right, and also important in holding down general inflation.

Medical inflation affects the business sector as well as individuals. For instance, included in the cost of nearly all goods and services is the cost of health insurance for employees. And medical inflation burdens the public sector at the state and local level, where Medicaid is the fastest growing expenditure for most states. From the consumer's perspective, medical inflation is not simply a pocket-book issue--it also affects the quality of care and access to care.

The nation's economic investment in the health care system is substantial and increasing rapidly. The amount of public and private dollars going toward the health care delivery system is staggering--in 1977 it was \$737 per person, up from \$238 per person in 1967--and it will double within the next five years. As a nation, we devote \$1 million an hour to health care.

The dramatic increase in third-party payers, including the enactment of Medicare over the past decade and a half, has often been blamed for the uncontrolled inflation in health costs. But the trend of rising health care costs is not new nor has it changed since the enactment of Medicare and Medicaid. From 1959 to 1966, prior to the enactment of Medicare, the cost

of a semi-private hospital room was increasing on an average of six percent a year, compared to the rise in the CPI--less medical costs--of only two percent per year. Thus, price increases higher than those in the rest of the economy were characteristic of the health care sector long before Medicare and before the Nixon controls.

Hospital costs, which represented only 34 percent of the total health care dollar in 1965, now represent 40 percent. The total hospital bill has been increasing at a rate of 14 percent per year since 1965, from \$13.1 billion to \$73.9 billion. To the typical consumer, this means that an average hospital stay, which is now 7.7 days, will cost \$1,543.

Physicians account for an additional 20 percent of the health care dollar, or \$36.2 billion, and 15 percent of the remainder goes to drugs and nursing home care. In 1976, the median income of doctors was \$63,000, or 5.4 times as much as the average worker's salary.

Why are health care prices going up?

"Unlike the supplier-consumer relationships typical of other sectors in the economy," the Council on Wage and Price Stability has noted, "in the medical care transaction, the primary supplier of medical services, the physician, usually determines the level of services required by the consumer, the patient." COWPS also concluded that the third-party retrospective reimbursement system, which operates on a cost-plus basis, "impacts more directly on the hospitals and physicians' decision-making than on the consumers."

Thus, our current health care delivery system is governed by the providers of medical care. Upon entering the health care delivery system, the consumer is passive. Diagnosis, prognosis and prescriptions are not negotiable items, nor is price. The result of this domination by the provider is that supply often creates its own demand.

Large gaps in health insurance coverage discourage preventive health care and create incentives toward inappropriate utilization of services. The gaps are essentially in two areas: (1) the comprehensiveness of the benefit package, i.e. what procedures and what services are covered; and (2) cost-sharing features, i.e. deductibles, coinsurance and co-payments.

Present public and private health insurance policies are inadequate on both counts. No one insurance plan, including the most comprehensive--Medicaid has a benefit package which approaches true comprehensive coverage. The argument that the short-term costs of including a wide range of benefits is too expensive has resulted in large gaps in coverage and ultimately in higher costs over the long run. Anything short of comprehensive coverage risks distorting treatment patterns toward more expensive alternatives and away from prevention and early treatment.

The other major gap is cost-sharing. Cost-sharing mechanisms include the following: deductibles--initial expenses financed entirely by patients; coinsurance--specified percentage payments by the patient for services; co-payments--fixed patient's payments per service; and, finally, maximum liability--insurance up to a specified dollar amount. Cost-sharing is meant to discourage unnecessary utilization of services and to cut the cost of the program. But cost-sharing accomplishes these goals by restricting access to care. And it restricts access to care not on the basis of the need for care, but rather on the basis of income. This method of utilization control is the least sound medically, and clearly discriminates against the less affluent. In addition, cost-sharing discourages preventive medicine and thus encourages delay of treatment until more intensive and more expensive care is required.

A good example of the inflationary impact of these gaps in coverage is the dramatic increase in the number of senior citizens buying supplementary insurance (known as Medi-gap policies) to fill the gaps left by Medicare.

Maldistribution of physicians in terms of both geographic location and specialty of practice continues to plague the system. And because of the skewed supply and demand character of the industry, both of these factors tend to increase the cost of health care. Medical care is often three times more expensive in areas well populated with doctors than in areas where physicians are scarce. For example, a list of physician charges to Medicare in 1975 includes the following wide variances in charges:

- Gall bladder operations were \$1,000 in Manhattan, New York, but only \$290 in Findlay, Ohio.

- Cataract operations were \$1,000 in Beverly Hills, California, but only \$375 in rural Nebraska and only \$560 in Kings County, California.
- Prostatectomies were \$1,220 in Manhattan, New York, but only \$775 across the river in Queens.
- Hernia repairs were \$650 in Manhattan, New York, but only \$200 in Kansas City.

Statistical analysis of the fees for these common surgical procedures shows that the differences cannot be explained or justified by geographic variations in cost of living, differences in malpractice insurance premiums, differences in other physicians' professional expenses, or differences in the quality of physicians' services. This again illustrates the reverse supply and demand dynamics of the health sector. Where the supply of physicians is large, rather than competing by lowering their fees, they make up for the loss in patients by increasing their fees.

The second type of maldistribution, that of specialty, is similarly unhealthy, both economically and medically. In 1977, 64 percent of the physicians in this country were in non-primary care specialties. HEW states that at least 50 percent of the nation's doctors ought to be in the primary care specialties. There is a tremendous cost attached to this increased specialization. Because supply tends to create demand in this sector of the economy, the tendency to deliver inappropriate care is great.

Reimbursement

Fee-for-service and retrospective cost-plus reimbursement are the primary features of the payment structure. Under the cost-plus reimbursement system, reimbursement is basically calculated on the basis of the costs incurred by the institution. Similarly, the fee-for-service mechanism bases reimbursement on whatever the provider charges per service.

Neither of these policies encourage efficiency. On the contrary, all the economic incentives are skewed toward over-treatment and excess capacity. The cost in health and in dollars is enormous. For example, according to the House Oversight and Investigations Subcommittee, there were 2 million

excess surgeries in 1977, which cost \$4 billion and accounted for thousands of unnecessary deaths.

Another product of retrospective budgeting is the enormous waste and excess capacity which currently predominate in the hospital industry. HEW has determined that there ought to be four hospital beds per 100,000 population, but in 1973 the nation had 4.3, in 1978 4.5 (130,000 unnecessary beds), and in 1983 it is projected there will be 4.6 hospital beds per 100,000. The cost of maintaining a vacant bed is about one-half of the cost of an occupied bed. Figures vary but HEW claims this excess capacity costs up to \$2 billion a year.

Another example of the lack of economic incentives toward efficiency is the practice of weekend admissions to hospitals with no medical care delivered until Monday. HEW reported this practice wastes \$2 billion a year.

The following are examples of inefficiencies attributed to current reimbursement policies, which affect both quality of care and its cost:

- The Food and Drug Administration has estimated that up to 50 percent of hospital diagnostic X-ray exposure is unnecessary. For the X-ray units sold in 1976 alone, we could save \$70 million annually if these units exercised greater professional self-discipline.
- In Atlanta a few years ago, a group of neurologists installed a "CT" scanner--which cost more than \$400,000--across the street from a hospital which they knew would install a similar scanner.

In sum, the health care industry is characterized, especially in large urban areas, by conditions of oversupply and duplication of facilities, beds, equipment, and laboratory services. The overexpansion and misallocation of resources raises total medical care costs and encourages over-utilization of the health system, without improving the access to care of low-income persons and the under-insured.

Short-term priority--Hospital cost containment

Though the solution to rationalizing and thereby controlling the cost of the health care system is a universal and comprehensive national health insurance program, a short-term response would be stringent across-the-board limits on hospital cost increases.

Presently, hospitals have no reason to operate efficiently because they are reimbursed for whatever they charge. Placing a limit on hospital expenditures would force hospital administrators to operate and make decisions on a sound business basis. Hospital cost containment programs in nine states have achieved substantial savings. In 1977, these states had an average 12 percent increase in hospital costs, compared to nearly 16 percent for the rest of the country. Considering that none of these programs dramatically reforms basic reimbursement policies, it is obvious that there is indeed considerable room to economize without sacrificing quality.

Three basic principles should be included in a hospital cost containment law. First, the cap should be mandatory and fair, taking into account changes in the cost of the items typically purchased by a hospital as well as changes in patient mix. Secondly, the quality of care must be maintained or improved and patients must not be transferred from institution to institution or refused admission on the basis of any criteria other than medical. And thirdly, a hospital cost containment law should be devised with the clear intent of being replaced by a national health insurance system with built-in cost controls.

Cost containment programs should emphasize conversion of unneeded health care facilities into less expensive treatment settings which will meet the needs of the public. Increasing the number of primary care clinics, for example, would reduce the use of highly expensive emergency room treatment for routine illness.

Long-term, structural reforms* Controlling costs through national health insurance

A universal comprehensive National Health Insurance (NHI) program is the only means by which the nation can once and for all regain control of the health care system. Without reforming the health care delivery system, the current incentives toward high intensity expensive medicine will continue to drain both private and public dollars from other uses without improving the health of the American people. Canadian experience shows that a truly comprehensive program can stabilize the share of GNP devoted to health care. (The share in Canada went from 7.3 percent in 1971 to 7.0 percent in 1977.) When the program is in full operation, prospective budgeting of hospital and physician expenditures should become the principal method of cost control.

Hospital budgets and schedules of payment of physician fees should be determined by periodic negotiations between representatives of all parties, including providers, consumers, and the government. Future increases in health care costs should not be permitted to exceed rises in the costs of other goods and services.

Providers should not be allowed to charge patients additional amounts above those that are negotiated in the budgetary process. National, area-wide and state budgets for health services and medical care would set maximum levels of expenditures.

NHI should provide adequate incentives to control costs such as currently provided by health maintenance organizations (HMO's). Competition between provider organizations should be encouraged by financially rewarding the most efficient providers and the patients they serve.

Any suggestion that a catastrophic health insurance program would alleviate current problems in health care is totally false. In fact, because such a system would encourage the most expensive care, even when less expensive modes of care would be adequate, it is highly inflationary. Moreover, because proposals for catastrophic insurance have enormously high deductibles, they would not protect anyone from financial ruin except those who need it the least--the rich. Similarly, catastrophic health

insurance does not put a limit on the amount of out-of-pocket health care expenses an individual or family may incur, i.e., it does not limit liability except for the cost of covered services. In addition, catastrophic health insurance does not remedy the problems of excessive hospital bed capacity, unnecessary surgery, maldistribution of physicians by specialty and geography, or the duplication of equipment. Finally, and perhaps most importantly, it would delay serious consideration of a truly comprehensive national health insurance plan for years.

* Reducing environmental threats to health

Until the second decade of this century, the principal diseases and causes of death were infectious diseases--tuberculosis, scarlet fever, whooping cough, cholera, influenza, and typhoid. With the exception of polio, the declines in mortality rates from infectious diseases long predated effective medical developments. Those infectious diseases were "conquered" through improvements in sanitation, municipal water supplies, nutrition and housing--in short, through prevention.

Today the leading (non-violent) causes of death for people over 40 are the so-called chronic degenerative diseases--heart disease, cancer, stroke, cirrhosis of the liver, bronchitis, and emphysema. Many experts believe that 80-90 percent of cancer cases result from environmental exposures to chemicals, dusts, cigarette smoke, and radiation. HEW Secretary Califano recently reported that as much as 20 percent of cancers could be a result of workplace exposure alone. Similarly, the workplace is currently the source of about 15,000 accidental deaths and from 100,000 to 300,000 deaths annually from occupational diseases (out of 2 million deaths in the country). Outside the workplace, air pollution from power plants, factories and motor vehicles creates a heavy burden of lung and other diseases.

All this means that we ought to be strengthening, rather than weakening, regulatory efforts to prevent illness and injury. By maintaining effective curbs on dangerous pollution of food, air, water, and workplaces and by toughening occupational and consumer product safety laws, we reduce the demand for medical treatment, which in turn helps hold down spending and prices in the health sector.

* Promoting health maintenance organizations/cooperatives

Health maintenance organizations (HMO's) provide comprehensive health care on a prepaid, per capita basis. This method of payment rewards HMO's for preventing illness, using less costly methods of treatment and minimizing hospital lengths of stay. Patients in prepaid HMO's use 30 to 60 percent fewer hospital days than fee-for-service structures. Rates of surgery have been shown to be nearly half that of fee-for-service in a private health insurance setting. And HMO's also add competition to local health care markets.

In its November 6, 1978, issue, Fortune concluded that the benefits of prepaid systems have proven to be pretty much what their supporters had always claimed but were hard put to document until these systems had time to develop. In this article, Fortune examined the Minneapolis-St. Paul health care system, where a majority of the doctors are now associated with prepaid systems. The oldest and largest of the prepaid plans is the Group Health Plan, a consumer cooperative with 115,000 members. The cost of health care in the Twin Cities area has been reduced by 15-20 percent according to one insurance company executive quoted in the article. Medical prices rise slower in Minneapolis as well. Group Health intends to increase its rates by 12 percent over two years, about half the industry average. Fortune also found that consumer satisfaction was extremely high at the co-op, in sharp contrast with general patient disgruntlement. Finally, Fortune found that the prepaid plans had pioneered innovative consumer services, such as follow-up calls to assure that patients are following physician advice and action to screen incompetent physicians out of the medical community.

Unfortunately, due largely to historic discrimination against them by medical associations, current HMO enrollment is less than four percent of the population. Access to existing HMO's should be improved. For instance, currently Medicare payments are only permitted on a retrospective basis; Medicare should be authorized to pay qualified HMO's on the basis of a predetermined fixed rate just as the private sector does. Also, legislation should provide additional loans and loan guarantees to HMO's. These should be subject to favorable certificate-of-need (CON) review and

federal qualification for the construction of facilities (or, where possible, the conversion or rehabilitation of existing facilities) which demonstrate significant cost reduction potential.

* Giving consumers a stronger voice

Consumer control over decision-making in health care is essential to achieving comprehensive quality health care at a reasonable cost. Consumer participation in the decision-making process at all levels will ensure public accountability of the nation's health institutions.

This participation should include broadly representative consumer control of administrative and regulatory programs (such as HSA's and PSRO's), health insurers (Blue Cross-Blue Shield) and the management of the delivery system... (such as governing boards of hospitals and HMO's). When providers are presented on health decision-making bodies, the providers ought to be broadly representative of all health care personnel-- professional, technical and support staff.

One area in which consumers could play a substantial role is health planning. The National Health Planning and Resources Development Act of 1974 provides an organizational structure for area-wide planning of health facilities. Under it, about 200 area-wide Health Systems Agencies (HSA's) each serve as the primary planning body in a specific geographic area. A primary purpose of the planning process is to improve the distribution of health resources, avoiding redundancy, yet ensuring access to adequate health resources. The localization of health planning through the consumer-dominated HSA's is a major step toward wresting control of the health care system from the providers.

One way the health planning law can be strengthened is to give HSA's the statutory right of access to hospital records dealing with cost of financing, patient care costs and patient discharge data.

Although the law requires that the development of HMO's be a priority for HSA's, there has been evidence that HMO's are not always equitably evaluated by them. Sometimes they tend to focus on short-range cost-effectiveness, where HMO's are at a disadvantage. Over the longer term,

however, HMO cost performance would improve. Therefore, federal law should require that HMO's have proper appeal procedures to the Department of HEW if they believe they have been treated unfairly and that sanctions should be imposed against HSA's in such situations.

Finally, although there are Certificate-of-Need (CON) laws in a number of states (all states must have them by 1980), they have fallen far short of their potential. Currently, CON is only required for hospital expenditures, including non-hospital capital projects such as health provider sectors, CON should be required for all significant capital expenditures, including non-hospital capital projects such as ambulatory care centers, clinics of any type, and expensive medical equipment in physicians' offices.

Similarly, CON procedures should be strengthened and CON decisions rigidly enforced to prevent duplication and overbedding.

* Cutting clinical costs

Evidence presented over the past few years to both Congress and HEW has demonstrated that clinical laboratories, including those regulated by federal law, have high error rates; estimates have ranged from 20 to 50 percent. The human costs of such errors are, of course, enormous. So, too, are the economic costs. False negative test results, for example, can leave illness undetected, eventually requiring expensive treatment that might well have been avoided. False positive test results can cause costly and unnecessary therapeutic programs, such as surgery.

During 1975, it was estimated that nearly 5 billion tests were conducted by more than 65,000 clinical laboratories (including physician office labs) or an average of more than 20 tests per person in the nation. About 10 percent, or \$12 billion out of \$120 billion spent for health in 1975, went for clinical laboratory services.

To improve the quality and control the escalating costs of clinical laboratory services, uniform national standards should be set, kickbacks prohibited and adequate records maintained. A clinical laboratory regulation

bill was passed by the House Commerce Committee in 1976 which would have saved, according to the Congressional Budget Office, \$251.6 million over a four-year period.

* Reducing unnecessary surgery and hospital stays

As noted earlier, in 1977 approximately 2 million unnecessary surgeries were performed at a cost of almost \$4 billion.

Efforts to reduce unneeded or questionable surgery have led to experimentation: with second opinion surgical programs. These encourage or require patients for whom elective surgery has been recommended to get another professional opinion before surgery is performed.

Second opinion surgical programs, such as the one the American Federation of State, County and Municipal Employees (AFSCME) ran in New York, have significantly reduced--in this case by over one-third--the incidence of unneeded surgery. Such programs should be expanded. They should be developed and included in health plans offered by employers and in all public and private health insurance plans.

An efficient and equitable means of controlling hospital use is to establish pre-admission testing procedures and strong utilization review programs. By diagnosing the problems in advance, hospital pre-admission testing will shorten lengths of stay by eliminating one to three days of initial hospitalization while test results are awaited. Utilization review programs are necessary so long as the economic incentives of current hospital reimbursement practices encourage inappropriate care, including high intensity treatment, delayed patient discharges and weekend admissions. Utilization review is also necessary because the physician continues to be virtually the only decision-maker once the consumer has approached the health care system.

Pre-admission testing and the retrospective and concurrent programs of reviewing appropriate uses of hospital facilities and services will perform the following functions, all of which will improve the quality and decrease cost: eliminate admissions where hospitalization is not required, reduce average length of hospital stay by eliminating unnecessary extended stays in the hospital, and assure quality health care at an appropriate level.

* Reducing the cost of prescription drugs

Prescription drugs cost Americans \$12 to \$14 billion a year or nearly ten percent of the nation's health care expenditures.

When used rationally, drugs minimize the need for far more costly, and all too often needless, alternatives such as surgery, hospitalization or physician office visits. Despite this and the fact that the use of drugs is one of the most moderate types of medical treatment, many health insurance policies including Medicare do not cover out-patient prescription drugs. Thus, drugs represent one of the largest out-of-pocket health expenditures to senior citizens.

For over two decades the pharmaceutical industry, and its ally, organized medicine, have systematically and effectively lobbied and unduly influenced the policy decisions of Congress and the Food and Drug Administration. As a result, consumers have been over-prescribed, and over-charged. The Drug Reform Act of 1979 could be a vehicle to address these problems. There are some salutary proposals in the proposed legislation, including information labeling for patients which will enumerate side effects and give consumers other information now provided only to doctors; and the requirement that pharmacies post prices.

The proposed legislation, however, does not address an important issue of prescription drugs: the extraordinary price differences between drugs prescribed under their trade names and products dispensed under their generic names. The FDA could undermine the deceptive claims of the industry about the safety and effectiveness of generic drugs by publicizing a list of interchangeable drugs. The FDA also has the authority to inform the medical profession and the public that there is no difference between the two products.

In addition, COIN recommends the following:

- Currently, drug information is provided to physicians by salesmen (detailmen) or through trade publications dependent upon drug advertisements. This practice has led to higher priced drugs, irrational prescribing and the overuse and misuse of drugs. To counter industry's multi-billion dollar propaganda program,

FDA ought to serve as the source of drug information and as the aggressive disseminator of this information.

- HEW should develop a "Formulary of the United States," which would include only those drug products which medical experts consider necessary for good medical practice.
- Congress should enact laws requiring pharmacists to substitute lower priced generic equivalents or brands for higher priced brands, unless otherwise indicated by the prescribing physician, and require that savings in cost be passed on to the consumer.
- Patent laws should be amended to provide for a protection period for drug developers and to require prescription drug patent holders to license other drug manufacturers who want to produce the drug during the patent period. In addition, trade names should be put into the public domain after a patent expires.

* Eliminating cost-sharing will encourage appropriate care

Cost-sharing measures are principally adopted to cut program costs by requiring the patient to pay some portion of the cost of care and by discouraging over-utilization of services. The methods include deductibles (initial fixed out-of-pocket payments), coinsurance (a fixed percentage of the total charge), and co-payments (fixed dollar amounts per service or item).

Cost-sharing is complex and expensive to administer and enforce and it is of questionable effectiveness as a device to regulate physician-initiated services. Indeed, cost-sharing may well increase health costs by deterring patients from obtaining treatment early in the process of disease when treatment would be simple and inexpensive.

A more appropriate, efficient and equitable means of controlling utilization is by establishing pre-admission testing procedures and requiring strong utilization review programs. Controlling utilization, after all, is primarily in the province of the physician.

On Conservative Scapegoats, Corporate Power and Consumer Justice

With a public angry and confused over skyrocketing prices, corporate and government leaders have developed a set of useful scapegoats for inflation. Many Republican members, conservative Democrats, laissez-faire economists, business spokesmen and the trade press routinely, if not reflexively, pin the blame on government regulation and government spending. Cut both and inflation will go away, it is said.

But slogans repeated often enough are still slogans--and these vogues have little support other than the political theology of those who repeat them.

Government Regulations

The case that government regulation causes inflation has been dominated by funny numbers and conceptual confusion.

First, the estimates of the costs of regulation are usually provided by business regulatees, who have an obvious self-interest in exaggerating the alleged costs. In the early 1970's, for example, chemical manufacturers announced that a proposed federal standard on vinyl chloride, a proven cause of cancer, could cost two million jobs and \$65 billion to \$90 billion. The standard nevertheless was adopted and the industry has flourished--without any job losses and at a cost that is one two-hundredth of the original industry estimate. For one more of numerous examples, the Securities and Exchange Commission has a curious case pending against U. S. Steel: The company allegedly has established two estimates for the cost of meeting certain pollution standards--a higher estimate issued publicly and a lower one sent to the SEC.

Second, opponents of regulation frequently speak only of the costs of regulation, ignoring the often substantial benefits of regulation. For example, sulphur oxide and particle emission standards from stationary sources may cost \$9.5 billion this year, as Lester Lave and Eugene Seskin estimated in a recent book. But the standards will save an estimated \$16.1 billion just in health outlays, which have been playing a large role in fueling inflation. By their calculations, the anti-pollution standards are actually deflationary, not inflationary.

After Washington imposed strict safety standards for car bumpers, auto engineers developed bumpers that are far stronger and lighter--and saved consumers an average \$100 in repair costs over the life of the car. By 1985, federal fuel economy standards for cars will be saving 15 billion gallons of gasoline annually, or \$640 per car over the life of the vehicle.

And there are the benefits of regulation that cannot even be calculated in monetary terms. How much will you pay for a six-year-old who is not disfigured from flammable sleepware? How do we calculate the exact benefits of being able to see across the Grand Canyon, of avoiding needless destruction of recreational areas? Exactly how many lives will be saved or how greatly will productivity be increased in 30 years by reducing toxic substances in the workplace today?

Despite these and other gains, regulation is still blamed for inflation. Yet when Data Resources, Inc. analyzed the annual inflationary impact of all air and water pollution regulation, they put it at about 0.3 points of the annual increase in consumer prices. And this calculation did not even factor in many of the benefits of the regulations. Even taking these numbers at face value, a significant 20 percent reduction in regulatory costs would only lower the annual rate of increase in the cost of living index by one-tenth of a percentage point. Any reduction in inflation is not to be disparaged, but the contribution of regulation to the problem is relatively modest--certainly less than the contribution of price-fixing, trade barriers, natural gas deregulation, oil deregulation or the latest OPEC price increase.

Finally, it is important to note that many of the cost-of-regulation studies fail to distinguish between cartel-regulation (ICC, CAB, FMC), where the government substitutes for a viable marketplace by fixing prices and frustrating entry, and health/safety regulation (FDA, OSHA, NHTSA), where the government controls "spillover effects" and deters hidden defects because the marketplace fails to do so. There is a crucial difference between government intervention where competition can work, and where it hasn't and can't.

Government Spending

Much of the public believes that excessive federal spending causes inflation. This sentiment, in part, is a major spur for a balanced budget amendment. A 1976 report by the Joint Economic Committee concluded, however, that if a balanced budget strategy had been followed between 1965 and 1974, there would have been a decrease in economic growth, an increase in unemployment and only a minimal effect on inflation. And one wonders how Germany, often cited as a model in this area, could have such lower inflation rates with both a faster growth in money supply and far bigger deficits (e.g., four percent of its GNP in 1978 versus five-tenths of one percent in the U. S., combining federal, state and local expenditures).

Herbert Stein, former chairman of President Nixon's Council of Economic Advisors, says that: "Deficits don't cause inflation all the time. We have had deficits almost all the time since 1929 and haven't had inflation all the time. Whether deficits are inflationary or not depends on their size, their timing, their rate of change, and how they are financed." Roughly agreeing with this observation is Dr. Stein's Democratic successor, Dr. Walter Heller. "Except where federal deficits pump more purchasing power into an already prosperous or overheated economy, they do not feed inflation," he says. "When the economy is slack or in a recession, when there are idle workers and idle plants and machinery to be activated by additional demand for goods and services, tax cuts or spending hikes that enlarge the deficit help the economy get back on its feet." Heller adds that to balance the budget in a sluggish economy "would send the economy into a deeper tailspin, thereby throwing more people out of work, further cutting tax revenues and boosting unemployment compensation, food stamps, and similar entitlement

expenditures, thus throwing the budget even more out of whack. A dog chasing its own tail comes to mind."

In contrast, the benefits of gross cuts in federal spending range from small to negative. According to the Congressional Budget Office, all of President Carter's budget cuts will reduce inflation by one-tenth of one percent. Economist Lawrence Klein of the University of Pennsylvania has estimated that cutting our federal budget deficit today to zero, which not even most budget-cutters expect or advocate, would lower the inflation rate by about one point.

In any event, if one wants to argue that excess spending causes inflation, the culprit would be not federal spending but all government spending--federal, state and local. And all annual government spending today approximates all annual government revenues. That is, the government budget is already balanced--since the federal deficit, which includes \$77 billion in grants-in-aid to state and local governments, is counter-balanced by a \$26 billion state and local government surplus.

Government budgets are in balance, yet inflation continues. Why? Because of the structure, shortages and inefficiencies in each of the four basic necessities of life--food, energy, health care and housing. A "New Inflation" caused by structures and shortages sector by sector is not susceptible to quick-fix cures like a "balanced budget." If tomorrow federal outlays exactly matched federal revenues, does anyone really believe that the cost of a day in a hospital would stabilize or that the price of imported oil would come down?

Controlling Inflationary Corporate Power--In the Market and In Government

There are two final flaws in our industrial economy which alone do not cause the new inflation, but which must be addressed as part of any long-term solution.

Monopolistic structures and practices frustrate economic competition and maintain an artificially high price level year after year. Market concentration and price-fixing, for example, do not jolt the economy suddenly into higher prices from one year to the next. Their enduring presence, however, frustrates other strategies to achieve lower, stable and cost-based prices. Similarly, widespread consumer abuse combined with consumer inability to correct and be compensated for such abuse wastes purchasing power. Again, such abuse does not definitionally cause inflation--which is defined as yearly increases in price beyond increases in quality. But it helps sustain a price level above the effective market ideal.

Anticompetitive Structure and Practices

The most costly anticompetitive practice, of course, is price-fixing, which has been a per se criminal offense for half a century. Although there are no economic studies on the extent of price-fixing in the economy, the evidence indicates it is extensive and costly. The Justice Department's Antitrust Division recently found that substantially increased spending on investigating price-fixing conspiracies uncovered a proportionate number of new conspiracies. Joe Sims, the former deputy head of the Division, complained in 1976 that "price-fixing is a common business practice." When the Corporate Accountability Research Group surveyed the presidents of Fortune's top 1000 industrials in the early 1970's, it asked whether they agreed with the view that many businessmen price-fix. Of the 110 respondents, 60 percent agreed.

The results of a successful antitrust conspiracy are high prices. After surveying the empirical studies in this area, the Antitrust Law and Economics Review concluded that "(price-fixing) inflates prices by some 25 percent or more above the non-collusive or competitive level." More spectacularly, overcharges of 900 percent and 600 percent were reported, respectively, in the 1960's electrical machinery bid-rigging scandal and world quinine case. Before the government moved against an antibiotic conspiracy in the late 1960's, a bottle of 100 capsules of 250 milligram dosages of tetracycline retailed for \$51.00; after, it sold for about \$5.00.

More costly than overt price-fixing is the concentrated structure of American industry. Professors William Shepherd and Richard Barber both have calculated that oligopolies control nearly two-thirds of our manufacturing sector. For example, four firms control domestic production of 98 percent of locomotives, 96 percent of aircraft propellers and parts, 96 percent of automobiles, 93 percent of electric lamps, 88 percent of chewing gum, 81 percent of cigarettes, 72 percent of soaps and detergents, and 71 percent of tires and inner tubes. Most industrial economists agree that when an industry has a four-firm concentration ratio of 50 percent or more--i.e., when four or fewer firms control 50 percent or more of a market--it tends to act like a cartel or monopoly.

Even these descriptions of the extent of market concentration probably understate how much industrial power is concentrated in a few hands. First, interlocking managers and directors in an industry are prevalent. Second, joint ventures, especially in the oil industry, are common forms of business. And "businesses that are partners in one market," said the Cabinet Committee on Price Stability in the late 1960's, "may be disinclined to behave independently when they meet as rivals in others." And third, by 1967 just 49 banks were trustees of \$135 billion in assets. These banks held five percent or more of the outstanding shares of one or more classes of stock--which can constitute a controlling interest--in 5,270 companies (many being direct competitors).

There is also aggregate concentration--when our largest conglomerates control the assets of various industries. Market concentration is concerned with a firm's percentage of a particular industry; aggregate concentration

is concerned with a firm's asset size. Due in large measure to the conglomerate merger wave of the late 1960's and the more recent increase in large conglomerate mergers--there were 41 mergers involving acquisitions of firms with over \$100 million in assets in 1977, and 80 in 1978--aggregate concentration has significantly increased in the past few decades. As Chairman Edward Kennedy of the Senate Judiciary Committee has pointed out:

The Fortune top 100 firms control about the same share of manufacturing assets as did the top 200 thirty years ago....The top 200 firms now have the same percentage share of manufacturing assets as did the top 1,000 in 1941....In 1955, the top 500 industrials controlled 65 percent of all manufacturing and mining assets. In 1965 the figure was 73 percent, and in 1977 it was 83 percent....They control almost 60 percent of our gross national product, 30 percent of total business receipts, and about 70 percent of manufacturing revenues.

And even conglomerate mergers, though not between direct competitors, can help solidify oligopoly power. Such mergers can entrench leading firms in a market, result in intra-firm "reciprocity" among subsidiaries which forecloses markets to outsiders, discourage the potential competition of a firm that may have entered by construction rather than acquisition, and encourage "mutual forbearance" with other conglomerates they meet in the marketplace.

The consequence of market, vertical and aggregate concentration is higher than competitive prices.

It seems like ancient history, but prior to the 20th century prices would rise and fall, depending on such classic variables as supply and demand. No longer. Price in concentrated industries is, as economists say, "sticky downward." The phenomenon of "administered prices"--a term developed by Gardiner Means--is simple in its operation. A monopoly or well-coordinated cartel can obviously charge a higher-than-competitive price and make it stick since the consumer lacks a cheaper alternative. Yet when a few firms dominate an oligopolistic industry, a system of mutually beneficial "parallel pricing" or "price leadership" can achieve the same result. For example, an industry leader, such as U. S. Steel, announces

a price increase of six percent on certain major items; within days all other firms in the industry increase their prices by a comparable or identical amount. Since different firms have different costs, only a system of noncompetitive price leadership can enable them to charge similar prices. Industrial economists William Shepherd and F. M. Scherer estimate the transfer cost of oligopoly at three percent of GNP annually--i.e., higher prices transfer over \$60 billion a year from consumers to producers.

Also, profits are higher in concentrated than in competitive sectors. Economist Leonard Weiss of Wisconsin has collected and analyzed virtually all econometric studies of concentration and profits: of 45 studies, 38 showed a significant positive correlation and seven showed an insignificant or zero correlation. Weiss concludes: "The bulk of the studies show a significant positive effect of concentration on profits or margins....All the studies together reflect a wide range of experience--from 1936 to 1970, and covering Britain, Canada, and Japan as well as the United States."

The persistence of perennially high prices can aggravate inflation in two ways. First, countercyclical monetary and fiscal policy assume that an increase in interest rates or reduction in government spending will reduce aggregate demand, cool off the economy, and control inflation. But oligopolies can frustrate such governmental efforts, maintaining high prices or even increasing them since consumers may have nowhere else to go. Hence, when the Nixon and Ford administrations prescribed the classical Keynesian cure of tight money, this oligopoly power contributed to a new disease dubbed "stagflation," which combines inflation and recession.

Second, studies by Blair and Means indicate that prices rise faster in concentrated than unconcentrated industries. From 1969 to December 1970, with aggregate demand contracting, Blair found that average prices rose 5.9 percent in industries with four-firm concentration ratios of over 50 percent and fell 6.1 percent in industries with four-firm concentration ratios of under 25 percent. Means looked at the 12-month period beginning in September 1973 and documented that wholesale prices increased 27 percent for oligopolistic firms while prices rose less than five percent in

competitive industries. In the view of Leonard Weiss, the pricing behavior of concentrated and unconcentrated industries differs during periods of cost-push inflation (which the former can pass on to consumers while the latter cannot) and demand-pull inflation (which affects competitive firms but not oligopolistic ones).

What appears beyond doubt, however, is that administered pricing does create an inflationary bias in the economy. At the least, concentrated industry prices increase even in recessions, increase rapidly in cost-push inflation, and set a standard for less concentrated industries to reach for in a demand-pull inflation.

The extent of price-fixing and oligopoly in the United States is not ordained. It is the result of the abuse of market power and lax law enforcement. There are several long-run approaches that could accomplish the radically conservative goal of restoring competitive prices to our industrial marketplace:

- o Existing penalties against price-fixing--up to three years in prison and up to \$1 million per count for companies--are almost never imposed and can still be wrist-slaps to giant firms with billions in profits. New legislation could require that culpable firms pay fines that are twice the size of their illegal profit or gross overcharge, whichever is higher. This standard would help assure that, regardless of firm size, the penalty quite literally fits the crime.
- o The Antitrust Division has for over two years been trying to develop a "shared monopoly" lawsuit--one that attempts to attack oligopoly market structure under the existing Sherman Act. It should either announce that a case will be forthcoming and/or propose new legislation--along the lines of the late Senator Philip Hart's deconcentration bill--that would deconcentrate oligopolistic industries into more competitive structures.
- o President Carter has criticized large oil firms for using their new-found profits not to produce more energy but make new acquisitions. Senators Edward Kennedy (D.-Mass.) and Howard Metzenbaum (D.-Oh.) have introduced legislation, S. 1246,

that would prohibit the 16 largest oil firms from making acquisitions of firms of over \$100 million in assets. The Administration should support this measure and Congress should pass it.

- o Given the political and economic consequences of increasing conglomeratization, an amendment to the Clayton Act could: prohibit all mergers of firms each with over \$2 billion in sales or assets; prohibit mergers between firms each of which was either over \$350 million in assets or accounted for at least 15 percent of its industry's sales, unless the firms demonstrated that the acquisition would promote competition and divested themselves of roughly an equivalent amount of assets.

New Forms of Ownership to Reduce Inflation

Beyond traditional approaches to strengthening competition, we believe that it is important to give strong support to new forms of ownership to increase competition and reduce the influence of corporate power on government policy.

There are several specific areas for concentrated attention:

- o Experience in the United States and Europe indicates that cooperatives can substantially reduce consumer and producer costs by increasing competition.

The success of various cooperatives has illustrated their potential anti-inflationary impact. The Group Health Cooperative of Puget Sound, with 200,000 members, offers health care at below half the average per capita expenditure on health care nationwide while providing greater service than most other insurance coverage. In Minneapolis, where a majority of doctors are now associated with prepaid systems, the cost of health care has been reduced by 15-20 percent, and medical care prices rise more slowly than elsewhere. The Berkeley Coop discovered that the supermarket chains lowered their prices to match the near-by coop store. Other examples of lower prices resulting from the growth of food coops have been mentioned in Chapter 2.

Cooperatives should be supported through an adequately funded National Cooperative Bank. Although recently enacted into law, anti-cooperative members of Congress continue efforts to block all appropriations to the bank.

They should be vigorously opposed. In addition to financing cooperatives, it can encourage new coops through the provision of seed grants and technical assistance to establish local cooperative enterprises.

o Publicly controlled agencies offer another anti-inflationary ownership alternative. Such an agency might help curb food inflation. A public export corporation, such as a U. S. grain board, could coordinate a commodity export strategy designed to give first priority to domestic grain needs. By requiring U. S. purchasers to pay a predetermined, relatively stable price, and selling additional stocks on the world market and banking the difference in a cash reserve, the United States could enjoy substantial stabilization of consumer prices. The cash reserve would be used to support farm income in bad years and to help third world nations expand their productive capacity in agriculture. This country would thus be insulated from jolts and from profiteering by grain dealers, and enjoy stabilized farm income and consumer prices.

Similarly, in the energy sector, the federal government could set up an agency to be the sole legal importer of oil. Through secret bidding for an oil supply and delivery contract, this plan would encourage individual oil-producing nations to compete and sell at prices below the cartel level. This invitation to compete could be very attractive to several OPEC members currently short on cash, burdened with large under-developed populations, and producing well below capacity.

o In areas where monopoly power dominates an industry, publicly owned firms can provide competition and other benefits. A federal oil and gas corporation could serve as a yardstick in determining fair energy prices, establishing accurate data on reserves and providing competition in an extremely non-competitive market. Only the vast resources of the government could hope to challenge the control of the major oil companies. Furthermore, it could provide for more efficient use of resources while protecting the environment, participating in research and development, and give supply preference to regions where the need is greatest. Thus, a TVA-like federal gas and oil company could lead to greater energy supplies at a lower cost to the American consumer.

Precedent for publicly owned firms exists outside the United States as well. Several Canadian provinces, for instance, have experimented successfully with government insurance companies--costs have been kept low while services remain high.

o Worker-owned firms demonstrate further potential for reducing prices, particularly through increased productivity. The widespread evidence collected in recent years overwhelmingly indicates substantial productivity increases due to such ownership forms--estimates range to twenty percent and above. For example, the South Bend Lathe Company saw a twenty-five percent increase in productivity within one year of its purchase by its employees. Other experiences with alternative ownership forms, including community development corporations, employee stock ownership plans and labor-management productivity committees demonstrated similar results.

Such productivity rises, by reducing unit labor costs, could help hold prices down. Increasing the supply while keeping costs fixed would clearly lead to lower prices.

Several pieces of legislation to assist employee organizations attempting to buy firms have been introduced in Congress. The implementation mechanisms range from the provision of loans and/or loan guarantees to tax incentives to technical assistance. We believe that these bills should be supported and that these new economic institutions deserve an opportunity to demonstrate their effectiveness as competitive spurs.

Consumer Access to Justice

Business fraud and deception can lead to high prices and wasteful purchases. A survey of supermarkets in Tennessee in the early 1970's found that 70 percent short-weighted meat. A 1979 study by the Department of Transportation of auto repair concluded that about half the \$50 billion a year spent on repairs bought nothing of value--due either to fraud, incompetent work or unnecessary work. Senator Philip Hart, former chairman of the Senate Antitrust Subcommittee, once aggregated all known studies about the extent of marketplace fraud. His conclusion: about a quarter of every consumer dollar bought nothing of value.

To be sure, there are many local, state and federal laws that prohibit most of these practices and that provide remedies for consumers. But even if the substantive laws were adequate, are consumers procedurally able to use them? And do consumers have access to bureaucrats and judges to promote their interests--which include safe, quality goods at fair prices? Too often the answer is no--due to court rules, agency rules, and the cost of lawyers. But if sellers have no fear that defrauded buyers will be able to demand and obtain compensation, they will not be deterred from seeking illegal gains. As a result, Senator Hart's economy, of 75 cents on the dollar, will persist.

Ensuring consumers' access to manufacturers, sellers, agencies and courts is a final way to avoid the high price structure that is the inevitable consequence of unchallenged fraud. Seven proposals would go far to providing this access and deterrence:

* Consumer Class Actions

In an economy where companies can defraud consumers in bulk, consumers in turn should be allowed to sue in bulk. Consumer class actions can be an efficient way to centralize claims based on similar facts--claims which

separately may be too small to warrant the costs of lawyers and courts. Yet statutory and judicial standards--requiring that each member of a federal class have a minimum \$10,000 claim, that all potential members of a class actually be notified and that large classes may be excluded due to "unmanageability"--have frustrated the use of this tool. Legislation should modify these standards to allow federal class actions if the class in the aggregate meets the jurisdictional minimum of \$10,000, to provide for reasonable mass notification, and to permit the Justice Department to bring "public actions" on behalf of a class when the injury involved is below \$500 per consumer.

* Illinois Brick

The Supreme Court ruled in 1977 that indirect purchasers, such as consumers, could not sue manufacturers who allegedly price-fixed. According to the Court, the only plaintiffs in these cases could be direct purchasers--i.e., middlemen, who for reasons of industrial comity often won't sue their dominant suppliers. Chairmen Rodino and Kennedy support legislation, as does the Administration, to overturn this decision.

* Standing to Sue

The Constitution in Article III requires that there be an actual "case or controversy" before a court will consider a lawsuit. Judicial decisions have expanded this "standing" requirement into a serious barrier to the initiation of lawsuits where citizens challenge illegal government actions. Legislation introduced by Senators Metzenbaum, Kennedy and Ribicoff, restoring the doctrine of "standing" to its limited constitutional dimension, should be adopted.

* Private "Attorneys General"

Until 1975, courts could award attorneys' fees to prevailing litigants whose lawsuit vindicated a general public policy. The purpose of this exception to the usual "American rule" of not granting fees to the victor in litigation was to encourage citizens to question illegal or unconstitutional governmental actions as if they were "private attorneys general." In the Alyeska decision, however, the Supreme Court prohibited such awards

absent specific statutory authorization. But since going to court is expensive and the beneficiaries of such successful suits are the public and not the plaintiffs, legislation is needed to restore the status of such plaintiffs to the pre-Alyeska situation.

* Dispute Resolution Act

The judicial system is designed to resolve major commercial disputes, but not what have been called "little injustices"--small consumer claims. Although a \$50 consumer fraud may be insignificant to a person earning \$25,000 a year, it can mean some meals deferred to a poor family. And many such frauds can collectively undermine a community's economic health. Federal legislation introduced by Rep. Bob Eckhardt (D.-Tx.), H. R. 3719, would provide \$15 million to local authorities and non-profit groups to develop alternate dispute resolution models--arbitration, mediation, accessible small claims courts--to hear and resolve small consumer disputes.

* Consumer Voice

Federal agencies make decisions affecting billions of dollars in commerce, as well as the health and safety of millions of consumers--yet consumer voices influence only a tiny minority of the 7,000 federal rules and regulations promulgated annually. The Senate Governmental Affairs Committee studied representation of business and consumer interests before regulatory agencies, and concluded that the former were usually multiply represented while the latter often had no spokesperson in formal proceedings. A "Consumer Voice" could be a small, non-regulatory, advocacy office designed to insure that bureaucratic decision-makers hear more than one side in pending controversies and to be able to go to court to challenge adverse agency decisions. The Consumer Voice would monitor and prod the bureaucracy on behalf of unrepresented consumers.

* Public Participation

A provision of the pending regulatory reform bills (S. 262, S. 755) would provide another way to return the bureaucracy to the people. The Administrative Conference would distribute small grants to groups or individuals to appear in agency proceedings if they couldn't otherwise afford to appear and if they had something substantial to contribute that no other witness had covered. This program already exists by statute at the Federal Trade Commission and six other agencies. These bills would apply the concept government-wide.

Senator MCGOVERN. Mr. Mohn, I know you have to go on to another engagement. I would break in for that reason and ask you a couple of questions.

There is a move on in the Senate to bring the catastrophic health care bill to the floor.

Mr. MOHN. Catastrophic health care, Senator, will just add a little dab to the very unsavory system that we are engaged in today. It will do nothing to change the whole system of health care and its delivery.

For the poor people, it will have little impact. If you are really poor, you can get care; maybe not the kind of care you would like to buy for yourself, but you can get care.

Senator MCGOVERN. I agree with that. I'm opposed to that approach. I think it may even further distort some of the already serious distortions in the health care industry, but it does have a kind of superficial appeal to a lot of people. I find a lot of people that I talk with in my State say: Let's at least take care of the more expensive illnesses if we can't have the whole thing. Let's begin with the ones that are likely to bankrupt even a middle-class or upper-middle-class family.

It does have a kind of superficial logic that is somewhat difficult to handle.

Mr. MOHN. The medical care industry has been very successful over the years in offering little improvements here, little improvements there, at very little help to the people that need health care. But, as you say, they sound good, and people are prone to look at them and say, "Well, they are trying to be helpful."

That is their way of keeping a national health care plan from succeeding in this Congress.

Senator MCGOVERN. There is another problem. I would say that, essentially, communications and political problems exist on this matter of cost containment. The hospital administrators and doctors that I talk with say, "How can you ask us to undergo a cost-containment program aimed at a single industry?"

They point to the fact their fuel costs are skyrocketing; interest rates are up; food costs are up. It costs a lot more money to run a hospital now than it did 5 years ago. They make a rather convincing case that it's discriminatory to single out one industry for, in a sense, price controls and leave everybody else free.

Mr. MOHN. That's correct, but that is another approach to the problem that keeps us from doing too much about it.

Senator MCGOVERN. Mr. Alperovitz, who is next?

Mr. ALPEROVITZ. Mr. Flug will now deal with the energy sector.

STATEMENT OF JAMES F. FLUG, DIRECTOR AND COUNSEL, ENERGY ACTION EDUCATIONAL FOUNDATION, WASHINGTON, D.C.

Mr. FLUG. This is an auspicious day for us to be discussing this subject. As of the last reports out of Geneva this morning, the discussion there was \$18 a barrel minimum, something on the order of a \$20 per barrel maximum for OPEC oil.

Now, even as recently as a year ago, that would have been considered unimaginable pricing, because a year ago the main problem in the

world oil markets was the oil glut. The expectation was that the production of oil would exceed the usage of oil and that the supply of oil would increase faster than the demand for oil; that that would continue well into the 1980's, and that the main problem for the OPEC producers would be who was going to do the cutting back to prevent a substantial fall in the real price of crude oil around the world.

Well, as we all know, there have been some things that have happened since then. I don't think they changed the basic fiscal trends. They have changed the political situation and, as a result, the economic situation. We are in a position now where the cartel has been able to curtail its production sufficiently to tighten the world market, but I don't think that is a sufficient explanation for what is going on, nor is it really entirely satisfactory as an explanation for what has been going on in the U.S. market because, after all, we still supply to ourselves 75 or 80 percent of our energy. Only 20 or 25 percent comes from abroad, if you look at our entire energy supply.

So when OPEC is given as the reason for our energy inflation, we can take that as a partial explanation at best, because OPEC does not control the vast proportion of our energy supply.

Senator JAVITS. Mr. Flug, I'm with you, but I do think you should make it clear, however, that we are dependent on foreign oil for 50 percent of that category. You can't use what you pipe into a utility plant to run an automobile.

Mr. FLUG. Yes and no.

Senator JAVITS. You have to be clear on that.

Mr. FLUG. Over anything past the short term, there is a great amount of substitutability among energy forms. As I will point out in a minute, since I think state of mind is an important part of the problem, I think it's important to begin with the overall picture.

Just to see where we have gotten so far in domestic terms: In 1970 the cost of fueling the economy, the total cost of energy as a percentage of gross national product was about 2.1 percent. By 1977 that had risen to 5.5 percent. If in 1977 all our energy had been priced at what was then the OPEC levels, the cost of that energy as a percentage of our GNP would have been close to 11 percent, or double what it was.

If the world energy price continues going up at the pace that it is, and if we allow all our energy to move to the world price, then we will be talking about 14.7 percent of our GNP to fuel the economy. This has tremendous implications, both on a personal level, family level, and on a macroeconomic level.

More and more of our effort will be going just to fuel the economy. More and more of the transactions in the economy will be to produce and purchase energy.

Now, as Gar Alperovitz was pointed out, there is no sector of the economy rising faster. It's clearly one of the driving forces in inflation. It impacts on—Mr. Kahn doesn't like to use that as a verb—it has a tremendous impact on every other sector of the economy. You need only look at the major energy inflation indicators since 1972 to see, for example, that while the average worker earnings went up 50.2 percent from 1972 to 1978, No. 2 fuel oil, for example, went up 184 percent. Of course, that would be much more, right now.

Now, on the materials that I submitted—I will submit the whole thing for the record—the one entitled, "America's Energy Challenge:

The Right Route to the Right Result." I go through some of the reasons why this is happening. In explaining why, I implicitly suggest some of the answers.

I won't read the whole thing, but basically, I think we have been encouraging the world price to go up. We have not had either the will or the preference or the domestic coordination and organization to take on the rising world price. We have been talking as though there is no choice and we have to say, despite the fact, as I say, that the world oil price affects only a fraction of our energy, and that we are a major customer doing business with people who, indeed, are major suppliers of ours.

We have allowed our own oil industry to support—be in partnership with the cartel. We have actually encouraged our oil industry through tax policy, through the invisibility of their investment production decisions, and other positive policies, we have encouraged them to support OPEC. Even our strategic petroleum reserve, which was supposed to be a counterforce to OPEC, has not in fact worked out that way.

It has worked to tighten the market at the wrong times, to deprive the domestic market of crude oil at a time when the domestic refining industry could have used it.

Most relevant right now because of what is going on today or yesterday on the House floor, and will be going on the Senate floor, we have made and encouraged public and private long-term investments in future energy sources at an extremely high level. In other words, given an entire spectrum of possible future energy costs, we have picked for our major investments the highest cost, most investment-intensive investments with the least short-term results. I think that this is helping to pull up the OPEC price.

We are establishing the replacement cost of energy, in economist terms, at a high level that OPEC can depend on, that our oil producers can depend on, rather than seeking lower points on the continuum of energy supply and energy-saving investments that would give us the lower replacement cost.

We have not used our public resources affirmatively as a sword, both in dealing with OPEC and our domestic industry. To take just one example, the Outer Continental Shelf. Instead of using the oil and gas resources there to stimulate competition, to get rapid production, and as well, to get a fair return to the Treasury, we have continued to use a system—despite congressional criticism—we have continued to use a system that puts our public resources in the hands of the largest oil companies, allows them to inventory those resources in such a way that they don't operate as a counterforce to OPEC.

Most of all and finally, we have allowed our domestic resources—or we are in the process of allowing our domestic resources—to go up to OPEC price levels.

Now, it seems to me that there is no way we can be critical of OPEC today for raising its price when we are in the process of letting our own producers get the same price. We can't say that \$20 per barrel is too high a price if at the same time we are justifying the receipt of \$20 a barrel for large amounts of our domestic oil, and the equivalent of that for our domestic gas for our own producers. We take away our own argument and, conversely, give the OPEC producers the argu-

ments about elasticity of supply and demand that are made to support our own decontrol efforts, to use that against us.

In short, to the extent that our substantial resources of energy can, at the margins, provide some competition, some downward constraint on OPEC, we are giving that up. Controls are not a goal in themselves. The only purpose of controls is to prevent harm to the economy, to insulate the economy from impacts that are unacceptable to us.

By definition, the OPEC price is set by a cartel. The purpose of a cartel is to restrict supply and prop and protect the artificially high price.

We have a right to protect our economy against the artificially high price. That does not mean we are providing artificially low-cost energy because, in fact, the price of energy in this country is already substantially higher than the cost of energy would be in the truly competitive free market in this country.

So, our recommendations, especially our short-term recommendations, focus on price controls. It is not because price controls are a goal in themselves, but a necessarily interim vehicle while we do the other things necessary—competition, production, conservation—that will get us back towards the potential that a free market might give us. Whether the free market itself will ultimately do that or whether additional Federal intervention will be required because of the malstructuring of the industry, because of the history of energy in this country, is a question we can leave to another time.

In the meanwhile, we must control these prices. If we don't, then we will see inflation continue as it has gone in the past, with energy leading the charge.

I am sure I will have more to say in answering questions.

Senator McGovern. Thank you.

[The following materials were supplied for the record by Mr. Flug:]

AMERICA'S ENERGY CHALLENGE: THE RIGHT ROUTE TO THE RIGHT RESULT

(Address by James F. Flug, director and counsel, Energy Action Educational Foundation, before the American Bar Association, Section on Science and Technology, New York, August 8, 1978)

Nothing could more vividly dramatize why America's energy path is so thoroughly confused, counter productive, and calamity-prone than the session being conducted simultaneously with this one by the ABA's Section on Natural Resources. There the speakers are the Secretary General of the international oil cartel, the Senior Vice President of one of the Seven Sister companies which are literally partners, agents, and prime beneficiaries of the cartel, a U.S. Senator whose votes almost never vary from the cartel/sister position, and a senior official of the U.S. Department of Energy which, as far as one can discern, seems bent on having the U.S. support, strengthen, and effectively join the OPEC/Seven Sister fold. That Section, by the way, will be chaired this year by a man from one large oil company, and next year by a man from an even larger oil company.

You can understand why as a member of that Section, I have dispatched to the Section Chairman a "Notice to Show Cause," why I and anyone who believes that any serious discussion of energy issues must include a broader spectrum of views, should not leave that Section to its incestuous musings, and look elsewhere in the ABA for a more meaningful and relevant forum.

And you can understand why it is therefore especially gratifying to appear before an ABA Section which recognizes, as your program chairman wrote in his invitation, that "It is very important that we balance our presentation" to have a "consumer advocate" to "present a viewpoint that is different from that presented by industry."

If national energy policy-making were structured as this program is, with imaginative technologists laying out the widest range of physical options, reasonable businesspersons identifying financing and organizational choices associated with those options, and the public interest having the last word, then there would be hope not only for viable, but also for optimal—happy, if you will—solutions to the nation's energy challenge.

I use the word challenge purposely, because misuse and overuse of the word "crisis" has become a major part of our energy problem. Instead of using "crisis" to mean, as Webster's puts it, "a turning point in the course of anything; decisive or crucial time, stage, or event," politicians and pundits have focused on its other sense, more synonymous with "emergency" ("Sudden or unforeseen situation that requires immediate action"). This mindset has produced a substitution of a crisis management approach—that is, reacting defensively so an imagined emergency—instead of a policy planning approach which sees the turning point as an opportunity to assess alternative results, and alternative routes to those results, and pick the best route to the happier result.

As a nation, we are not so powerless and unimaginative, so insignificant and unskilled, that we cannot aspire to something grander than merely fending off disaster. Nor need we be satisfied with scenarios which restrict the American public to "least worst" choices left over from a process by which other forces aggressively seek joint optima for their particular interests. Certainly we can ask that public policy decisions made by public officials not be the very instruments of any private optimization which ignores and precludes true goal-setting by and for the public.

Yet if as a nation we continue on our present course, we will create a crisis by our handling of the challenge; we will condemn our children and our grandchildren to a world where usable energy becomes a luxury for the individual, where energy production absorbs many times its historic share of the nation's capital flow, product, and income, and where the entire industrial structure is increasingly dominated by conglomerates radiating from the core of an ever concentrating energy oligopoly. In the interests of brevity, and of getting to the point, I will not attempt to be rigorous or persuasive as I describe what I—and many others—see as the path we are now on:

1. The U.S. is allowing and encouraging the world price of oil to go up and stay up, despite a glut that is now expected to last for at least a decade. Our contribution includes:

Talking as though there is no choice, and we have no say.

Allowing our oil companies to support, administer, be in partnership with OPEC, and encouraging them by tax policy, sanctioned invisibility of investment and purchase decisions, and the entitlements program to buy oil from the cartel.

Using our Strategic Petroleum Reserve Purchases to help stabilize the world market—we are actually paying list prices when there is discounting all over the world.

Making and encouraging public and private long-term investment decisions in future energy sources at twice current OPEC prices, to the exclusion of lower-priced alternatives (see below).

Taking and expressing the most pessimistic views of world and domestic energy supplies.

Failing to insist on rapid and maximum exploitation (consistent with environmental constraints), and use to destabilize world markets of already leased and exploitable public domain resources in Alaska, on the OCS, and onshore.

Failing to have a meaningful conservation program.

2. We are allowing all our conventional domestic resources to rise to OPEC price levels, through phasing out of natural gas and oil price controls. While not effectively limiting producers to costs and generous returns, these controls have, fortunately, insulated our economy from the full brunt of the artificially high OPEC price levels which will:

Accelerate inflation, with adverse employment and production impact;
Create massive economic inequity as producers reap windfalls at the expense of consumers ("we're sitting on a lot of 50¢ gas that is now going to sell for \$1.80 or \$2," one industry source told a reporter recently).

Allow and encourage production of our most costly domestic resources before we have come near exhausting our less costly resources, thus tying

up investment and productive activity unnecessarily and for uses that don't justify those costs.

Place immense energy-generated cash flows in the hands of oil and gas producers who have no obligation to use them for future oil and gas production and can, for example, use them to buy up reserves or technology of potentially competing energy sources (as well as to extend their influence throughout the economy, a la Mobil-Montgomery Ward).

3. We are allowing and encouraging the concentration of the energy industry, its insulation from competitive forces, and the spread of Cartel/Seven Sister control. Some examples:

The U.S. has not only done nothing to break up such old anti-competitive joint ventures as ARAMCO (Mobil, Exxon, Texaco, SOCAL), and Colonial Pipeline (10 companies), but has allowed such new partnerships as LOOP (the 7-company supertanker port in the Gulf of Mexico) Alaska Pipeline (Exxon, ARCO, BP, Mobil, Phillips, Union, Amerada) to be formed to control key elements of current energy flow;

While the FTC labors over a major case challenging vertical integration in the oil industry, the energy agencies expand vertical integration by supporting Sohio control of a major West to East oil pipeline, adopting regulations that pushed a new independent grassroots refinery into the hands of an integrated company, and will probably do the same for the large independent refinery in Puerto Rico.

Interior continues to use leasing systems and standards that place most of our offshore resources in the hands of major oil companies;

The World Bank and State Department are helping the Seven Sisters and OPEC itself gain entry into energy development in areas of the world with great new oil potential;

And most important, the U.S. Government has not only decided not to prevent the oil industry from taking over potentially competing sources of energy, but has been helping them do so, with solar subsidies to Exxon (despite its TV ad bad mouthing solar), coal and nuclear subsidies to Gulf (despite its admitted participation in a uranium cartel), and geothermal subsidies to Union Oil (despite its unsurprising practice of setting geothermal energy prices at the precise equivalent of oil prices).

4. Perhaps most important in the long run, we are placing the preponderance of our research and development and commercialization eggs in very high cost baskets and doing so in ways that bind us to an extended transition period of high-cost, low efficiency, capital intensive, low labor factor energy—even if it turns out that we have ample lower cost conventional energy or unconventional options available to meet our needs.

Our approach seems to be to accept as a given the highest level of world oil price which OPEC and the Seven Sisters might ask during the next decade, and to invest public venture capital heavily in any technologies that are viable at that price level. The figure apparently being used by DOE, and by key oil industry leaders like Robert O. Anderson of ARCO, is \$25 a barrel oil, i.e., twice today's OPEC price. In other words, DOE will consider as commercially "viable" any suggested energy technology which comes in at the equivalent of \$25/bbl plus inflation, and will subsidize, finance, provide rolled-in pricing, or otherwise support it right now. Of course, this strategy becomes a self-fulfilling prophecy for a variety of reasons:

Once the government invests heavily in \$25/bbl. technology it has a strong incentive to rationalize and protect that investment by seeing to it that oil prices do rise that far.

There are lots of takers of subsidies for energy production at that price who want and will help get and keep all energy prices up to that \$25 level—like oil companies, who'd like that number for their own oil and gas; or utility companies who have or would like to have in their rate bases expensive nuclear, LNG, or SNG facilities, which allow them to invest more per energy unit delivered and thus to profit more.

If \$25 is the going rate, potentially lower cost processes will be gold plated and otherwise inflated to get the highest attainable price and profit.

If huge new plants begin producing large amounts of new technology energy at \$25 a barrel, then hordes of Chase Bank economists will swear that \$25/bbl is the 'replacement cost' of energy and thus the "proper" price for all energy sources.

Every federal dollar prematurely spent on commercializing \$25/bbl. technologies is a dollar not spent on R&D to reduce the cost of those technologies,

or to develop lower cost alternatives, and, as we shall see, these alternatives face non-cost barriers which only a massive effort can overcome.

OPEC and the Seven Sisters will know exactly how much they can demand for oil without running into real competition from readily available new sources and will do so.

At those price levels the likely technologies are ones with high energy loss in processing, inappropriate matches between process temperatures and end uses, and thus built-in inefficiencies that create a lowest common denominator allowing other similarly high-cost inefficient technologies or applications to develop and go onstream with private financing, thus reinforcing the trend, and causing any conservation in end use energy to be more than offset by increases in primary energy use.

Since these technologies are likely to have low labor inputs as the energy sector draws a greater portion of investment and income flows, the permanent jobs created in the economy per unit of investment or income declines, contributing to labor supply excesses, and weakening organized labor as a force resisting energy price increases at the same time as expanding segments of the business establishment are drawn into high cost energy production and thus into a vested political and economic interest in the high energy price scenario.

The bottom line of this "current policy trends" scenario is difficult to quantify precisely but not hard to get a general feeling for. Here are some indicators:

Under the proposed natural gas bill—now undergoing either its birth trauma or its death throes, depending on whom you ask—the prices of natural gas in 1985 will be over 16 times the 1970 price, over a period when the Consumer Price Index will have risen only 125 percent. With that sharp an increase, even if the gas consumer is willing to reduce the comforts and services he (by which I mean, of course, he or she) gets from gas, and make conservation investments that increase the efficiency of his gas use, he is still going to have to spend more of his income on gas each year.

The consumer's burden is the industry's boon: if the bill passes, then revenues to gas producers for the next 8 years will be over four times what they were for the past 8 years, \$254 billion compared to \$59.5 billion—for much less gas! That's almost \$1000 more for every man, woman, and child in the U.S.

Finally, and most relevant to this discussion, if we assume that world oil prices rise by 1990 to the inflated equivalent of what today would be \$25 per barrel, that all U.S. energy is priced at world prices, that energy use rises on a moderate path, and that GNP follows the expected trendline despite the energy price increases, the percentage of GNP going to energy in 1990 will be close to 15 percent as compared to 2.1 percent in 1970.

PAST AND PROJECTED U.S. ENERGY COST AS A PERCENTAGE OF GNP UNDER \$25 PER BARREL OIL (1980) SCENARIO

Year	GNP (billions)	Quads	Average price (cents per million Btu)	Total cost (billions)	Cost as percent of GNP
1970.....	\$982.4	67.1	31.1	\$20.9	2.1
1977.....	1,889.6	75.8	137.8	104.5	5.5
1985.....	4,003.1	94.7	600.0	568.2	14.1
1990.....	5,904.3	108.9	800.0	871.2	14.7

Sources: Project Interdependence: U.S. and World Energy Outlook Through 1990. Congressional Research Service, June 1977; DRI Trendsline, June 1978; Economic Indicators, May 1978; Statistics, and Trends of Energy Supply, Demand, and Prices, vol. III, 1977, U.S. Department of Energy, Energy Information Administration, Annual Report to Congress, May 1978; Arco Oil Price Projections.

Is this a desirable route to a desired result? Is it a necessary route to an unavoidable result? Must we allow a mushrooming fraction of our national product and personal incomes to be expended on stagnant or declining amounts of inefficiently created end-use energy produced under circumstances that generate huge windfalls for some, unemployment for others, and inflation for all?

Or do we have other options that offer reasonable amounts of energy at reasonable costs in logical sequence from efficient sources that exploit renewable resources, create jobs, and avoid excessive windfalls?

Consider this hypothetical option, for example:

The Government, after public hearings in 1979 selects the energy demand trends it wants to achieve from 1980-2000. It then selects appropriate maximum average price levels based on a return to the pre-1973 energy share of GNP, the pre-embargo historical price trends, and the actual cost of conventional energy production.

It then offers for bidding by U.S. companies—starting downward from the fixed maximum average price—an exclusive contract to supply all energy to the U.S. economy for the twenty-year period in the amounts specified. All energy production, imports, and BTU savings through conservation practices and investments would count toward the total and would have been sold to or through or under license from the exclusive contractor. It would be a monopsonist vis a vis all providers of energy or energy-saving devices and a monopolist vis a vis all energy users. It could charge different prices for different types of energy, or to different sectors, but every high price sale would have to be offset by a low-priced sale to stay within the winning bid average price. To assure that it gave due weight to the needs and desires of the individual consumer, 5 percent of the gross would be withheld in escrow subject to release based on the percentage of affirmative votes in a referendum on public satisfaction with the contractor every five years. At least 5 percent of the gross each year would have to be spent on R & D.

Bidding would be furiously spirited. Bidders would include companies with vested interests to preserve, like oil companies or fiberglass companies, but also non-energy related companies with pre-existing administrative and communications networks, like ITT, or with claims to superior management skills, like Booz Allen. It would not matter that a bidder had no energy resources since it would have exclusive access to everyone else's resources.

A potential bidder coming fresh to the scene and trying to determine his bid would look at basics:

The actual cost and potential quantities of production of existing conventional fuel reserves.

The actual cost of finding, developing, and producing each increment of conventional resources over the period (taking into account his ability to schedule these efforts so as not to produce sudden surges of effort that artificially inflate these costs), and the size of those increments.

The actual cost per unit of energy delivered from such new sources as solar hot water, methane from trash, and waste heat recovery, the expected decline in costs over the 20 year period with various levels of R & D expenditure, and the amounts installable over the 20 year period.

The actual cost per unit of energy saved through such measures as insulation, clock thermostats, or weatherstripping, the R & D potential for reducing that cost, and the quantities obtainable.

Last but not least, the actual costs of oil production in and transportation from foreign countries, the amounts of oil they are likely to have available after domestic needs and non-U.S. exports, and the level of their desire or need to sell those amounts.

Going back to these basics, here is what the bidder would be likely to find:

Huge amounts of flowing U.S. oil and gas available at lifting costs under \$1 per barrel (17c/mcf) and almost unlimited amounts available on a cost continuum from there as additional amounts of enhanced recovery expense are applied.

Huge amounts of additional U.S. oil and gas from discovered and undiscovered areas, available at costs ranging from \$2 per barrel (33c/mcf) to \$4 per barrel (67c/mcf), with improvements in exploration, drilling, and production technology offsetting most of the gradual shift to deeper or tougher sites.

Ample off-the-shelf solar-thermal, biomass, waste heat recovery and similar technology at costs substantially lower than any state-of-the-art SNG, LNG, or nuclear facilities, (especially if all corollary costs are internalized and subsidies removed), with the likelihood that R. & D. applied to the former group would produce more cost improvements than equal amounts of R. & D. applied to the latter group, and that such technologies as photovoltaic and hydrogen-related processes can come in at costs below nuclear, and eventually below delivered fossil fuel energy, depending on the rate of R. & D.

The equivalent of one-fourth to one-half of our current primary energy use capable of being saved (or displaced for later or different use) by improvements in our efficiency of energy use, at costs per barrel of savings ranging upward from zero, like closing windows, turning back thermostats, car pools (any slight convenience reduction is offset by a cost reduction), to minimal, like automatic thermostats, to significant but still well below current delivered energy from fossil fuel sources (now averaging \$8 or \$9 per barrel equivalent wellhead cost), like storm windows, insulation, pilot-less gas appliances.

And finally huge amounts of already discovered or easily discoverable oil and gas from foreign countries with lifting and transportation costs on the order of \$2 bbl. (33¢/mcf for Canadian and Mexican gas).

Of course, as a monopsonist, or sole buyer of energy, facing a wide variety of competing sources, the potential bidder would be able to assume that he could get each seller to sell at the seller's cost plus a reasonable return for each class of energy purchased. Looking at the prospective needs over the 20 years, he would see that the real marginal cost trend for fossil fuels if in fact rising, is likely to be intersected by the falling marginal costs of substitute energy forms during that period, with R. & D. slowing the rise in the former and accelerating the fall in the latter. This allows the bidder to expect that he will never have to utilize the high cost part of the conventional fuel spectrum during the period, and he can expect to make take it or leave it offers to each low cost producer at the producer's own marginal cost level. The producer cannot leave it, because he will be unable to sell his resource for 20 years, at which time the additional costs of withholding may make it uneconomic compared to then available resources.

OPEC and its members would certainly be falling all over each other to offer deals to prospective bidders for long-term fixed price subcontracts to supply oil. It is one thing to worry about nearly 50 percent of our oil coming from imports. It is quite a different thing to negotiate about 15 percent or less of our total energy supply, which is already priced well over our own marginal production costs (not to mention our conservation costs) at a time when the world market is and will remain in glut status, and when the exporting countries are quietly discounting to avoid production cutbacks. The fact is that the exporting countries need our oil demand at least as much as we need their supply, and the prospective bidder would be able to drive a very hard bargain based on his estimate of the domestic cost of producing or saving an additional 10 to 15 percent of energy, the level of potential oversupply in world markets, and the respective revenue needs of the exporting countries. If we go back to the \$2.50 level which obtained in the last pre-embargo year, add about 50 percent for inflation and \$2.00 for transportation (although that figure might be substantially lowered), the negotiations would revolve around a \$6 price delivered (\$4 in the Persian Gulf), which is consistent with our earlier assumption of ample domestic oil and gas supplies available at cost levels of \$4 per barrel (67¢/mcf) and very substantial conservation investments saving energy at costs well under \$8 per barrel.

Similarly holders of large domestic oil and gas reserves and potential reserves would have to offer prospective bidders favorable supply terms or be prepared to bid themselves so as not to be frozen out of the market. Collusion among the oil companies would be difficult and dangerous, because of the ability of non-oil bidders to deal individually with them and exposure to huge anti-trust penalties if discovered. Their usual control leverage through their integrated structure would be neutralized since the successful bidder would be able to control crude flows, both domestic and imported.

Under all these circumstances what kinds of bids could we expect? Considering that large fraction of energy supplies and energy savings would be obtainable at costs below \$2 per barrel equivalents, much of the remainder at \$2-\$4, and marginal increments at no higher than \$6, the government's maximum average price could comfortably start at \$6 per barrel with an expectation of very heavy bidding downward. For assuming roughly one-third of supply and savings from each of the above brackets (0-2, 2-4, 4-6), the average cost to the bidder would be \$3/bbl. equivalent, for an average margin of \$3/bbl. at a \$6 selling price, or a total margin of some \$47.5 billion in 1980 if 85 quads (quadrillion BTU) were the contracted for amount. The bidders would have to sharpen their pencils to see what their after tax net profit would be on such a venture and how much below that figure they'd be willing to go to get the contract. A \$5 successful bid would not be surprising, and here is what the previous chart would look like under that assumption (projecting a 6-percent inflation rate though inflation would probably be reduced and GNP increased at this energy price level):

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1970.....	\$982.4	67.1	31.1	\$20.9	2.1
1980.....	2,576.6	84.5	100.0	84.5	3.0
1990.....	5,904.3	108.9	149.4	162.7	3.0

Naturally to be able to stay as profitable as possible at the \$5 (constant dollar) average price, the successful bidder would have to do several things:

- exploit the cheapest forms of conventional energy first in hopes that, through conservation and substitution, use of expensive forms can be avoided during the contract period, or through R&D their cost can actually be reduced by the time they are needed;

- through expenditures on business and consumer education, stimulation of imaginative financing and merchandising mechanisms, and pricing and allocation systems sensitive to both variances in price elasticity of demand and the need for public approval, obtain as much avoidance of energy waste and increase of energy efficiency as can be obtained for costs, per barrel saved, below the marginal price of additions to supply;

- invest heavily in R&D efforts that hold out hope of additional energy conservation or production techniques at costs below the current and expected marginal cost of conservation or production within the contract period;

- all other things being equal, select small scale, decentralized energy saving and production techniques which provide permanent employment to the most people, both because this will be a factor in the 5-year referendum and because choice of long-lead time, long payback, highly centralized, capital intensive modes increases risks by locking in large increments of supply at fixed cost levels which may prove over time to be non-economic;

- vigorously challenge through litigation, administrative procedures, legislative action, and public exposure, any efforts by potential suppliers to collude, withhold, extract monopoly profit, or otherwise prevent the contractor from obtaining each increment of production, imports, or savings at cost plus a reasonable return to the supplier;

- allocate his purchases in such a way as to strengthen those who can and will compete aggressively to underbid and take market shares from those seeking to extract excess profits from their production.

Of course, during the 20 year period, those companies which were unsuccessful bidders would be spending their own R&D funds aggressively, in hopes of developing technologies that make them competitive suppliers to the successful bidder and/or put them in position to bid successfully on their own for the next 20 year contract.

On the face of it that scenario seems much more desirable than the first one I described, the one I believe we are on. Instead of energy price at today's equivalent of \$25 a barrel we would have energy at \$5 a barrel, instead of allocating more than 14 percent of our GNP to our energy budget, we would allocate roughly 3 percent. Inflationary pressures would be reduced. Our level of dependence on foreign sources of energy would be by choice and mutual economic advantage not by necessity. We would improve our energy efficiency substantially even though average prices remained constant. We would bring on new low-cost energy sources as quickly as possible and postpone or avoid reliance on the highest cost parts of our conventional sources and high cost substitute sources.

Apart from the fact that working out the contract details—like how to give the contractor credit for energy was avoidance derived from public education expenditures—would require the hiring of some high-priced lawyers, what's wrong with that scenario? The result seems fine—"happy" even. But the route has severe problems. Would we be willing to let one company run our whole energy policy for twenty years?—Even a President is limited to an eight year term. Would we stand for delegating such a massive public responsibility to a private entity even for a shorter time? Would we want to risk the political and social impact of giving one group so much power in society? Would the contractor misuse his leverage to feather his own nest for the indefinite future, to amass hidden powers over the segments of the economy? What if the contractor just plain messed up? Would the corporate sector, especially the energy giants, ever let such a threat to their status quo be adopted?

Obviously my purpose in positing this hypothetical is not to advocate it or defend it, but merely to look at the theoretical results so that we can appreciate the range of possible goals and seek appropriate paths to the best of them. Even if the hypothetical assumptions and calculations are off by a bottom line factor of 100 percent the difference between the potential scenario and the course we are on is startling. If we can analyze the components of that difference, perhaps we can see where and why we have gone wrong, and select realistic policy options that move us in the direction of the hypothetical result.

Here are some of the essential differences I see, and possible approaches to them:

1. *Relationship to OPEC.*—We have allowed OPEC to deal with us as though they exercised monopoly power over our energy supplies and we as ultimate consumers had no bargaining leverage to resist monopoly pricing. Changing this dynamic has two components. First, as long as OPEC operates in concert with domestic oil companies which, through their joint ventures and vertically integrated structure, do exercise market power over our oil supplies, there is an effective monopoly relationship or at least a mutuality of interest in the imposition of monopoly pricing. The ultimate remedy would be a restructuring that separates U.S. oil buyers (refineries) and U.S. oil sellers (producers) from one another and from their joint ventures with the exporting nations. A modest alternative is imposing disclosure requirements that make this partnership more visible, so that when Exxon's TV ads talk about its efforts to find "energy for a strong America", the public would also know that at least half of Exxon's energy investment is going abroad, that it is in close partnership with many of the OPEC nations, and that its interests both here and abroad lie in raising the price of oil, thus accelerating the cost of imported oil, our trade imbalance, the rate of inflation, the cost of our exports, etc., rather than in providing us with the cheapest possible array of energy sources. Second, our relative strength in the world market because of our huge low cost domestic energy reserves, our buying leverage because of our ability to select among sources for large purchases in a time of glut, our ability to do without imports entirely merely by improving our inefficient energy use patterns, and the pressing revenue needs of the exporting nations should give us the ability to bargain at least as equals if not as big buyers in a buyers' market. This is not to say that we have to aspire to "break OPEC," or have political motivations, or consider the exporting nations as adversaries, but merely that we deal in a normal commercial environment of intelligent buyer and good faith seller, and at least make sure that they do not break us. And as long as they are going to pool their selling power, and the structure of our oil industry facilitates rather than resists that pooling, we may also have to pool our buying power—as our hypothetical contractor would—probably by interposing an exclusive governmental purchasing authority for imports with a specific mandate not to make any purchases at prices above our marginal domestic production or conservation costs, and to negotiate below those levels where market conditions permit.

Of course, the potential in this area is to reduce the cost of what is now 15-20 percent of our energy by 50 percent, instead of letting it double. It is not the amount of imported energy which is particularly worrisome—in fact in their candid movements, DOE planners will admit that the figure is about "right" now. It is the cost of that energy that is the problem—in balance of trade, inflation, and impacts on domestic energy prices.

2. *Decoupling domestic energy prices from the cartel/monopoly world price.*—Whether or not we as a nation are successful in dealing with the external price-setting mechanism for imported oil, there is no reason why we should have our domestic energy prices set by those external, non-free market, essentially political forces. If we had a sufficiently competitive domestic energy industry, the OPEC price would be irrelevant. In fact no oil would be imported unless it was able to compete with the competitively set domestic price, which itself would reflect real costs and reasonable returns on domestic production, and our price would help draw any excessive OPEC price down. But for a variety of reasons our energy industry does not behave according to the free market models. Much of our fuel is purchased by transportation and distribution monopolies, which, although regulated, are allowed to pass all costs on and in fact have long term motivations to prefer the highest possible costs for their fuels, as long as potentially competing fuels rise in price at the same rate. Because our oil industry is structured in an interlocking network of vertically integrated giants, joined in a vast array of partnerships, exchange agreements, and trade groups, only a small part of our oil stream ever gets out on the open market, and the ability of that part to impact the market is constrained by the presence of the same giants as preponderant buyers, sellers, and transporters in these markets. The long and the short of it is that, left alone, the oil and gas industry—as well as the coal and uranium industries, with which oil and gas companies are increasingly linked—would have the market power to raise all fuel prices in the U.S. to the level of delivered imported fuels, no matter how high, no matter how adverse the social

and economic impacts within the U.S. And in fact since 1970, domestic oil, gas, coal, and uranium price levels have moved almost as fast as OPEC oil prices despite Congressional efforts to impose or maintain price regulation on large parts of the market. Contrary to theoretical expectations, the rapid price increases have not rapidly accelerated production, but in many cases depressed it, either because of a backward bending supply curve, which reflects the willingness of suppliers to keep constant income with less effort, or because of withholding in anticipation of even quicker price acceleration in years ahead.

Again the ultimate remedy is a restructuring of the energy industry to render it as faithful as possible to the competitive ideal. That will be a long and difficult process, as the history of the FTC's Exxon case and Senator Hart's divestiture bill demonstrate. And even if such restructuring were accomplished and productive, the presence of monopoly oil and gas pipelines, regional and local electric utilities, gas distribution utilities, and vast amounts of federally owned energy resources would still require various forms of official oversight of the energy market. For the present and near term the choices are clear—"deregulation" is not one of them: we can either have domestic energy prices regulated by public officials according to public standards which seek to imitate true free market, i.e., cost based, results, or regulated by private interests which seek to imitate monopoly results.

The potential in this area is to reduce the current cost of 50 to 75 percent of our energy by 25 to 50 percent, and prevent it from tripling in the years ahead.

3. *"Not using champagne to satisfy our thirst until we run out of ginger ale, and not paying champagne prices for the ginger ale if we add a bit of champagne to the punch."*—The problem here is how, if we are not that hypothetical monopsonist, we can climb up our macroeconomic supply curve increment by increment. In a crude way (no pun intended) our gas and oil price controls have attempted to do this through "vintaging" (different prices for different discovery time) and "area rates" (different prices in different geological areas), but they have been replaced or riddled with exceptions, and if present trends continue, will merely become counter-productive incentives to sale of higher-cost and non-sale of lower cost resources. These need rethinking and reform. To some extent the windfall element to the producer could theoretically be moderated by an effective and progressive income tax structure, but under any foreseeable political circumstances, such a tax remedy is not possible. Moreover, taxing the producer does nothing to remove the income drain and inflationary impact on consumers. Another avenue would be utility type pricing for producers where overall rates of return would determine allowable prices to each producer.

What is more difficult and more important is structuring investment and production decisions so that investments are not made in more expensive supply sources when there are less expensive sources of supply—or energy saving—available. Again our monopsonist was positioned to make and act on those economy-wide judgments. Most decision-makers in our energy structure are not or have no incentive to. Most gas utilities, for example, will invest in LNG facilities, at their customers' expense, despite the fact that for the same total incremental customer cost, an investment in insulation or solar hot water would save, and thus make available for other use much more gas. Because of "rolled-in" pricing which spreads the incremental costs thinly over all gas sold, the individual customer does not see this potential trade-off. And unless the utility can benefit from the conservation or substitution investment (as some are trying to do by placing insulation or solar equipment in their rate base, a problem in itself), its only interest is in having incremental energy sources that feed its network. "Incremental pricing" helps here, i.e., requiring the marginal gas users (the ones who could easily switch to something else) to pay the full cost of the incremental gas. They then could and would make the trade-off calculations, although they might not be the ones who can utilize the conservation or substitution alternative.

Thus again it is government agencies which will have to make, or force the utility to make, the trade-off calculations for the consumers as a group. Given an application for a new energy source (e.g., imports), or facility (LNG), the relevant regulatory agency will have to ask and get an answer to the question "If your customers as a group made an equivalent investment in conservation or solar energy would they save and thus release for other use, more energy than you will get?" If the answer is yes, as it probably is right now for LNG, SNG, and nuclear vs. conservation and solar, that is not the end of it, for some public or private entity must see to it that the alternative path is in fact taken.

We are just beginning to understand and address that need and its fulfillment. I cite to you Seattle's Energy 1990 program as a model, and urge you to focus your own attention on how best to structure that function in your own communities.

For the fact is that even at existing price levels there are many conservation or renewable energy source investments which would have carrying costs less than the cost of the purchased energy they would displace. Yet the lack of basic information about the availability of the trade-off, the low per month cost differential, the lack of easy access to financing, the risk of dealing with unfamiliar vendors or technologies, just plain inertia, and institutional barriers to some of the alternatives all combine to prevent the individual energy user from doing the right thing for himself and for society. Developing educational, financing, sales, installation, servicing, warranty, and assistance mechanisms to reverse that process at the local level is one of our major energy challenges right now.

4. *Investing our R&D funds in a way that places a lid on energy prices at reasonable levels rather than placing a high price umbrella over an industry whose members have sufficient market power to make prices grow to almost any height.*—Two simple prescriptions to add to those implicit in the earlier discussion. First, like computer and statistical models, what R & D puts out is a direct result of what you put in. If we ask for technologies that are viable at \$25 a barrel equivalent that is just what we will get. If we design a program to produce \$5 technologies, we will get at least something at \$5, and a lot at damn close to \$5. Second, let's not put our R & D money into the hands of those whose built-in conflicts of interest make them more interested in umbrellas than lids. The federal government has made this mistake time and time again for decades: R & D money for oil shale, coal conversion, solar, geothermal has gone to companies whose primary interest is in protecting and increasing the price of oil, not undercutting and replacing it. Major research on hydrogen processes was placed in the hands of a company whose only real interest was in selling nuclear reactors to sustain the processes, dooming them to nuclear costs levels. It is no surprise that oil shale, which in the 60's was expected to come on at 20 percent over the then oil price, is still not viable despite a quadrupling of oil prices the R & D still remains in oil industry hands.

I appreciate your indulgence and your kindness in hearing me out on what is only a first try at bringing together three years of full time exposure to the energy challenge and those who are addressing it. I know that those in industry are aimed at the wrong result for the nation. I know that those in the Department of Energy know not where they are headed, but that it leads to the wrong result. I believe a better result is possible. I think some of the route there can be mapped already, but there are unbridged rivers and uncrossed wildernesses still in the way. Perhaps in meetings like this we can find ways over and through them. Perhaps here, at the nexus of law and technology and business and the public interest, we can find Kurt Vonnegut's chronosynclastic infundibula," where all of those who are "exactly right about everything" in their own worlds but "wouldn't agree on anything," can come together and "catch on to what the other was talking about," "where all the different kinds of truths fit together as nicely as the part's in your Daddy's solar watch."

THE 1979 FUEL "SHORTAGE": ROOTS, REALITIES, RESPONSIBILITY

(A research report from the Energy Action Educational Foundation, May 1979)

SUMMARY

1. Although there is a "shortage" in the sense that (a.) government and industry statistics show "low" levels of gasoline and heating oil stocks compared to statistical measures of demand, and (b.) there is less gasoline available to service stations in some places than people would be willing to buy, there is inadequate evidence to show that the actual level of usage of gasoline and fuel oil in 1979 is beyond the capability of U.S. refineries to produce, or that the actual level of all stocks, not just those in industry and government statistics, is seriously low. There is thus an inadequate factual basis upon which to allow the industry to cut back sharply now on current gasoline deliveries in preparation for an alleged-

ly unavoidable future product supply shortfall, especially when the industry itself is not now and has not been utilizing refinery capacity to its maximum, the normally expected behavior when product stocks are truly low in relation to actual user consumption.

2. The low level in the current official "stocks" figures, especially for distillate fuel oil, is directly attributable to the oil industry's deliberate failure in 1978 to replenish its product stocks when both crude oil and refining capacity were amply available, leaving the nation on Oct. 1, 1978, the start of the Heating Season, with extraordinarily low and truly precarious gasoline and fuel oil stocks and extremely vulnerable to any dislocations of weather, supply, or demand. The Department of Energy apparently was unwilling to take the steps necessary to prevent this dangerous situation, although it had both the information and leverage necessary to do so.

3. Over the course of the recent Heating Season (Oct. 1978-April 30, 1979), the oil industry continued to operate far below available capacity, leaving gasoline stocks at 1975 levels and drawing down distillate almost as fast as and to a lower point than the previous year (when stocks had started high and were intentionally being over-reduced), despite the availability of crude oil and the likelihood that the failure to rebuild product stocks would contribute to the expectation and fear, if not the accomplishment, of later shortages. Again the government not only acquiesced in, but sometimes contributed to this result.

4. At the same time as the industry was decimating product stocks from the supply side, the U.S. government, from the highest levels on down, was contributing to excessive demands on those stocks by deliberate attempts to panic the American people into believing that the pause in Iranian oil production was having dire impacts on American crude oil supplies, impacts which never in fact occurred during the Heating Season. The resultant panic, predictably, caused various forms of hoarding, topping off, increased user storage, and other behavior which served to deplete "primary" stocks, make "demand" increases appear larger than usage increases, and generally create a "shortage" atmosphere much more virulent than the true supply-demand picture justified.

5. The operation of Department of Energy's Strategic Petroleum Reserve, instead of strengthening the U.S. ability to deal with the world oil supply situation, served during 1978 and 1979 to exaggerate our problems: by helping tighten world crude supplies in 1978, it helped lay the foundation for the OPEC price increase; by drawing oil away from refineries who wanted to produce additional product, it helped worsen the product stock situation.

6. So many of the goals of the oil industry and the Administration were congruent with the creation of an appearance of shortage, and the creation of that appearance was so predictable from the actions and inactions of both industry and government, that it is not unreasonable to apply the normal logic that intelligent persons intend the expectable results of their conscious activities, particularly when they have strong motives to desire these results. Such goals as ending stable gasoline prices, quickly achieving sharply higher gasoline prices, selling crude oil decontrol, and doing something to force "conservation", were so important to the oil industry and/or the Administration that, in the absence of evidence to the contrary, a course of voluntary behavior that appears calculated to create an atmosphere that fosters those goals must be considered deliberate.

INTRODUCTION

U.S. demand for gasoline and distillate fuel oil varies from season to season over the year. Gasoline use peaks during the summer months. Fuel oil use peaks during the winter months. Since the output of refineries includes both gasoline and fuel oil, and most refineries can switch this yield of the two products by only a small fraction, there must be certain levels of stored gasoline and fuel oil to supplement current production during the peak demand period for each. The level of these product stocks is determined by a combination of rate of demand, rate of refinery production and rate of imports of oil products. The adequacy of stock levels is roughly assessable from comparisons of the relationship of stocks to actual demand and forecasted demand, including the height of the peak stock levels and the depth of the lowest stocks levels, compared to previous years.

The following analysis attempts to trace the origins and causes of the present apparent inadequacies of "primary" gasoline and distillate fuel oil stocks, and to determine the seriousness of the supply problems in the coming months, to the

extent that analyses can be made from the overall national statistics made available by the Department of Energy and the oil industry.

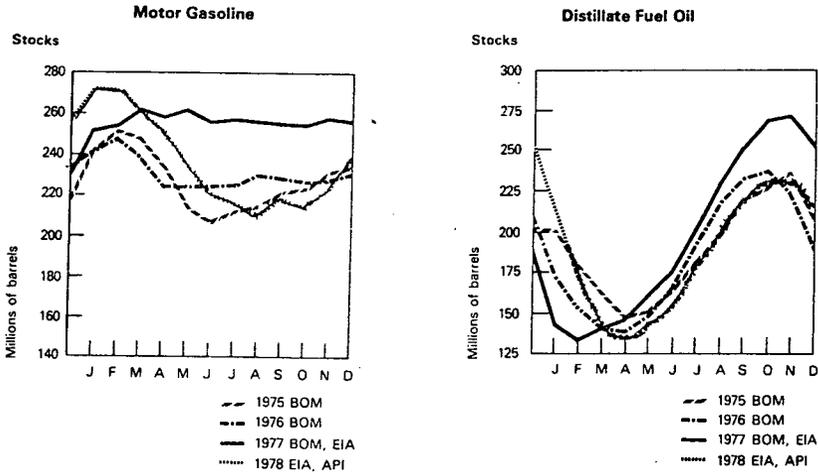
The analysis is divided into three time frames: 1. 1978: First Nine Months; 2. The 1978-79 Heating Season (10/1/78 - 4/30/79); 3. The Remainder of 1979.

I. JANUARY-SEPTEMBER 1978

The roots and causes of the current problem can be traced clearly to decisions made and actions taken a year ago.

As shown in Figure 1, stocks of both gasoline and distillate began the year 1978 at levels substantially higher than in previous years. The usual explanation of this is that the industry had overprepared for the winter of 1977-78 after the experience of the extreme cold and natural gas problems a year earlier.

FIGURE 1



Fuel oil stocks down, demand up.—Although it is normal to draw down fuel oil stocks during the first quarter of the year, those stocks were drawn down faster and farther than in any of the previous three years. In each month between March and July, 1978, distillate stock levels were below every one of the previous three years. The April 1978 level of 136 million barrels was the lowest level of any month since April of 1974 (except the extraordinary month of February 1977 when the freeze and natural gas interruption produced a temporary drawdown which was quickly replaced by increased production and imports). The maintenance of lower stock levels was not justified by an actual or predicted lessening of demand—in fact in every month between February and June, fuel oil demand was above that of the corresponding month in each of the previous three years. For the first half of the year total distillate demand was up by 3.9 percent over 1977, and the forecast (Oil and Gas Journal, July 31, 1978) was for a 4.6 percent increase for the entire year. The result of increased usage and decreased stocks shows clearly in this comparison of stocks, in numbers of days of each month's daily demand for the start (Oct.) and end (April 30) of each recent heating season:

TABLE 1.—DISTILLATE STOCKS

[In days]

	1977-78	1976-77	1975-76
Oct 1.....	83.2	76.7	82.5
Apr. 30.....	44.1	50.1	49.2
Change.....	-39.1	-26.6	-33.3

Gasoline Stocks Down, Demand Up. Similarly with gasoline stocks, the high levels at the beginning of 1978 plunged sharply throughout the first half of the year, so that by summer they had been reduced to levels lower than any time since the summer of 1975. They bottomed out at a level 22% below 1977 and 7.1% below 1976. Again no lessening in demand had occurred to justify these lowered stock levels. In fact, gasoline demand was up 3.6% over 1977 for the first half of 1978, and Oil and Gas Journal forecast was for a 2.7% increase for the year as a whole. One indicator of the speed and depth of the gasoline drawdown in early 1978 is the change in the number of days of each month's daily demand being held in stocks:

TABLE II.—GASOLINE STOCKS

	[In days]			
	1978	1977	1976	1975
Jan. 1.....	40.8	39.0	37.6	39.0
June 30.....	27.7	33.8	30.1	29.3
Change.....	-13.1	-5.2	-7.5	-9.7

Production Response Minimal.—One would have expected that the prospect of such a serious drawdown of stocks would have caused an immediate industry-wide response in the form of intensive utilization of available refinery capacity, or, if capacity was inadequate, a buildup of stocks from additional product imports, or both, as had occurred in February of 1977 when U.S. refineries ran at 92.6% of capacity, which appears to be their effective maximum capacity, allowing for maintenance and other planned shutdowns and unplanned interruptions (although capacity utilization did go as high as 93.5% in July of 1976). However throughout the period of January to September of 1978, including the critical period beginning in March, when stocks of both distillate and gasoline began plunging down through and below previous years' levels, U.S. refineries ran well below capacity.

TABLE III.—U.S. REFINERY CAPACITY UTILIZATION

	[Percentage]		
	1978	1978 v. 92.6	1978 v. highest rate same month; 1975-77
March.....	84.8	-7.8	-4.8
April.....	83.2	-9.4	-5.6
May.....	88.9	-3.7	-4
June.....	87.7	-4.9	-5.0
July.....	88.5	-4.1	-5.0
August.....	91.2	-1.4	+1.5
September.....	89.9	-2.7	-1.1
Average.....	87.7	-4.9	-2.9

Measuring actual capacity utilization against the 92.6 percent apparent maximum, the unused available capacity during the key period ranged from a high of 9.4 percent in April to a low of 1.4 percent in August with the average under-utilization for the March-September period measuring roughly 4.9 percent.

Since each percentage point of refinery capacity represents about 170,000 barrels a day, the 4.9 percent under-utilization implies an ability to have run well over 800,000 barrels additional per day during the approximately 210 day period, or some 168 million barrels of potential additional runs. Under typical circumstances of 21 percent yield of distillate, and 44 percent yield of gasoline, this would have allowed maximum rebuilding of stocks of about 35.3 million barrels of distillate and about 73.9 million barrels of gasoline. In other words for each additional 1 percent of increased capacity utilization in a 30 day month, U.S. refineries could have run an additional 5 million barrels of crude oil, producing about one million barrels of additional distillate, and 2 million barrels of additional gasoline. Thus, even if the 1978 utilization rate is compared month by month to the highest actual rate for the same month in the previous years,

rather than the theoretical maximum, the potential for additional utilization, which averaged 2.9 percent for the seven-month period (see Table III above), would imply possible additions of 20 million barrels of distillate and 41 million barrels of gasoline to stocks during the March-September 1978 period. By changing refinery yields, the amount of distillate produced relative to gasoline could have been increased several percent.

There is no apparent explanation from any of the statistical series for the substantial under-utilization of U.S. refinery capacity during what should have been the stock buildup period prior to the heating season of 1978-79. Certainly there was crude oil available to U.S. purchasers. In fact during the period March through September, the U.S. Department of Energy made purchases of crude oil for the so-called Strategic Petroleum Reserve of nearly 33 million barrels. A presumption of sanity and regularity requires the conclusion that D.O.E. would not have been buying up large amounts of crude oil for placement in large, untappable caverns if U.S. refiners had desired, but were unable to obtain, additional crude oil to increase refinery runs and add to stocks.

The best explanation seems to be that given by Oil and Gas Journal in the midst of the period under review (OSJ, 7/31/79), namely that U.S. refiners had intentionally "lowered refinery runs and cut yields hoping to bring down the excessive product inventories." As OGJ pointed out, by April this "hope" had been more than realized with stocks already drawn down to "normal" levels, yet even with somewhat higher capacity utilization in succeeding months, "the added throughout wasn't enough to offset the lower runs for the other months." In other words, as explained above, the capacity utilization was never actually increased sufficiently to bring stocks into line, despite the higher demand levels and the availability of crude oil.

Result: Precarious Stocks Position at Start of 78-79 Heating Season.—For all practical purposes, the die was cast, for the year to come, by the end of September 1978, the beginning point of the 1978-79 Heating Season Distillate stocks were 32 million barrels, or 14.5 percent lower than in 1977, and 11.5 million barrels lower than 1976, despite the fact that demand was running significantly above '77 and well above '76, and was forecast (OGJ) to be up by 8.3 percent in the 4th quarter of '78 over '77. At that point in time gasoline stocks were 39 million barrels or 18.1 percent below this point in 1977 and almost 10 million barrels below 1975!

It is thus merely a matter of objective description rather than subjective criticism to conclude that the U.S. oil industry had by that point placed the nation in a position of extreme vulnerability. A cold winter, or any interruption in coal or natural gas, would unavoidably produce a major crisis in distillate. A warm winter with more than normal driving would require refineries to produce at high levels just to meet average current needs of distillate and gasoline, precluding accelerated stock building, and any interruption in crude oil supplies would also produce a crisis.

As far as we know, the Department of Energy made no effort during this entire period to monitor, expose, do anything about the entire situation, despite the fact that this was a time when D.O.E. had great leverage over the oil industry in the form of a multitude of discretionary legislative, administrative, and enforcement decisions, as well as direct standby power over refinery, utilization rates and product yields. The Department's only contribution appears to have been, as indicated above, the tightening of world crude oil markets by purchases for the Strategic Petroleum Reserve at a time when it had no capacity to tap that reserve, and when tight crude markets could only help justify an otherwise untenable substantial price increase at the forthcoming December 1978 OPEC Ministers meeting.

II. THE 1978-1979 HEATING SEASON (OCT. 1, 1978-APRIL 30, 1979)

As demonstrated above, as of the end of September warning lights should have been flashing all over the industry and all over the government that both distillate heating oil and gasoline stocks were at seriously low levels compared to previous years, and that any abnormal production or demand situation would cause serious problems.

The bare statistics for the entire period suggest that if the industry did anything at all in response to the challenge, it was to exacerbate the problem, particularly with fuel oil. Despite the low stocks at the beginning of the season, despite fuel oil demand at a level as high as the frigid winter of '76-'77, despite

normal growth in gasoline needs, stocks were allowed to be drawn down at an extraordinary pace and to extraordinarily low levels, as Table IV shows:

TABLE IV

HEATING SEASONS: 1975-1976 thru 1978-1979: Distillate Fuel Oil									
Stocks, Demand, Drawdowns, and Refinery Capacity Utilization									
(Stocks & Drawdowns in millions of bbls., Demand in thousands of bbls./day, cap. util. in %)									
	1975-1976		1976-1977		1977-1978		1978-1979		1979-1980
	STKS	DEMAND	STKS	DEMAND	STKS	DEMAND	STKS	DEMAND	Cap. Util. (Average)
	(Millions)	(Thousands)	(Millions)	(Thousands)	(Millions)	(Thousands)	(Millions)	(Thousands)	(%)
SEPT. 30	2,120		2,572		2,322		2,210		
OCT. 1		3,068		3,037		3,029		2,677	
		89.1		89.3		85.8		84.7	
			13		15		3		6
OCT. 31	2,133		2,677		2,335		2,226		
NOV. 1		3,602		3,421		3,714		2,544	
		90.7		88.7		90.6		86.9	
			(1)		3		(12)		9
NOV. 30	2,322		270		2,223		2,335		
DEC. 1		4,189		4,025		4,650		3,792	
		91.2		87.9		91.1		87.7	
			(16)		20		(22)		(27)
DEC. 31	2,116		250		1,925		2,089		
JAN. 1		4,959		4,429		5,103		4,298	
		87.2		85.1		89.0		85.7	
			(51)		(27)		(43)		(43)
JAN. 15	1,665		213		1,442		1,665		
FEB. 1		4,960		4,831		4,708		3,697	
		83.8		84.1		72.6		87.8	
			(38)		(48)		(9)		(15)
FEB. 28	1,277		166		1,333		1,500		
MAR. 1		3,714		4,089		3,442		3,336	
		84.1		84.8		89.6		86.9	
			(12)		(28)		8		(20)
MAR. 31	1,115		137		1,441		1,358		
APR. 1		3,102		3,092		2,936		2,788	
		84.8		83.2		88.8		86.5	
			1		(1)		7		(1)
APR. 30	116		136		1,148		137		
Total Demand		833,000		819,000		831,000		790,000	
Ave. Cap. Util.		87.3		86.2		89.6		86.6	
Total Demand		(104)		(116)		(74)		(83)	

The 104 million barrel drawdown of distillate stocks was only about 10% less than the consciously excessive drawdown of 116 million barrels in 1977-78, a year when stocks started extremely high and demand was more moderate. What opened the 1978-79 season was an already low figure of only 72 days distillate demand in stock (compared to 83.2, 76.7, 82.5 for the preceding years) was allowed to fall to an alarming 37.2 days at the close of the season, 15.6% below what was obviously the excessively low figure of 44.1 days for April 30, 1978, and even further below the prior year figures of 50.1 and 49.2 days.

Actually the drawdown for the first three months of the season (Oct.-Dec. 1978) was fairly moderate, because the mild fall weather kept heating oil usage down, and at the same time caused so much driving that the low gasoline stocks became a practical and political problem. The resulting public and press focus on the tightness of gasoline supplies helped foster an effort to rebuild gasoline stocks in the last quarter of 1978 through increasing levels of refinery capacity utilization (Oct. 89.1, Nov. 90.7, Dec. 91.2). A fortunate byproduct of this higher refining rate was that distillate stocks did not get significantly worse as the heat was turned on around the country, although once the cold weather hit in December there was no way to build up stocks, since distillate production can't equal current distillate use during the cold months, even when refineries are running fast. This is why stock levels at the start of the heating season are so crucial.

Thus as of Jan. 1, 1979, the rest of the heating season still could have gone either

way. Gasoline stocks had been built up by about 10% from September (though still a bit below normal in terms of number of days of December's daily demand held in stocks as of Dec. 31: 1978—31.7: 1977—34.9: 1976—32.4: 1975—34.5.) Distillate stocks by this measure were below those for '75 and '77, but above those for '76 when a vicious December had depleted year end stocks to dangerous lows. (Days in stock based on December demand: 1978—51.6: 1977—59.5: 1976—39.8: 1975—55.1).

The startling differences between the first four months of 1977 and those of 1978, provide excellent benchmarks against which to test the industry's performance in the first four months of 1979. Total U.S. Petroleum Demand for the period in each year was almost identical, just over 19 million barrels a day average. But in 1977 Jan. 1 distillate stocks were low, while in 1978 they were high. In '77 distillate demand was high, while in 1978 it was moderate. In 1977 there was an obvious desire to maintain and rebuild stocks of distillate, which continued on through the year. In 1978 there was an obvious desire to draw down stocks as fast and as far as possible, and to rebuild them at less than the usual pace. These differences show up most vividly in the refinery capacity utilization figures for the four months of 1977 and 1978, and by placing those of 1979 beside them it is easy to judge whether the 1979 pattern looks more like the 1978 "draw-down mode" or the 1977 "maintenance mode":

TABLE V.—REFINERY CAPACITY UTILIZATION

	[Percentage]		
	1977	1978	1979
January.....	89.0	85.1	87.2
February.....	92.6	84.1	83.8
March.....	89.6	84.8	84.1
April.....	88.8	83.2	84.8
Rough average.....	90.0	84.3	85.0

Without belaboring the point, it is clear that while the 1977 rates never went below 88.8, the 1979 rates never went above 87.2, and the average for 1979, while 5% below 1977, was just a shade above 1978. In short there can be no doubt that the refinery utilization pattern, especially in the face of a low starting point for 1979 and a heavy demand, looks much more consistent with the thesis that the industry was, as in 1978, consciously trying to draw down stocks than with the thesis that it was trying to maintain and rebuild stocks by using its refining capacity to the fullest. In fact, the industry continued to operate well below capacity, to draw down distillate stocks from their already low starting point, to let them in February cross below the record low of 133 million barrels during the 1977 freeze, and finally bottom out at 115 million barrels, a level not seen for any month for the previous five years. Gasoline stocks also ended up at about the 1975 level.

The most dramatic evidence that the industry was making no real effort to resist potentially disastrous drawdowns of fuel oil is the comparison of the December 1977–January 1978 cold snap with the similar two month demand peak in January–February 1979.

TABLE VI.—DISTILLATE OIL, RESPONSE TO PEAK DEMAND

	[Millions of barrels]	
	1977-78	1978-79
Stocks at start.....	223.0	216.0
1st mo demand.....	144.150	153.729
2d mo demand.....	158.193	138.880
Total.....	302.343	292.609
2 mo production.....	205.344	179.961
Production deficit.....	-96.999	-112.648
Capacity Utilization: (Percent):		
1st mo.....	91.1	87.2
2d mo.....	89.0	83.8
3d mo.....	92.6	84.1
Drawdown 3 mo.....	90.0	101.0

Thus despite the lower starting point for stocks, and the larger production deficit in 1979, refineries in 1979 were run at the kind of leisurely pace used in 1978 to draw stocks down quickly, rather than at the catch-up pace of 1977-78.

Alternative scenarios.—Would it have made much difference if the oil industry had made the extra effort to produce at fuller capacity in the first four months of 1979? Clearly yes, as Table VII shows. If they had merely produced in each month of 1979 the same amount of distillate produced in that month in 1977, then between January and April they would have placed about 32.2 million more barrels of distillate into stocks, raising the April 30 figure by almost 28% (see Table IV), and, purely coincidentally, leaving stocks at the same reasonable 148 million level they were at in 1977. Another alternative would be to assume that 1979 capacity utilization had been set at the rate for the corresponding month in 1977. This would have resulted in about 21 million more barrels of fuel oil over the January to April period, an increase in April 30 stocks of 18%.

TABLE VII.—ACTUAL AND POTENTIAL DISTILLATE PRODUCTION

	1977 Actual	1979 Actual	1979 w/ 1977 C.U.	1979 w/SPR and 1977 D%
January.....	104,439	95,821	97,347	111,104
February.....	107,460	84,140	92,880	102,460
March.....	98,363	93,961	100,140	99,076
April.....	89,850	90,000	94,295	92,400
Total.....	396,112	363,922	384,662	405,040
Difference from 1979 actual.....	32,190	.....	20,740	41,118

Either of these methods might have required some additional crude, which, as shown below should have been available from company stocks, or new purchases. But a third alternative might not have required any additional crude oil, but merely (1) shifting, starting Oct. 1, the 30 million barrels headed for the so-called Strategic Petroleum Reserve—where it was of no use whatsoever because there was no way to pump it out—into above-ground storage where it could flow into refineries that could have used it to increase their capacity utilization, and (2) shifting the emphasis in current production during the heating season towards heating oil and away from gasoline and/or other products. For the fact is that while distillate oil was in the most precarious position in early 1979, as in early 1977, U.S. refineries produced a significantly lower percentage of their runs in the form distillate oil in 1979 than in 1977. While the fuel oil production, as a percentage of runs went as high as 25.1% in the Jan.-April 1977 period, and never went below 21.1%, the figures for 1979 never went above 21.4%, and were below the lowest 1977 figure three out of the four months. While 32.2 million fewer barrels of fuel oil were produced during those months in 1979, 5 million more barrels of gasoline were produced in 1979.

As Table VII shows, combining these two assumptions, i.e. using all purchases of Strategic Petroleum Reserve crude oil for increasing refinery inputs, and producing at 1977 distillate ratios, additional fuel oil available would have been a maximum of over 41 million barrels. Because of changes in refineries and the mix of available crude oils, the precise result this year might be slightly different (up or down) from that estimate. But even if we cut that estimate in half, we would still be talking about a 20 million barrel increase in fuel oil stocks at the end of April, with at least no major sacrifice of gasoline stocks, and possibly an increase in such stocks as well.

Availability of crude oil.—The supposed unavailability of crude oil as a result of the Iranian revolution is sometimes suggested as the reason why refineries did not run more crude oil. Without rehashing that debate, for the purposes of this analysis, certain relevant facts are unarguable:

1. World oil production remained at a level about 4½-5% above the previous year throughout the period, with other countries more than making up for Iran's reduction at a time when demand increases were minimal.

2. In any event U.S. imports were actually up by 7.7%, not counting Strategic Petroleum Reserve imports, and by 8.4% including SPR imports, i.e. the

Iranian "shortfall" did not in fact affect our supplies during the heating season, as shown in Table VIII:

TABLE VIII.—CRUDE IMPORTS TO UNITED STATES

[Thousands of barrels]

	Excluding SPR		Including SPR	
	1977-78	1978-79	1977-78	1978-79
October	198, 679	195, 269	201, 562	201, 314
November	187, 440	190, 260	189, 630	195, 300
December	193, 688	201, 996	196, 137	209, 591
January	185, 194	197, 904	188, 728	204, 228
February	155, 428	202, 647	158, 480	204, 662
March	185, 411	192, 975	189, 503	195, 207
April	159, 930	181, 800	163, 170	183, 660
Total	1, 265, 770	1, 362, 851	1, 287, 210	1, 394, 862
Increase 1978-79 over 1977-78	97, 081		107, 653	

3. In fact, the U.S. Government continued to sink more crude oil into the *still* inaccessible SPR caverns, an indication that at least some people at D.O.E. did not believe there was a serious crude problem or that one was likely. (We have been told that D.O.E. refused to offer this crude to refiners who told D.O.E. that they were temporarily short of crude because of dislocations in the market.)

4. Beyond that, world stocks of crude oil were built up sharply in anticipation of the December OPEC meeting (and in response to the deteriorating situation in Iran), and were ample "to allow importing countries to squeeze through 1979 *without* Iranian crude if we have to," in a Gulf Oil executive's words.

5. U.S. stocks of crude oil were in satisfactory status throughout the January-April period compared to prior years other than 1978 when crude stocks had been kept abnormally high as oil companies were drawing down product stocks.

6. Data from individual company sources shows that they "more than offset" (Gulf first quarter report) Iranian cutbacks with (frequently more profitable) production elsewhere or with "substantial additional volumes" (Amerada Hess Annual Report) of oil they had purchased in late 1978.

7. In fact, as most neutral observers expected, as soon as the new government took over in Iran, the first thing it did was get the oil fields back into production at a rate which meant that there need not have been nor need be any real fear of crude shortages.

The bottom line is that *total* domestic petroleum stocks (crude and product *together*) were, at the end of April, at a level consistent with each previous year (other than the aberrational 1978), not including SPR, and substantially in excess of previous years, including SPR. The only question was whether it was better to keep the stocks in the form of crude or in the form of product. With distillate stocks so dangerously low, it should have been clear that failure to rebuild them quickly over the entire year would mean creating unnecessary shortages of either distillate or gasoline later in the year, since even at full capacity refineries cannot both meet current gasoline needs during the driving season and rapidly rebuild fuel oil stocks. If crude oil stocks had been drawn down to build product stocks, these could have been rebuilt later in the year. If there were crude oil interruptions later in the year, then mandatory allocation, rationing, and other emergency plans could have been implemented to deal with the *actual* problem. But the failure to refine crude when both crude and refining capacity were available meant causing a future product supply problem *whether or not* an interruption of crude oil in fact occurred later in the year.

The panic factor.—As soon as the Iranian interruption began, officials of the International Energy Agency, and of European governments, immediately sized up the situation. They counselled calm, and warned that overreaction would cause more problems than the interruption itself. The German Economics Minister, for example, said that the only problem would be price, not supply.

The U.S. Government took exactly the opposite approach. Beginning in January, Administration officials from the President and Secretary of Energy on down began talking in doomsday terms. Secretary Schlesinger for example, said that

the situation could be worse than the 1973-74 embargo. D.O.E. picked February to send to Congress its long overdue "mandatory conservation" proposals, a routine, statutorily required standby procedure, which at any other time would have gone almost unnoticed, but which at this time could only have exacerbated the public's growing fears caused by the Administration's own trumpeting of alarms that we were facing a drastic shortage of fuels in the near future. The D.O.E. continued dramatizing inflated figures of the world and U.S. shortfall even when its own researchers confirmed that these estimates were wrong. And the industry joined in by citing a minor reduction in gasoline stocks—which in fact were probably the result of the panic itself, as evidence that there would be an even worse shortage ahead.

The government and industry overreaction was not just something to be criticized as sloppy, or wrong, or intemperate in hindsight. In advance, the U.S. officials should have known what the Europeans obviously recognized: a public panic in fear of a shortage can cause a real problem, whether or not there is in fact a true shortage. Those who have supplies on hand don't want to give them up. Those who don't have supplies on hand want to get them and build them up. The result is a disruption in the entire flow of supplies that looks and feels just like a shortage even if in fact the same amount of supply is flowing into the system and the same amount is actually being used by ultimate users.

To a large extent that is precisely what happened in the U.S. this year. Every one who had a tank for fuel oil, gasoline, or other fuels, began filling it up as soon as the Schlesinger-type warnings began. For example the Wall Street Journal reported that the largest U.S. fuel storage company was 98% full and that there was such a run on 5 gallon gasoline tanks that the manufacturer could not keep up with demand, while airliners were taking off with full tanks for short hops—a step which not only meant the originating airport had less jet fuel to offer others, but also meant a huge waste of fuel as the planes had to take off with the excess weight of the full fuel tanks. It is difficult to estimate what the impact on the statistics of the panic factor is because neither D.O.E. nor apparently anyone else, knows what the amount of storage *beyond* "primary stocks" is, that is, what storage by utilities who burn oil, by taxi and rental car companies, by industrial and commercial fuel oil, diesel, and gasoline users is normally, and how much spare tank capacity they have. But here is a partial rough estimate: If the tanks of the 145 million motor vehicles on the road are normally an average of half full, they would contain approximately 50 million barrels of gasoline. If people, in fear of unavailability of gasoline, now refill their tanks each time they get down to half full, they would have an average of three-fourths of a tank on hand at all times, or a total of 25 million barrels more taken out of the normal company stocks and placed in personal stocks. This figure is conservative in that it doesn't include all the non-rolling private storage.

A similar impact could be expected for distillate fuel oil (diesel oil), although the proportion of non-rolling storage and the size of tanks is probably much larger.

Such a "topping off" phenomenon has several describable, if not quantifiable features:

It *reduces* the national figures for "primary" stocks—i.e. makes it look like we have less on hand than we really do, thus helping feed the panic.

It *increases* the national "demand" statistics, since demand is a derived figure calculated as net "withdrawals from stocks," rather than a true measurement of actual usage, i.e. we may actually be *using* much less than before even though the D.O.E. and industry numbers tell us we are using much more.

It does create *actual* interruptions in the supply flow because dealers and their suppliers are in fact drained of their supplies as private tanks are filled.

Most of it is temporary—i.e. you can only increase your average level of storage once (unless you build new storage, which will happen if the panic continues). Then your "demand" once again reflects your actual usage, although purchased at more frequent intervals.

Topping off (as well as holding back supplies) is encouraged if prices are expected to rise sharply. Thus the announcement of oil price decontrol in the midst of everything else accelerated the panic buying for those with large tanks.

Was There a "Conspiracy," "Plot," or "Plan"? We have no access either to the internal working of the oil industry or the minds of D.O.E. officials. There is a presumption that they intended the predictable results of their actions. It is reasonable to conclude, in the absence of evidence to the contrary, that actions

taken which are consistent with and beneficial to their separate and joint goals, were taken in pursuit of those goals. Thus for example the fact that wholesale gasoline prices stayed stable—and even declined—during the 1977–78 Heating Season, when stocks of both were ample, may explain why the industry worked so hard to draw down and tighten stocks of both during 1978. In fact, after these drawdowns, prices of both began rising sharply. And it could not have escaped the attention of both the industry and the Administration that right after the 1978–79 Heating Season, a decision would have to be made on crude oil price decontrol, and that the *appearance* of shortage might well help attract attention to their claim that decontrol, as a possible—albeit speculative and costly—way of increasing supplies, was a step worth taking. It is certainly widely believed in the industry that we may be approaching the peak of U.S. gasoline demand in 1983–4 (see, e.g. National Petroleum News, May 1979), and not unreasonable to conclude, therefore that the next 2 or 3 years may be the last chance for the industry to ratchet gasoline prices up sharply, that a shortage environment presents the best setting for such ratcheting (since people fearful of not getting gas will pay almost any price for it), and that the Iranian pause presented a perfect opportunity for creating such an environment. It is certainly well known that the Administration has been unable to come up with a meaningful conservation plan, while the Government has committed us to our International Energy Agency partners to a 5% cutback in oil demand. Of course allowing distillate stocks to be drawn down so low that rebuilding them will require a cutback of gasoline production at the height of the driving season, thus requiring anticipatory cutbacks in gasoline allocations, thus causing panic at the pump, lines, and, in effect, rationing by inconvenience, is one way of bludgeoning the public into cutting back on automobile usage, since it is obvious that even outrageously high prices are not an effective conservation tool.

The statements from both the oil industry and the Administration about the desirability of higher fuel prices and about the likelihood that a few good shortages will teach the public a lesson, taken together with the *absence of any effort to prevent what the industry knew was happening and D.O.E. should have known was happening suggests either that they both wanted it to happen, or that the industry wanted it and knew that D.O.E. would not, or did not know how, to stop it.*

III. OUTLOOK FOR THE REMAINDER OF 1979

D.O.E. says that it wants to have fuel oil stocks rebuilt from the 116 million April 30 level to a 240 million barrel level by Oct. 1, an increase of 114 million barrels. On its face, this looks like a much larger buildup than in any recent year:

TABLE IX.—APR. 30–OCT. 1 DISTILLATE STOCKS

	1979	1978	1977	1976
Apr. 30.....	116	136	148	137
Oct. 1.....	240	220	252	232
Buildup.....	114	84	104	95

And it is the prospect of this larger buildup, requiring extra distillate production during the peak gasoline use summer months, which, together with high gasoline demand forecasts based on the official “demand” figures of the first quarter, provide the basis for the industry and government forecasts of a gasoline shortage this summer. And of course, it is the prediction of a summer shortage which is justifying the industry’s decision, with government approval, to hold back on supplies right now, in a purported attempt to spread the impact.

Of course, as we have seen above, there are two vital variables which make these calculations, predictions, and cutbacks shaky at best and grossly irresponsible, if not totally irrational, at worst. First, if “secondary” seller stocks and ultimate users stocks, which do not show up in the official stocks figures, have increased substantially, then the need for and expected future drawdowns from both distillate and gasoline stocks may be substantially less. In addition, the apparent “demand” levels for the 1st quarter of 1979 may be substantially

inflated, and, in fact, demand for both fuels may be much more moderate once everyone who is going to increase average storage has done so.

Thus the most urgent need is—and has been—to get some clearer picture of secondary and user stock levels; the rate they were built up at, and the comparison to last year. Then we can derive more relevant estimates of stock buildup needs and prospective demand. If the buildup of non-primary stocks is (a.) as large as suggested above (possibly 25 million barrels each for gasoline and distillate), (b.) implies a true usage level that is not nearly as far above previous years as the official figures indicate, (c.) about to level off either because it has reached its physical limit or because the government calms down, then we can actually look forward to a fairly normal supply situation for the rest of the year, unless there are new external problems or interruptions.

That is, the April-October buildup of distillate stocks actually required may be not greater than the 94 million barrel average of the past three years, the slightly increased level of actual distillate and gasoline usage may be well within the current capacity of the over 1 million barrels a day of added refinery capacity, and substantial upgraded capacity, since 1976, and there may in fact be no need for any true shortage this year, or any spreading back to the present of an expected shortage.

The public deserves this kind of full and accurate analysis of the situation which can only come from industry data obtained mandatorily by the government. The need for post-primary stock data is not new, but past efforts to obtain it have been frustrated by the absence of real effort by DOE and its predecessor.

At the same time, there is still no excuse for U.S. refineries *not* to be operating at full capacity (the latest available figure was 85.5 percent). If the situation—or the doubts—are serious enough to require cutbacks in gasoline allocations—then it is time as well to use the crude oil stocks for the purpose they are supposed to serve, and replenish them later. The idea that crude oil will not be available on world markets is directly rebutted by Sec. Schlesinger's own most recent prescription that the oil companies buy gasoline and distillate from *foreign* refineries. Of course this product must come from crude oil stocks somewhere, and, in fact, the availability of products from foreign sources adds to the credibility of suggestions that any unavailability of crude oil to U.S. refiners, especially independents, has been the result of diversion of crude oil by the majors from the U.S. to foreign stocks for refining abroad and later sale as product at extremely high prices to the U.S. market.

In short, with the evidence of actual need for the current cutbacks in gasoline allocations sadly lacking, and, with the continuing underutilization of refinery capacity preventing maximum current production, the justification for instituting sharp cutbacks appears to be extremely weak, especially in the light of the predictable and substantial hoarding, topping off, and other psychologically induced impacts which such cutbacks produce. One can only assume that D.O.E. officials continue to believe, as President Carter himself has suggested, that a good dose of "underdeliverability" is the only way they can think of to constrain gasoline demand, without regard to what that artificial "underdeliverability" does to the lives, jobs, time and temper of a public which believes that driving is a necessity in modern America. And, of course, the oil industry is glad the oblige, since that same dose of induced shortage helps inure the public to otherwise unacceptable price gouging.

[From Energy User News, Feb. 26, 1979]

HIGH ENERGY PRICES: THEY'RE NOT THE SOLUTION

(By James F. Flug, Director and Counsel, Energy Action Educational Foundation, Washington, D.C.)

(The following essay is excerpted from a speech given last month before the National Retail Merchants Association in New York City.)

I know how confusing it's been to follow energy policy recently so let me try to help sort it out. It's probably a good idea to put aside any notions of reason or reality, suspend any habits of calm consistency, and keep firmly in mind role models like "Chicken Little," "The Boy Who Cried Wolf," and the "Emperor with the New Clothes."

[We might think that one of our energy problems was a shortage of natural gas, since Congress and the President spent most of the last two years trying to pass an energy program that would "solve the gas shortage" by preventing use of gas for some purposes and raising its price so high that all users would think twice before using it.

But we didn't have it quite straight. As our current energy czar Schlesinger put it a few weeks ago, our real problem is "to avoid chronic surpluses having a dampening effect on incentives."

Translation: We have so much gas that prices will go down unless we do something to encourage more—even the least-efficient—users to use more gas, and, of course, we don't want prices to go down.

We might have thought that the discovery of really huge amounts of oil and gas in Mexico was a plus. But Dr. Schlesinger set us straight once again. We can't let Mexico share its gas glut with us if that would endanger our ability to build the Alaska gas pipeline, a project which promises to help us quadruple present gas prices.

Nor can we let Mexican oil—in Schlesinger's words—"diminish the domestic incentives," which, in English, means it might—Lord forbid—help us get back down from the \$2.09 price which much of our gas will be getting this year, towards the 25/35¢ price Mexicans pay for their gas and which we were told five years ago would be a price that would have us swimming in gas.

We might have thought that OPEC price increases during the '70s were a terrible thing, that they caused inflation, recession, and excessive profits to foreign producers and international oil companies. But, according to the Tri-lateral Commission's energy experts, we missed the point: the real problem is that we didn't follow OPEC's lead. We should not only give our producers OPEC-style profits at the expense of the rest of the economy, and make sure that every bit of our own inexpensive energy resources carry the burden of the cartel prices, but we should go OPEC one better and raise our energy prices even faster than the cartel.

You might have read in the N.Y. Times that the price of energy was a major complaint of Westchester executives, or headlines saying that the December increase of 4 percent in gasoline and 1.9 percent in fuel oil helped boost the wholesale price index to a 1978 increase of 9.1 percent, the largest rise since 1974, and you might have said to yourself, "Here's the culprit!—energy ought to be the first target for the anti-inflation program!"

But if you had called the White House, you would have been told that oil and gas producers are exempt from the price guidelines (though oil and gas drilling costs are covered). You would have understood more fully what to do about the inflationary impact of energy from the headline in an issue of the Wall Street Journal which read "Administration Is Devising Ways Other Than Decontrol To Raise U.S. Oil Prices."

Your mistake is thinking that ever-increasing energy prices are the energy problem. You have to do what the Mobil "op-ed" pieces try to get you to do: Keep on saying to yourself: "Ever-increasing energy prices are the solution to the energy problem." This way you will not only put yourself in tune with our policymakers, but stand idly by while energy prices go up faster—and to heights that even the oil and gas industry never imagined possible.

As you can see, the whole energy situation could be a wonderful topic for a situation comedy. Except that it isn't funny to most Americans. I'm talking about everyone; the welfare widow who has to choose between food and fuel, the wage earners, the restaurant owners, the farmers.

Everyone who is trying to figure out how to handle a 15 or 20 percent increase in costs this year especially when your customers have less to spend in your stores because they've had to absorb the increase in their driving, heating and cooking costs, and in the energy component on all the items they buy.

So let me now be as serious and straightforward as I can be. Energy policy-making in the U.S. today is a disaster area. There is agreement all across the board that chaos, confusion and conflict are the government's only consistent energy themes.

Even the consumer-oriented lawyers are feeling sorry for the utilities which having fought a long, losing battle against the government's efforts to stop them from using gas, finally capitulated, only to be told now by DOE that they should not only keep using it, but switch all facilities to gas.

One day "U.S. officials" are quoted as saying that the Iranian oil interruption won't cause any problem for six months and, a few days later, Schlesinger says the Iran cutoff could force rationing.

Our president and ambassador have to repair the damage done when Mexico's oil chief storms out of DOE charging "unbelievable arrogance and insults."

Our Strategic Petroleum Reserve (SPR) has very little oil in it, no equipment to pump the oil out, catches fire, and is costing twice as much per barrel as planned. Two divisions of DOE are reported to be spending their time fighting with one another over who should get a few million dollars of solar technology money, resources and support from above.

So my advice, unfortunately, as we celebrate the tenth anniversary of the Nixon-Ford-Carter energy policy, has to be to look elsewhere than present officialdom for leadership and insight on energy. Outside the government you can choose between those who think high energy prices are the remedy and those who think high energy prices are the disease.

The leaders of the first group are from the oil industry and they write articles titled "OPEC's Price Hike Was Good News." Ninety-nine out of 100 of their followers are people who solicit consultant fees, contributions, or advertising from, or sit on boards with, or like to go to summer camps in Aspen run by, the oil industry, or are theoretical economists—who are nice people, but you wouldn't let them run your store.

The second group is necessarily very small. Most of them do not have beards. We do not agree on everything but here is one person's version of our perspective.

It is as likely that we will have ample world supplies for the foreseeable future as it is that we will have shortages. The Irving Trust Co., for example, anticipates that non-OPEC oil supplies will rise one-third in the next five years, while "free world" consumption will rise only ten percent. Thus, OPEC production would have to be cut back significantly and fall from 56 percent of supply to 47 percent to prevent excess supply.

This is consistent with the Trilateral Commission's suggestion that rising real oil prices might not occur if major new discoveries of 10 billion barrels or more are made—a condition already met by Mexico's recent increase in proved reserves from 11 billion to 40 billion barrels.

And the likelihood of a continuing world oil glut explains the recent decision by Aramco not to proceed as fast as had been planned with new production facilities for the mid-80s. This does not mean we should not conserve—conservation not only stretches out existing supplies further into the future, it brings restrained demand that helps create downward pressure on energy prices. But these facts do mean that we need not react precipitously to scare tactics.

There is nothing wrong with importing a reasonable amount of our energy as long as we diversify our sources as much as possible, so that we are not overly dependent on one source or group of sources, and we do not pay more than a reasonable price. The price we pay should reflect the supply situation, the fact that we are a very large buyer of oil and can select among our potential suppliers, and that we have very extensive and inexpensive energy resources of our own. In fact, we waste, or use for "luxury" purposes, more than 15 to 20 percent of the energy which we import.

We should have normal bilateral buyer-seller relationships with our suppliers, neither approaching them as supplicants nor treating them as inferiors. We should eliminate the vertical industry structure which makes some of our largest buyers of imported oil at the same time partners in and beneficiaries of the production of particular producing countries, and thus unable to deal at arm's length and to shop the world for the best prices.

We should certainly eliminate the loophole in our tax system which allows much of the cost of foreign oil from an affiliate to be treated as a tax credit, and thus encourage such imports.

The Administration must take some responsibility for the size of the increase, since it did nothing to stop the oil companies from overstockpiling in late 1978 and thus tightening the market. It spent SPR equipment funds for its own stockpiling, adding to the tightness.

Secretary Blumenthal's statement after his Middle East visit that we could "live with" an 8 or 10 percent increase insured that the rise would be higher: Carter's Bonn promise to raise U.S. energy prices to world levels, and the passage of the Natural Gas Act allowed OPEC to feel that we really thought high prices were good.

World production normally has to be curtailed anyway at the beginning of the year to make up for the industry's end-of-the-year excess stockpiling, so that Iran's decreased production is merely absorbing this excess. Only after several months of very low production would world consumers even begin eating into normal stocks.

We must develop an understanding with the Mexicans that neither the oil and gas industry, nor for that matter, DOE, truly represents the American people, that we want to work together to our mutual benefit, and that we are not in the same position as Japan or Israel or other customers for Mexican supplies, because we have substantial oil and gas of our own, obtainable at an actual cost far below world prices.

Thus, we must resist an import mechanism through which Mexican fuels would help ratchet up U.S. as well as OPEC prices.

Then we come to the myth of artificially low energy prices: As long as world oil prices are set by a foreign cartel, aided by an industry which even John Sawhill calls an "oligopoly" and an FTC complaint calls a monopoly, then uncontrolled energy prices will, by definition, be artificially high.

And the myth of incentives: Once you get above-cost, plus a generous return on investment, "incentives" become a matter of gamesmanship, not economics. President Carter himself said that, beyond a certain point, incentives become windfalls.

Energy prices are already amply high to justify huge amounts of conservation investments which are not being made because of lack of information, fear of riffs, shoddy products and insufficient front-end financing.

Alternative Sources: If we want alternative sources that make sense, i.e., come in at present or lower energy costs, we had better make sure the oil companies don't control them. Otherwise, we'll see the same behavior as with oil shale, which always seems to be viable at just above whatever the current oil price is.

But the fact is that OPEC is only a small part of our energy inflation problem. The \$3 billion which the OPEC hike itself will cost us this year is far less than the nearly \$5 billion cost of natural gas price increases which the gas industry and the Administration are inflicting upon us. And if oil is decontrolled this May, the cost for the rest of the year could be \$11 billion.

And if energy prices keep rising the way the oil companies and their friends hope, we will be facing an economy where almost 15 percent will go for energy in 1990—seven times the 1970 level.

I urge you to consider the revolutionary impact of such a trend, for, if higher and higher portions of our family and business and national budget are diverted to the energy industry, every other element of the economy will suffer deeply.

Mr. ALPEROVITZ. I do want to comment again on what you said, Senator MCGOVERN, about Walter Heller's point that many industries in the country are now being severely hurt—it's showing up in retailing—because of the tax that our failures in energy policies are extorting from commerce. We see it as not only inflationary, but as part and parcel of a descent into the recession. That policy must be changed. I would like to call on Mr. Brown, cochairman of the COIN task force on housing policy.

Senator JAVITS. I have been to many of these hearings, but I would like to compliment the Chair on this one. I think it's a brilliant conception to bring in the basic necessities and show what they have done to us. I hope it will have a very profound effect. It's certainly having a profound effect on this Senator, I assure you.

Mr. ALPEROVITZ. We appreciate that, also, Senator.

STATEMENT OF JONATHAN BROWN, DIRECTOR, PUBLIC INTEREST RESEARCH GROUP, WASHINGTON, D.C.

Mr. Brown. Thank you, Senator McGovern and distinguished members of the committee.

I will briefly present COIN's analysis of inflation in the housing sector. I would just like to give the highlights of most of the details presented in the COIN document.

There are several underlying themes which we address in our analysis of the housing sector. The first one is that there is a fundamental supply-demand imbalance in the housing sector. That is a major cause of inflation. The best evidence of this can be seen by looking at the increase in the median sales price of existing homes.

In 1977 and 1978, that price increased at an annual rate of 15 percent. That is much higher than the overall increase, inflationary increase in the economy at that time. In 1977 the Consumer Price Index increased by only 6.8 percent and increased in 1978 by only 9 percent. So you are talking about increases in home prices running almost twice as high as the increase in the overall rate of inflation.

Now, one of the questions which was often asked is: Isn't really inflation in the housing sector a drive inflation that is really a result of the underlying inflation of the whole economy and this is merely responding to that?

We think this type of evidence, showing a much higher rate of inflation in the housing sector, demonstrates just the opposite. And that is, the housing sector itself, like the energy sector, like the agriculture sector, like the health-care sector, is an initiator of inflation, is a dynamic, underlying cause of inflation.

That is not to say that the housing sector does not also respond to overall inflation. Obviously, as the price level rises, as interest rates go up, housing becomes a more attractive investment, particularly with people who have other limited savings opportunities. So there are two factors at work.

Nonetheless, there has to be an underlying inflationary factor that is fueling inflation in the housing sector which is more than just simply a reflection of aggregate inflation. The reason why the inflation in the housing sector has been increasing, why it's a dynamic force, is because of this underlying supply-demand imbalance.

One of the best evidences of that is the fact, coupled with the shortage of housing, there is a very strong demand for housing. In 1978 there was an addition to the number of households of 1.8 million; 1.8 million new households. That should be contrasted with the average rate of household formation during the 1950's and 1960's, which was only about 1 million additional families each year.

So you can see, when you go from a long-term trend of about 1 to 1.5 million and, last year, 1.8 million, you have a substantial increase in demand. Along with the increase in demand, there are several underlying factors why the supply is not feeding that demand.

I will briefly summarize them. They are very complex. They could be summarized briefly as four points. One is that there is a long-term problem of cyclical instability in housing production. We have had repeated cyclical downturns in housing production since the end of the Second World War. These cyclical downturns have a long-term effect in reducing the supply of housing. They create shortfall, and it's difficult to make up that shortfall in ensuing periods.

The second reason is that moderate-income homeowners are increasingly being priced out of the market for new homes. The percent of

families able to afford meeting the price of new homes has fallen from 46 percent in 1970 to roughly 24 percent in 1978, a dramatic decline. What that means is that more and more new home production is oriented toward upper-income individuals and can't respond to the housing needs of the more moderate income person.

There is a third primary factor which is limiting the supply, and that is a long-term structural weakness in the rental housing market. One of the causes of this weakness is the Federal income tax deduction which favors homeowners and places rental housing at a severe disadvantage.

The fourth factor contributing to supply failure is the decline in the level of Government subsidies for low- or moderate-income housing.

Now, the solutions to these structural problems which are causing a supply failure are difficult and varied. I will address some of them later as I talk about the impact of monetary policy.

But there is one intermediate-term solution which is obvious, and that is the need to expand Government subsidies for low- and moderate-income housing. I think it is important to put this in the context of the debate about whether budget deficits contribute to inflation.

I think this is one of the best examples of where increased Government expenditure—that is, expanding the supply of low- and moderate-income housing—would have a beneficial impact in term of relieving the shortage in the housing market, thereby reducing the inflationary pressure on the housing sector. And that would outweigh any inflationary impact on the budget deficit you would have from additional spending.

It is clear this is the type of Government expenditure that gains more than it loses in the fight against inflation.

The second then in COIN's analysis of the housing sector is that reliance on monetary policy has a major adverse effect on housing costs. There are three factors here at work.

The first is obvious. In a restrictive monetary policy, it pushed up the interest rates. The higher interest rates have major impact on the Consumer Price Index. During 1978 the mortgage rate rose on a national basis from 9 percent to 10 percent. That alone added 0.7 percent to the Consumer Price Index. The construction loan rate for residential construction increased on average from around 9 percent to 14 percent. That alone added 0.6 percent to the CPI. Finally, interest rates on commercial loans and corporate bonds added roughly 0.4 percent to the CPI.

Add that up, that is a total of 1.7-percent increment in the Consumer Price Index during 1978 attributable to higher interest rates, which primarily came about through the tightening of the money supply by the Federal Reserve Board. I think that that is rather clear evidence that the use of restrictive monetary policy has cost-push effects that outweigh any demand effect. And though the higher interest rates—no one argued they contributed anything near, or had an offsetting effect anywhere near the 1.7-percent increment they had on the CPI.

In fact, when we had the introduction of the money market certificates, so that restrictive monetary policy really worked more through

higher rates rather than disintermediation, which choked off the supply of mortgage credit, the main people bearing the brunt of restrictive monetary policy, the moderate-income homeowner, was cut out because he couldn't afford to pay the higher mortgage rate.

The second reason why restrictive monetary policy is very adverse in the housing sector is that it's the root cause of cyclical instability in the housing sector. In the past, we have had disintermediation. Now we have high rates that cut out the moderate-income home buyer. Both of these causes are responsible for the cyclical downturns in housing production.

These downturns have ranged from roughly 30 percent to 50 percent of housing production. That is a major economic disruption in one of the key sectors of the economy. For 1979, the forecast is for roughly a 30- to 35-percent decline in housing production as we enter a recession.

As I indicated before, these cyclical downturns create a production shortfall that leads to a long-term supply problem. More important, in some cases, is the impact they have in terms of raising the cost of production. They result in production inefficiency because the industry is in a constant stopping, heatup and slowdown posture.

The reason for these cost increases are several. Workers demand higher wages to offset extended periods of unemployment. Homebuilder bankruptcy rates are high. Therefore, they demand a risk premium. The cost of borrowing is higher. When the housing sector has to expand rapidly, there are supply bottlenecks in the building materials industry. Supplies have to be purchased at higher prices. Therefore, the greatest number of homes is produced when they cost the most.

Finally, the production techniques used by homebuilders are inefficient. They seek to minimize their investment of fixed capital, and, therefore, their techniques are not the most cost effective.

We have estimated, based on our conversations with people at the Harvard-MIT Center, that the long-term cyclical instability in the housing sector could add 10 to 20 percent to housing costs. That is, a long-term, dynamic inflationary system allows that. I don't think this has been adequately addressed by Congress and the administrative agencies. It is time this committee and other committees of Congress looked at that.

Our proposed solution to this long-term problem of cyclical instability is the use of selective credit controls. We believe that selective credit controls which are authorized by the Credit Control Act of 1969 are means to curb credit uses without resorting to higher interest rates, and they are also a means to stabilize the housing sector.

So they have two primary benefits. That is, lower interest rates and stability in the housing sector.

Finally, I think that as the Congress is exploring the idea of eliminating regulation Q and moving the financial institutions into the non-Q environment, it becomes more and more important to have a national debate on the use of selective credit controls, because as we move into a non-Q environment, higher interest rates become more and more ineffective in terms of curbing down-the-line demand for credit.

Finally, we believe that the third main idea which we have addressed as a cause of housing inflation is the Federal income tax deduction

for mortgage interest and property taxes. This is a \$12 billion subsidy for upper and upper middle income persons. In fact, the subsidy is roughly twice the subsidy provided for low- or moderate-income housing.

Just to summarize our objections to this and why we think it is a root cause of inflation, this subsidy, this tax break which goes to the upper income and moderate, middle-income homeowner inflates this demand for housing, particularly the demand for luxury housing, increases the price of luxury housing. This tax break in large measure is capitalized in the form of higher prices.

It injures the rental housing market. This is seen by the large number of conversions from rental units to condominium ownership.

It is grossly progressive. It provides very little benefit to the moderate-income home buyer. According to IRS and Congressional Budget Office data, in 1977, taxpayers with incomes of below \$15,000—these represent 70 percent of all taxpayers—received only 9 percent of this tax subsidy. Because so little is received by the moderate-income home buyers, the people who might benefit the tax subsidy has little impact in terms of expanding housing supply.

According to IRS data, there are one-third of homeowners with mortgage debt who don't itemize deductions. They take the standard deduction and therefore the tax benefit is not available to them. The IRS data show these one-third homeowners who don't itemize deductions are primarily the moderate-income home buyers. Therefore they don't get any tax advantage.

The IRS data indicate there are very few homeowners or taxpayers at all with income below \$18,000 who itemize their deductions. We feel that elimination of this tax break would be beneficial in terms of lowering inflation in the housing sector as well as a matter of tax equity, obviously increasing tax revenues.

Finally, the fourth and last in the COIN analysis of housing inflation is the need to strengthen cooperative mechanisms within the housing sector. There are three areas to be identified where the cooperative principle can be used to benefit consumers by lowering housing costs.

The first one, obviously the most important, is to increase use of cooperative housing by construction and maintenance of multifamily buildings by cooperative nonprofit organizations, which can lead to a substantial reduction in both construction and maintenance costs. I could give you one example. In Detroit, cooperative housing multifamily buildings there which were built by nonprofit cooperative organizations were built with construction costs roughly 25 percent lower than those built by private developers. In addition to that, the rents which they charge, because of the construction cost and lower maintenance costs and more efficient maintenance, are roughly 35 percent below rates comparable to private developer builders. And the buildings are better maintained than private developer buildings.

The reasons for the cost savings that come with cooperative housing are the fact that cooperative developers don't take the high profit that private developers do. They can obtain professional fees at lower prices, primarily because they have incentives for building both energy-efficient buildings and buildings that have structural designs and equipment that minimize the long-term maintenance cost.

The second key area where cooperative principles can expand the supply and also lower the housing cost is to have a nationwide urban homestead program. We think that there is a large stock of abandoned housing units which are not really being used. In many cases programs can be devised whereby tenants, prospective tenants engage in self-help rehabilitation.

This program has worked in New York City, where the tenants have been able to rehabilitate these buildings at a cost 50 percent below the cost of private developers.

Finally, the third area where we feel that savings can be accomplished is in the area of real estate brokerage. Nationwide now they charge commissions of roughly 7 percent, which is an outlandish price in view of the service they render. It's really services that are really much more extensive than needed.

I can speak from personal experience about the number of useless and trivial calls you receive from brokers. I think many people had that experience.

We think by establishing Government-sponsored, low-cost real estate brokerage services that provide a moderate-price referral service, that the cost of real estate brokers could be lowered by 50 percent, commissions around 3 or 4 percent rather than 7 percent.

Just to quickly identify some of the key solutions in the cooperative sector that are relevant for Federal legislation, the first would be increased technical assistance for cooperative organizations, tenants seeking to form cooperative organizations, establishing a goal or target after the end of 5 years that roughly, maybe, 30 percent of section 8 subsidized housing would be for cooperative-owned housing. Establish a national homesteading plan with a target of 100,000 units a year. That is relatively modest when you consider the fact we have an abandoned housing stock ranging from 2 to 4 million, depending on whose estimates you use. In addition to that there is roughly an annual loss every year of around 500,000 to 700,000 units in housing stock which in some cases are potentially salvageable.

That really completes my analysis of the COIN view of the housing sector. I would like to comment on one question addressed to me in a letter from the committee. That was the issue of whether or not the housing cost component of the consumer price index is constructed in a way that it overstates inflation in the housing sector.

That is a very difficult question. COIN has not really taken a position on that, or analyzed it in depth. I would make one comment—several comments, though.

That is, the main criticism of the consumer price index, as it is constructed now, comes from those who feel that an approach should be used that would include appreciation in home prices, and that is not included now, in the way the consumer price index is constructed. If you included appreciation in home prices, when you have prices increasing annually at 13 to 15 percent per year, that will have a major impact.

Obviously, the appreciation accrues to the homeowner. However, if you view that as an offset to his cost of homeownership, you will find it will have dramatically reduced the housing cost component.

In many cases, the debate focused not so much explicitly on including appreciation, but they referred to using real interest rates, which is really the same thing, because they take the nominal interest rate and subtract some underlying inflation factor from it. But it's roughly the same thing. If you consider the market interest rates of 11 percent and an annual rate of inflation of 13 percent, then you see you are talking about, really, a negative real interest rate.

You can understand why including appreciation would have a dramatic impact. Underlying the belief that appreciation should be included is a view of homeownership as an investment, not a consumer expenditure. That raises a lot of philosophical questions which we haven't fully analyzed.

But I would add that the BLS considered that change, and they have rejected it. In particular, the comments they received, both from industry and labor, suggested that this was really an unrealistic change and would not be beneficial.

Finally, the other factor why the consumer price index is possibly overstated is the fact there is no adjustment made for tax subsidy or the benefit that homeowners receive by being able to deduct their mortgage interest and property tax payments. I would comment there that including the tax adjustment is a very difficult process because, obviously, the tax benefit varies between individual homeowners, depending which bracket they are in.

A much better solution would be, rather than tamper with the consumer price index, would be to eliminate the tax subsidy.

Thank you.

Senator McGOVERN. Thank you.

Mr. ALPEROVITZ. Mr. Oswald has one brief comment on the last question.

Mr. OSWALD. In terms of the CPI measurement on housing, there were lengthy discussions with the Bureau of Labor Statistics, with various advisory groups. No alternative provided a measure of real transaction prices.

If anything, we believe that the consumer price index understates the housing change, because it is information based on FHA housing prices, which are the lower part of the housing market, which have not escalated as rapidly as the non-FHA market price changes. And if anything, the housing CPI transactions understate to that extent the CPI.

Mr. ALPEROVITZ. I might note in passing, that there are dozens of ways one can improve, quibble with, and fight with the consumer price index. But I agree with Mr. Greenspan's comment yesterday in the Washington Post that on balance, it's probably the best measure we have unless we do a total recast.

Now, Ms. Ellen Haas.

**STATEMENT OF ELLEN HAAS, DIRECTOR, CONSUMER DIVISION,
COMMUNITY NUTRITION INSTITUTE, WASHINGTON, D.C.**

Ms. HAAS. Thank you.

Food inflation has been a pernicious problem. I remember when you held the hearings in 1975 on food prices and how important those

hearings were. It is really sad that we are here faced with a more serious problem today concerning food producers and consumers and all who are part of the food system.

When you have a fact, as was mentioned before, that in the first 5 months food inflation soared 17.8 percent, it is most alarming; particularly for the poor, those who must spend at least 40 percent of their income on food. What that does in such a situation is create nutritional risks, health risks—really, endangering the quality of life for those on fixed incomes and those who are needy.

What are we doing about it? What is the administration and Congress doing about it? Unfortunately, not enough. It is not effective even when it is being done. It is really hurting many people.

Let's look at the wage and price guidelines of the administration. These have been virtually ineffective for two primary reasons.

First, the processing and manufacturing level. The guidelines are maintained only on a firm-by-firm basis, rather than a product-by-product basis. With 12,000 food items in our supermarkets escalating rapidly, having this on a firm-by-firm basis in a concentrated industry makes little sense.

The second point is that the administration has only requested that gross margin percentages be maintained by individual firms. This, too, has created problems; problems that the administration has finally recognized, but has done little about.

In March of 1979 the Council on Wage and Price Stability in an inflation update stated: “* * * during 1978, the increase in spread appears to have exceeded cost increases and, as a result, profit margins of processors and retailers widened.” That is recognition of what is taking place.

The ineffectiveness of the administration's program is further demonstrated by the profit increases reported from most major food retailing and processing concerns over these past 7 months. For example, the profits of Safeway leaped 43 percent; Kroger, 41 percent; Winn-Dixie, 26 percent; General Foods, 41 percent; and for Quaker Oats, 36 percent. Even in a time of high beef prices, fast-food chains such as Ponderosa increased their profits 73 percent and Gino's did a whopping 52 percent.

What has caused this food price inflation? Contrary to popular governmental thinking, massive food price inflation is not a necessary evil. It is not an evil which results solely from the fact of uncontrollable shortages. To be sure, there are source supply problems; we all know that. But these are not the total picture. In fact, we must address the issues of a concentrated food industry.

Why during this decade is there such a situation in the Congress where, instead of responding to the consumer need, there has been, instead, a response to the special interest lobbying to make sure that their part of the domestic food economy is supported? These groups have seen it as their mission to gain the best possible deal; and, more often than not, that deal comes at the expense of the consumers.

If the administration was truly serious about waging a successful war on inflation, it would cast aside its preoccupation with meeting these needs of special interests.

In the next several weeks, both Congress and the administration will face very hard decisions, decisions that relate to food inflation.

These must be weighed very carefully with the needs of producers and consumers, but they also must be looked at regarding their inflationary impact.

Two examples that come to mind are raising the dairy price supports and sugar price supports. Both of these measures currently before Congress are inflationary. Also before the Congress could be legislation that would countercyclically allow greater amounts of beef to come into the United States during times of very tight domestic supply. This kind of legislation is sorely needed.

In the second place, there are structural problems which, left unattended in the last decade, contribute substantially to today's food inflation. The first and foremost in importance to producers is the need to strengthen the family farm. Now, legislation such as the Family Farm Development Act is one such approach. In addition, there are two other major areas that we feel need immediate attention in the long run.

The first is equitable and responsible strategy for managing domestic supplies of critical foodstuffs, and the second is addressing the growing impact of food concentration. Food management—or grains management—strategy is one area we can see now to be of critical need. As grain prices are going up—and they are sure to go up over the fall—we need to look very carefully at how we are to make sure there is an adequate supply. History has not shown us to have done a very good job.

In 1972 and 1973, worldwide food and grain production shortfalls, coupled with imprudent policies, lifted us to unparalleled price increases. Then in 1974, farm prices declined and stayed down for several years, hurting the farmer. For consumers, this was a short-lived and very hollow victory. The higher grain prices made meat production far more expensive and cattle producers then began liquidating their herds.

We are now feeling that kind of "boom or bust" policy because that liquidation of herds has left us with severe meat shortages and 1978 and 1979 saw record meat prices for the consumers.

To tie this all together, preliminary analysis suggests that the grain policies of the early 1970's were responsible for 75 percent of the food price inflation in 1973 and as much as 40 percent of that experienced in 1978 and 1979. Perhaps we need not only economic policy but historical policy in the food inflation area so that we can learn our lessons from the past.

The Government has not since exerted adequate controls over food resources. We have pursued, instead, surplus food policies involving set-asides and land diversions when we really have a problem of short supply.

Not only that, but we have maintained only the meagerest oversight over our critical foodstocks and allowed the Nation's grain to be traded with only the smallest amount of public accountability. We have continued to allow the trading of commodities to be manipulated by speculators and giant corporations. Instead, we need to develop a very good management system.

Consumers may never recover from those jolts of 1973 and the Russian wheat deal but we can prevent the same self-infliction over

these next several months, and that is an issue that needs to be taken into very serious consideration.

The second point also is one that has been just eating away at food prices for so long, one that no one has really grappled with beyond some significant first steps. That is the corporate control of the food supply. Between 1970 and 1977, 70 percent of the total increase in food prices came as a result of an increased marketing bill; the portion of the food dollar spent for transportation, labor, advertising, and packaging of food products.

To some degree, these costs have also come from other pressures such as energy and transportation. However, in 1963, the 50 largest food concerns controlled 45 percent of all food manufacturing assets. By 1975, this figure rose to 56 percent. In 1978, the same top 50 firms accounted for 64 percent of all food manufacturing assets.

When you look at the concentration of profit and media advertising expenditures, you see it reaches the 90 percent mark. The extent of this concentration isn't easily recognized by the average consumer. It is not recognized by many people until you take a hard look and then begin to see the picture fit together.

It is not easy for a consumer who buys Wonder Bread to know it is owned by ITT. It is not easy to know that those who buy Armour hot dogs buy a product owned by Greyhound Bus Lines. This is causing real problems for both producers who are getting too little a share of the food dollar and consumers who pay too many dollars for food.

At the retail level, firms are concentrating not nationally but on a regional basis. Where we shop for food every day in Washington, D.C., we have two firms who make 63 percent of all grocery sales. The Joint Economic Committee, 2 years ago—this committee—held very significant hearings into food retailing concentration and came forth with some very startling data. That report, published 2 years ago, estimated that the national food retailing monopoly overcharges ranged to \$662 million that year alone, 1976. The total cost of concentration in the food manufacturing and retailing industry for an average American family of four was at least \$313. With that hearing, and with hearings held from time to time over the last 10 years, there was still little result.

Time is running out on consumer help, with too little results. During period of widespread inflation, concentration of market power in the hands of a few actually contributes to—and encourages—a worsening of the food price situation.

First, where competition is minimal, firms can demand a price for a certain product which exceeds the marginal cost of production and selling of that product. Second, since firms with great market power can easily pass on increases in costs as they occur, they have no incentive to bargain for lower costs, or even when these costs are rising rapidly, they just pass it on to the consumer.

Through price comparison surveys, the 1976-77 JEC report found these statistics to be startling, as I mentioned before. And what can be done? The big problem is a complex problem, with 12,000 food items.

There are many initiatives that can be taken. COIN has listed at least 15 initiatives that both Congress and the administration can

undertake. However, I would like to just say, in this concentration area, that there are some immediate vehicles which offer us opportunity.

One of these vehicles, which can be done right at the present time with the legislation pending now before Congress, is one through which individual consumers can recover damages from manufacturers, wholesalers and retailers for antitrust violations. This would involve the legislation to overturn the Supreme Court *Illinois Brick* decision.

The ability to sue for damages is important to compensate individuals who are victims of price fixing—which is very prevalent in the food industry—and as a deterrent to antitrust behavior.

Second on the agenda would be a reorganization of the antitrust law which would permit more effective enforcement against large-scale horizontal, vertical and conglomerate concentration abuses. We feel that legislation such as that which Senator Kennedy has proposed regarding mergers would greatly affect the food industry.

Yes, these are long-term initiatives but they are ones that need to be addressed in the short term, as soon as we can. Without addressing the issues that COIN has put forth, consumer health and nutritional health will continue to be endangered because of the fact there is not enough money to go around to pay for the food that is so important for all of us.

Thank you.

Senator McGOVERN. Thank you very much.

[The prepared statement of Ms. Haas follows:]

PREPARED STATEMENT OF ELLEN HAAS

Senator McGovern and members of the Joint Economic Committee, thank you for inviting COIN to address you today. My name is Ellen Haas and I serve as Chairperson of the Food Task Force. I also serve as Director of the Community Nutrition Institute Consumer Division—a public interest food and nutrition policy group.

During the past year, food prices have been increasing at break-neck speed—rising to a velocity of 18.7 percent annually during the first four months of 1979. The size and importance to the economy of food expenditures qualifies this prospect for very concerted attention; in the \$280 billion a year food industry, an (8) percent increase translates into an extra \$52 billion in annual US household food expenditures. This represents an additional \$944 in the annual food bill for an average family of four. What is most alarming about these figures is the certainty that many poorer consumers are being priced out of the food market. And when prices rise to the extent that some people can no longer afford to purchase certain essential food products, individual health and well-being become endangered.

There is no doubt that the greatest economic—and thus nutritional—pinch is felt by the poor, by wage earners on the lower end of the income scale, by larger families living on one member's income alone, and by the elderly living on fixed incomes. Many studies show that these persons are forced to spend over 40 percent of disposable incomes on food purchases—which compares to the 18 percent national average. As prices rise further, budgets of the poor are stretched thinner and the ability to maintain health becomes jeopardized.

COIN feels very strongly that the administration's anti-inflation strategy does not go far enough in attacking the structural causes of today's food price inflation. Bold and innovative initiatives are urgently needed if real and long-term progress is to be made in holding food prices down.

First of all we must state that the Administration's wage and price guidelines program is insufficient to effectively combat food price inflation. There are two primary reasons for this.

First, at the processing and manufacturing level, the guidelines are maintained on a firm-by-firm basis, rather than a product-by-product basis. The Adminis-

tration is requesting only that parent firms hold *aggregate* price increases to 6.5 percent or below. Hence, a firm that could not increase its price for a particular product, perhaps because the level of competition in that one area did not permit a price increase, could raise the price of other goods (perhaps in less competitive areas) by whatever margin—as long as the aggregate increase in terms of dollar volume did not exceed 6.5 percent. For example, coffee sales account for 40 percent of General Food's revenues. If, in that competitive market where raw costs until very recently were falling, no price increases were put through, General Foods could increase the prices for Kool-Aid, Raisin Bran, Alpha Bits, Log Cabin Syrup, Jell-O, and Birds Eye vegetables by an average of nearly 11 percent and—regardless of whether or not input costs warranted such increases—and the conglomerate would still be in "compliance."

The food processing industries are highly concentrated. The top 50 out of 20,000 firms account for 64 percent of all manufacturing assets and, according to several researchers, for as much as 90 percent of all profits. The firms involved are all highly diversified—operating in competitive as well as noncompetitive markets. Abuse of the guidelines standard, without incurring a reprimand by government can be expected.

Second, at the retail level, the Administration has only requested that "gross margin" percentages be maintained by individual firms. At a time when raw commodity and wholesale prices are increasing dramatically, this strategy will likely prove to add further to inflation.

During the past few months, producer prices have been increasing at a 13-16 percent annual rate. The Administration's program, in effect, allows a comparable increase in retailer margins—regardless of whether or not such increases are warranted. In recent months, increases in labor and overhead expenses have not even approached this level.

In addition, the current Administration approach might actually serve to inhibit retailers from seeking to control processor price increases—simply because the retailer can merely apply the standard margin to that increase and present the final tab to the consumer. Even if that extra return from the increased margin were not justified by input cost increases, that retailer would still be in compliance with the guidelines program. Thus, if a wholesale food increased in cost by 50 percent, so would the margin routinely applied to that food. Processor increases are actually to the advantage of the retailer.

Interestingly enough, the Administration is not unaware of these problems. In fact, a March, 1979 Council on Wage and Price Stability, "inflation update" states that "during 1978, the increase in spread appears to have exceeded cost increases and, as a result, profit margins of processors and retailers widened." Again in June, the Council reported that although the rate of price increase for food at the farm level had slowed, retail prices continued their upward march because of "dramatic increases in the farm to retail price spread . . . which are not consistent with wide-spread compliance with the gross margin standard of the anti-inflation program."

The ineffectiveness of the Administration's program is further demonstrated by the profit increases recorded for most major food retailing and processing concerns. For example, the profits of Safeway leaped 43 percent; for Kroger the rise was 41 percent; for Winn-Dixie, 26 percent; for General Foods, 41 percent; for Quaker Oats, 36 percent; for Kraft 19 percent. Even for the beef-oriented fast food chains, Ponderosa, Gino's and Hardee's, profits soared in 1978—increasing 73 percent, 52 percent, and 28 percent respectively.

WHAT HAS CAUSED FOOD PRICE INFLATION?

Contrary to popular governmental thinking, massive food price inflation in the United States is not a necessary evil—an evil which results solely from uncontrollable shortages in the materials necessary for the modern American food supply—the grains and meats we eat and the petroleum and metals necessary for the packaging and transport of those foods. To be sure, supplies of these resources are critical factors in the aggregate food price inflation picture, but beyond any doubt, they are factors *because* during the past decade, the government has neither managed the resources nor initiated actions against the principal industries in a manner which serves the principal financial and welfare interests of the consuming public.

Throughout the 1950's and 60's, food prices remained relatively stable year to year and this stability served to dampen increases in total household expendi-

ture that consumers faced due to rising costs of other consumer goods. In the early seventies, this pattern and the stability it lent came to a very abrupt end. There are several reasons for this.

In the first place, during this decade we have witnessed a surprising growth in importance of "single interest" politics as a factor in managing the domestic economy. The "viscous little lobbies" for sugar, peanuts, rice, and tobacco that Earl Butz spoke of as successful manipulators of agriculture policy still exist and, more importantly, they have been joined lately by many others in the food industry. These groups see it as their mission to get the "best deal possible" for that one special interest group—and more often than not that "deal" comes at the expense of the general consuming public.

Thus we have a government which is publicly committed to fighting inflation but which still answers first to the loudest and most well-funded special interests; interests that oppose the formation of a Consumer Protection Agency, that oppose certain mandates to decrease the restrictions on providing consumer services, that clamour for greater import controls, that seek to limit the ability of the consumer to sue monopolistic firms and that seek higher commodity support prices.

If the Administration were truly serious about waging a successful war on inflation it would cast aside its preoccupation with the isolated needs of small special interest groups and act on the basis of what is best for the entire nation.

For example, Congress and the President should be in the next few weeks turn back unnecessary increases in dairy and sugar support prices. It should enact legislation which allows greater amounts of beef imports when domestic supplies are very tight, it should seek an end to severely regressive food sales taxes and it should, allow the continued importation of Mexican produce.

In the second place, there are a number of structural problems which, because left unattended over the last decade, have contributed substantially to today's food price inflation. While we can not undo what has already been done, we can prevent the same problems from aggravating our fight against inflation in the future.

First, we must begin to develop a strategy for strengthening the family farm. Although Agriculture is still diverse and competitive, it is becoming less so. We must also examine our strategy for regulating the transport of food, the marketing and pricing of meat, and providing important ingredient and nutrition information on food labels.

Second, COIN feels that primary attention must be focused on two areas—developing an equitable and responsible strategy for managing domestic supplies of critical food stuffs and addressing the growing impact of concentration on the food price.

The urgent need for a food management strategy which will lend stability to the farm community as well as to consumer food prices is evident from an examination of the recent history of food supply management. In 1972 and 1973, world wide food and feed grain production shortfalls, coupled with imprudent and short-sighted government policies to regulate the flow of available domestic food stuffs in domestic and foreign markets, resulted in massive and unparalleled increases in prices for raw agricultural products—especially beef, pork and poultry. In 1973, for example, increases in prices for farm goods accounted for nearly three fourths of total food price increases that year. All food prices jumped by nearly 35 percent in the two years that followed—which compare to the annual rate of less than 5 percent prevailing through the late sixties and early seventies.

Farm prices declined in late 1974 and stayed down through 1977, but for consumers this was a hollow and short-lived victory. The higher grain prices made meat production far more expensive and, when coupled with bad weather and a shopper who was more willing to resist buying meat at higher prices, cattle producers started taking losses on animals sold. This prompted a massive liquidation of herds—leading to the greater supplies and lower consumer prices we had for several years. But it also was directly responsible for the severe meat shortages we have witnessed in 1978 and into 1979—which, as we all know, have meant record prices for consumers at the checkout counter. What is more, sharply higher grain prices in 1973 led to quick and sizable jumps in land prices—making it more difficult for young farmers to buy land or expand holdings and leading to increases in support prices, which, in turn, pushed food prices even higher. To buy more expensive food, wage rates were increased thus boosting machinery and other farm costs further.

To tie it all together, preliminary analysis suggests that the grain policies of the early 1970's were responsible for 75 percent of the food price inflation in 1973 and as much as 40 percent of that experienced in 1978 and 1979.

Why did all this happen? Because the government did not and has not since exerted adequate control over domestic food resources. We have pursued "surplus—food" policies involving set asides and land diversions during a time of dramatic growth in the global population and world food demand. We have maintained only the most meager oversight and control over critical food stocks—allowing the nation's grain to be traded with only a modicum of public supervision. We have continued to allow the trading of food commodities to be manipulated by speculators and giant, privately-owned profiteering multinational merchants who, despite their size and importance to global stability, are allowed to operate beyond the reaches of public accountability. We have developed farm policies which put the farmer *against* the consumer—encouraging one group to root for misfortunes to befall the other. We have repeatedly allowed the private interests of a few to take precedence over public interests.

In short, this source of inflation has been brought on through misdirected, inequitable and short-sighted federal food and farm policies.

Consumers may not ever fully recover from the jarring, inflationary blow dealt with the food economy in the early 1970's. But it can prevent this self-inflicted injury from occurring again.

What we have learned in the 1970's must be given a very prominent place in the national memory—and in the emerging national food policy. In the future, the demand for food is going to increase exponentially and if this country does not implement an equitable mechanism to manage food supplies and stabilize prices, consumers are going to be hit once again. Only this time we'll be hit twice as hard.

CORPORATE CONTROL OF THE FOOD SUPPLY

The second area that must be given increased attention is the growth in market concentration in the food processing and retailing industries.

Between 1970 and 1977, seventy percent of the total increase in food prices came as a result of an increasing marketing bill—the portion of the food dollar spent for the transportation, labor, advertising and packaging of food products. Excluding 1973 and 1978, moreover, nearly 90 percent of total increase in retail food prices was attributable to increased marketing costs.

To some degree these costs have come as a result of intensifying, non-food sector, inflationary pressures, but it is beyond doubt that these pressures have been aggravated by the very swift growth in concentration among the food marketing and processing industries.

In 1963, the fifty largest food concerns controlled 45 percent of all food manufacturing assets. By 1975, this figure had risen to 56 percent. In 1978, these same top fifty accounted for 64 percent of all manufacturer's assets. Concentration of profits and media advertising expenditures ranged substantially higher—reaching the 90 percent mark by 1975.

The extent of this concentration is not easily recognized. After all, how many would naturally associate the global telecommunication conglomerate ITT with good old Wonder or Roman Meal breads? How is one to tell that Dannan Yogurt is made by Beatrice Foods or that Greyhound Bus Lines makes Armour hot dogs? Very few probably suspect that three-quarters of the 6000 "new" food products that come out on to the market every year are produced by the top 50 food manufacturing firms.

At the retail level, firms are concentrated not nationally—but on a regional or city-wide basis. For example, in Denver, the two largest retailers hold 90 percent of the market, in Washington, D.C., two firms make 63 percent of all grocery sales. In Milwaukee, the figure for the top two is 61 percent. In over eleven major U.S. cities, moreover, the four leading supermarkets control 75 to 90 percent of the food sales business.

Several recent studies give us an idea how much this level of concentration is costing the American consumer. Russell Parker and John Connor of the Federal Trade Commission have calculated that concentration in the food manufacturing industries adds on the order of \$15 billion to annual consumer expenditures for food. This figure alone represents as much as seven percent of what the nation as a whole actually spends on food in one year.

In 1977, moreover, a Congressional Joint Economic Committee study of food retailers—using 1975 data—found that "in many markets, consumers are paying

larger dollar overcharges due to their market power." This estimate of national retailer monopoly overcharges ranged to \$662 million that year alone.

Thus the total cost of concentration in the food manufacturing and retailing industries for an average American family of four is at least \$313 annually.

The other \$11 to \$12 billion "consumer-to-oligophy" subsidy-overcharge which does not go to profits is spent on inefficiency—it accrues as a result of market behavior which is not cost minimizing but which is made possible because of raw market power. Such behavior is embodied in excessive advertising expenditures, the cost of excess plant capacity, excessive wage settlements, and other costly, anti-competitive, strategies designed to protect the monopolist bottom line.

During periods of widespread inflation, concentration of market power in the hands of a few actually contributes to and encourages a worsening of the price situation. This occurs primarily for two reasons. First, where competition is minimal, firms can command a price for a certain product which exceeds the marginal cost of producing or reselling that product. Second, since firms with great market power can easily pass on increases in input costs as they incur, they have no real incentive to barter for lower costs—even when these costs are rising rapidly.

Between the concentration in food manufacturing markets and the profit rates of the firms in those particular markets. In 1963, when the top 50 food manufacturers controlled 45 percent of all assets, the industry earned 9.5 percent on stockholder's equity. In 1975, when the industry's top 50 controlled 56 percent of all assets, the industry earned 13 percent.

The 1977 JEC study is possibly more telling. Through price comparison surveys, it found that the degree of retailer concentration in a specific marketing area directly affected grocery prices charged in those areas. For example, in Washington, D.C.—where two chains, Safeway and Giant controlled 63 percent of the retail market in 1974—the JEC found that "not only did those chains with dominant market positions enjoy relatively higher prices than their smaller rivals, but the high level of market concentration raised the overall level of prices in the city. The weighted average grocery basket price for the five firms examined was 7.2 percent greater than the sample mean."

Powerful and diversified food retailing chains have also been known to undermine anti-inflationary competition through price discrimination among stores and regions. This behavior can also result in higher than necessary food prices for consumers. For example, in metropolitan Washington in the spring of 1967, Safeway and Giant introduced special reduced pricing for the areas in the immediate vicinity of two stores that Shop Rite, a New Jersey discount chain, planned to open. In those selected stores, Giant met all of Shop Rite's lower food prices and Safeway carried 177 items in four contiguous stores at prices 25 to 30 percent below the price of 70 other Safeway stores in the same district. Eventually, the New Jersey chain was forced out of the market and food prices returned to the "Washington normal." This short-term cross-subsidization cost area consumers the availability of food priced at truly competitive levels. And it highlights the difficulty that truly competitive firms face in entering a concentrated market.

Mr. Chairman, we do not feel the situation is hopeless. To the contrary, we feel that there are a number of steps that can and should be taken to stem the rising corporate tide.

Perhaps most importantly, a strategy which will instill a sense of price and societal accountability in all phases of the food system must be developed. The most immediate vehicle through which this can be achieved is by enabling individual consumers to recover damages from manufacturers, wholesalers, and retailers for antitrust violations. This, of course, would involve legislation to overturn the Supreme Court's Illinois Brick decision.

The ability to sue for damages is important both (a) to compensate individuals who are victims of price-fixing overcharges and (b) as a deterrent to antitrust behavior. This ability is especially important during times of double-digit food price inflation when individual processors are apparently pushing through (to the retailer) price increases which are not justified by rising input costs. It is certainly possible that some of these increases are the result of anti-competitive practices.

Second on the agenda should be a reorganization of antitrust law which would permit more effective enforcement against large-scale horizontal, vertical, and conglomerate concentration abuses. We feel (as Senator Kennedy has proposed)

that (a) mergers involving assets of more than a threshold dollar figure be flatly prohibited (and Senator Kennedy's \$2 billion level would be entirely appropriate), (b) the largest firms be prohibited from acquiring leading firms in a particular industry, and (c) mergers involving the largest, say, 500 firms, not be allowed unless significant economies of scale could be demonstrated and the accrual to consumers of attendant financial benefits could be proven.

Very important, in this context, is the practice of exclusive territorial allocation. Franchising among processors, wholesalers and retailers should be severely restricted.

Tighter rules concerning the application of antitrust law to subsidiaries, as well as more sophisticated criteria for the establishment of harm to competition must be developed.

Closer regulation of intrafirm income sources and transfers—necessary to limit firms in reimbursing subsidiaries for predatory pricing, for example—is needed as another step toward more strict business income accountability.

Restructuring the tax code as it applies to expenses incurred for advertising should also be actively investigated. FTC might be able to develop a mechanism for evaluating advertising strategies in different industries based on the degree of intrafirm competition present.

These initiatives are not politically unrealistic. There is a large and ever-growing concern among the American citizenry about the problems of economic power. Several surveys conducted by the Opinion Research Corporation have demonstrated this concern.

For example, in 1965, 58 percent of persons interviewed agreed that "in many of the larger industries, one or two companies held too much control." In 1975, 72 percent agreed.

In 1965, 52 percent felt that there was "too much power concentrated in the hands of a few large companies for the good of the country." Seventy-eight percent (78 percent) agreed in 1975.

Lastly, in 1965, 37 percent agreed that the country would be much better off if many of the largest companies were broken up into smaller companies. In 1975, 57 percent felt this way.

Members of the Committee, we believe that if bold action along the lines we have suggested is not taken soon, we will have lost our opportunity to ensure an equitable, competitive and diverse foundation on which an efficient and stable food system can be constructed. Without such a base, moreover, it is highly unlikely that major causes of inflation will ever be remedied; that the spiral which we now find ourselves will be stopped.

Thank you.

Senator McGOVERN: I agree with the observations of Senator Javits that this has been an excellent panel this morning. I want to make sure that the full text of all the prepared statements be made part of the hearing record. I intend to read all of them over this weekend.

Let me ask the staff to notify me when my 10 minutes are up. I don't want to exceed my share of the questioning here.

I would like to begin, if I may, on the question of price and wage controls that has been alluded to in various ways by several panelists. Mr. Oswald appears to come out across the board on price and wage controls. Mr. Brown talks about selective credit controls. Mr. Flug, I'm sure, continues to hold to controls on gas and oil prices. We get various pieces from various members of the panel.

I have felt for some time that there isn't anything else we can turn to—at least, in the short term—to break the inflationary spiral other than price and wage controls. I know a lot of the economists argue that it never worked but I don't see the evidence of this. It seems to me it worked every time it was tried.

I thought they worked well in 1971 and 1972. Neither unemployment nor inflation went beyond 5 percent while those controls were on. I felt they helped stabilize the economy during that time. They may have been taken off too abruptly, and there may not have been

enough backup fiscal and monetary steps taken to undergird wage and price controls, but they worked rather well in the Korean war and World War II.

I don't see all the difference between a wartime situation and the kind of economic condition we have today. Personally, based on what I have observed, I would have to argue that, far from failing each time, they have succeeded each time rather well but I have to say that when I introduced legislation to get the President the standby authority to do that, if my memory is right, we didn't get a single call from anyone else in Congress saying they would like to cosponsor it. I don't think there is a labor leader in Washington that has even noticed that such a bill exists; or, at least, they haven't given any encouragement to it.

I am wondering, Mr. Oswald, when you testified that the AFL-CIO favors wage and price controls, was that just a manner of showing your unhappiness with the Carter economic strategy or would you really like to see wage and price controls.

Mr. OSWALD. Senator, we would like to see across-the-board controls. Your bill, I think, is a partial step. I think it fails to the extent that it does not provide for full direct controls, and just leaves it completely in the hands of the President.

We believe Congress should set forth the rules and the full extent of that control rather than leaving it as a vague standby type of arrangement. We find that the sort of amendments that were made in 1972 to the controls program by the Congress immensely improved the equity of what was originally established under the Nixon policies, and we believe that it must cover all sources of income as well as just basic wages and prices.

Senator McGOVERN. Would you your associates be willing to work with me and any other Members of Congress that are interested in trying to draft a more acceptable proposal?

Mr. OSWALD. Certainly.

Senator McGOVERN. I really think that someone ought to take the lead in getting that proposal actively considered in Congress. I may be the wrong person; I'm not on the committees that have immediate jurisdiction. It may be that we can persuade someone else who would have a greater chance of getting it heard.

In any event, I would like to at least explore with you, if you are willing to do that, the possibility of drafting the best possible proposal we could get and to see if we can't get some hearings on it. It is one option that ought to be considered.

Mr. ALPEROVITZ. May I make two brief comments?

One is that we think the COIN assessment is compatible with a carefully developed wage and price control system, but our main focus is on the sectors. COIN, as a whole, has not taken a position on wage and price controls.

On the other hand, it has been very clear to us that if the kind of exclusions that now occur under voluntary controls are permitted to go forward under the guidelines we would have the worst of both worlds, in some circumstances. Family wages or salaries could be held firm while heating oil, food, interest rate costs and so on are allowed to squeeze them against the wall.

The underlying sectoral issues must be dealt with, either with or without a controls program. Whatever you do, you have to deal with supply problems in housing and food problems in a serious and on-going way.

The other point I would make is that I often think that my brethren in the economics profession are sadly remiss in their professional duties in regard to wage and price controls. It is fair to say there will be certain inefficiencies under any program of that kind—there will be lots of bugs to work out, there are irrationalities; and no program will work entirely well. But if we were able, through a combined sectoral approach and a selected mandatory approach to prices and wages, to stabilize inflation, and if these tools were used to permit us to end the yo-yo unemployment growth, the real gains to the overall economy could be on an order of magnitude of \$100 billion a year in lost GNP regained.

There is a large cost-benefit analysis that simply hasn't been done between the costs and inefficiencies of a controls program against the gains that might be permitted by full employment and a better economy, which are very large, indeed. We calculated, for instance, in one study that, had the U.S. economy between 1956 and 1976 maintained simply the 1956 Eisenhower unemployment rate of 4.1 percent rather than going in slow growth cycles, we would have picked up \$2.3 trillion in additional GNP which we lost because we were not able to do that.

If controls were a way to allow us a stable growth path, the gains might be very large. It is a serious professional failure to focus only on the costs of controls without calculating the potential benefits.

Mr. FLUG. Let me point out one factor that comes out of the experience with energy controls over the recent years. That is, you have to have people who want the controls to work on operating the controls. One of the big problems with the energy controls was that they were imposed on an executive branch that did not want them and did not want them to work. That is the large part of why they didn't work.

The current situation with gas is cited as evidence that controls don't work and controls cause distortions. The problem is not too much control; the problem is badly designed controls, unreformed controls, and—in the case of gas and distillate shortages—a failure of adequate surveillance rather than overinterference by the Government.

Senator MCGOVERN. I don't think there is any question but that you are right when you say the energy price factor has been one of the things driving the inflationary spiral. Ms. Haas referred to the Russian wheat deal in 1972 and 1973. That also coincided with the 1973 oil embargo so it is very difficult to know which one of those had the greatest kicker effect on inflation.

I also think we continue to underestimate the inflationary heat that is generated by the Vietnam war and the subsequent increases in military outlays after the war ended, which came as something of a surprise to me.

In any event, Mr. Flug, you have been grappling with these energy questions now for the last few years. You have posed what seem to me to be a lot of commonsense steps we can take that would help that situation. Most of them have been rejected and yet, the public mood is

changing all the time to where people might accept something now that was rejected 1 year ago or 2 years ago. Do you see things you have been fighting for in the last few years that might have a better chance if we took another run at it in the summer or fall of 1979?

Mr. FLUG. Let me say two things. No. 1, despite the efforts of people like ourselves and many other groups over the past 2 or 3 years, I can't conceive of how the energy industry could be any better off than it is right now. Maybe that's because I have a limited imagination. They have decontrolled natural gas, decontrolled crude oil, no effective anti-trust action, no legislative horizontal or vertical divestiture, no effort administratively to inject competition into the energy field, and we are setting the future cost of energy at very high—unnecessarily high—levels. Basically, I have to say it is a disaster area.

The public has been willing to do a whole range of things, pleading for a whole range of things which, somehow, have not been able to translate themselves into governmental action. The public, of course, believes that decontrol will produce a lot of extra profits and not very much oil, which I think is proven by the best estimates there are. The public, increasingly, is willing to take drastic action.

There was always a third of the public ready to nationalize the oil industry and, certainly, some of the lesser structural changes—vertical and horizontal divestiture, for example—would get broad public support.

I think the most important thing at this point is having a coordinated, well-articulated, well-led program—that's first. These flip-flops on energy policy, basically in 6-month cycles, are worse than the wrong energy policy. No one knows, from the homeowner to the largest oil company, what will happen, and I think that has been a serious interference with getting any progress achieved in the energy field. I would have to put that first: a concerted, long-term, coordinated, well-led effort, which we just haven't had.

I think perhaps the reaction to the gasoline crisis, the synthetic fuel responses—or, as we like to call it, because of the double entendre, "sin-fuel"—is an opportunity that is being lost. Instead of using the great public outrage and desire for a solution to come to a well-thought-out meaningful solution that can give us hope of progress, we are reacting with the usual kind of "just vote for anything" response. Those 25 people who voted against the "sin-fuel" proposal will look good in the coming months, as we take a better look at what was done.

As I said before, we have got a whole range of potential energy production and energy-saving investments in this country running at the low end, from absolutely cost-free things—requiring a little education and a little leadership—running through all sorts of conservation investments, renewable resource investments, conventional oil and gas investments. And a lot of us believe there is a wide range of conventional oil and gas investments that will still produce a lot of energy and go on up into the more costly current and future energy sources.

There has not been the kind of empirical work done here—and we are beginning to try to do it, and others are trying to do it—to really figure out how much of each of those we have available. We don't have an inventory of our capacity to produce energy, no price on each segment of that continuum, no timeframe on each segment. We need a qualitative and quantitative assessment of the environmental impacts

of those options so we can order them, so we can do a cost-benefit analysis, so that we can pick a goal in terms of time and cost that makes some sense instead of tying ourselves to the highest cost, most capital-intensive, least employment-creating, perhaps environmentally troublesome types of technologies without building into the system some requirement that they compete against these other things.

Once you invest in these high-cost technologies—and I think you get the flavor of this out of the Cutler paper—you have to protect them. You have to make sure that nothing comes in below it because your investment is up there and you have to protect that investment. We really tie ourselves up and pull everything up to that cost.

We have seen a bit of that phenomenon already in Mr. Schlesinger's commitment to the Alaska Natural Gas Pipeline, which many of us believe was the reason why we would not allow the Mexican gas in. Once you are committed to the Alaskan Pipeline, which brings gas in at \$8 or \$10 a thousand cubic feet, while that pipeline is being argued for, you can't allow a major new supply of gas to come in at \$2 or \$3 a thousand cubic feet. You have to protect that project. That's an example of what would happen if we really tied ourselves to \$30 and \$40 "sin-fuels."

I think that the empirical process of inventorying the options and making a choice of options and developing a process for choosing among those options, both on a time basis and a cost basis, is vital. We just don't come near that process. The closest we come is that in some of the more enlightened public service commissions in the more enlightened States, where somebody comes in and says, "I want to build this new, huge electric plant," some of the commissions are saying, "Let me see the options. Tell me what the alternative would be in terms of demand constraint and development of alternative energy resources before I give you permission to build that centralized, investment-intensive, very costly plant."

Senator McGovern. I have more than exceeded my time.

Would you proceed, Congressman Reuss.

Representative Reuss. Thank you, Senator McGovern.

I would join with you in commending the panel on a first-rate presentation.

You have raised, Senator McGovern, the point of price and wage controls. This is one of the few differences between us, so maybe I should devote a minute to explaining why that is.

It is perfectly true that in World War II and in the Korean war and in the early 1970's, after the Presidential-congressional fiasco in Vietnam of trying to run a major war and expand a set of social programs without raising taxes, in each of these cases price controls were successful.

The reason they were successful, in my judgment, was that you had, one, an inflationary psychology on the part of the public which needed to be calmed down, and two, importantly, an inflationary bubble caused by World War II in the first case, the Korean war in the second case, and the economic softheadedness of Congress and the President in the third Vietnam case.

Now what we have got, I regret to say, is not an inflationary bubble, but we have an inflationary psychology—which would be nice to break

on the part of the public—but we are suffering not from an inflationary bubble which could be punctured by a year or two of comprehensive wage and price controls, but what confronts us is a structure of the American economy that is increasingly more ramshackle, and to get that ramshackle structure of the economy into some sort of shape so that we can live in the same world as the Germans and Japanese will take a long time. It will take a generation, if we started tomorrow—which, unfortunately, we are not likely to do.

In my judgment, wage and price controls are a remedy which works very well with the kind of inflation we had in the past but they aren't suited for the current agony. I am glad, therefore, that the COIN conglomerate here has not taken a position on it.

As to my friends in labor—and, particularly, Mr. Oswald here—I would say: Have a care when you want controls on things. You will gladden the heart of every “fat cat” in the land who would be tickled to death to avoid the receipt of current income and high tax brackets and let the corporation be his tax shelter.

I think there are a lot of problems even with the comprehensive across-the-board programs suggested by labor as to the contention of labor that the present system of controls is grotesquely inequitable and puts the burden on the wage earner and forgets about everyone else. That is something else.

So these are the reasons, my dear Senator McGovern, why we differ.

Now on some of the very interesting specifics—and that is why this is a great hearing; because it is specific—let me turn to Ms. Haas and your sad story of food retailing, generally, but let's talk about an area we all know something about: The District of Columbia, where we live for a large part of the time.

You point out that 63 percent of the food retailing is in the hands of two large companies—Giant and Safeway—and you also point out, interestingly, when, in 1967, a New Jersey discount food chain started to “case the joint,” Safeway started to cut its prices by 25 percent to 30 percent and Giant met the competition's lower prices so the New Jersey outfit lost heart and decamped from the scene, leaving it once again to Giant and Safeway.

OK, you have described one of the reasons for our miseries today.

It is with your list—which I look at as a partial list of remedies—that I confess to a certain amount of disappointment. Looking at your testimony, I find you say repeal the Illinois Brick decision and let the consumer sue the chains. I am all for repealing the Illinois Brick decision but I am not at all sure that the conduct you describe on the part of Safeway and Giant is, in fact, within the ambit of current antitrust laws. It would be nice to have a consumer gain locus standi to sue, but when he loses his lawsuit, where are we?

Second, you cheer for the merger bill of Senator Kennedy and similar legislation. I am all for that, too, but a merger bill does nothing about “them as is already big.” Then you have something to say about advertising. But I think we could adopt your remedy on advertising and Giant and Safeway would still go their merry way; a way which, according to study by this committee, raises food prices in the District of Columbia area about 7 percent over what they would be in a competitive situation.

Well, having been churlish with your solutions, it is up to me to suggest another one. The other one which suggests itself—and which, indeed, to do COIN justice, does appear frequently in COIN's recommendations—is, if we used the new National Consumer Bank setup to set up a real, well-financed and well-managed cooperative, you would, it seems to me, automatically do two things to lower the 7 percent price premium which Giant seems to be able to exact.

One: Since, by reason of their concentration, they are able to exact this 7-percent premium, one would think a well-financed and well-managed third entry—whether it be a cooperative or private enterprise, whatever it is—would be able to beat them down, as, indeed, the New Jersey outfit threatened to do.

Two: There is something about a cooperative which is very good in terms of that which Giant and Safeway are forever complaining about with respect to their center-city stores; namely, that the neighborhood kids knock boxes off the shelves and that pilferage and waste is high.

One of the reasons it is high is because poor people view the chains as their natural enemy and, starting at age 3, anything you can “ripoff” is all to the good. A cooperative, properly run, has an advantage in that it gives everyone a feeling of participation. The mothers, themselves, do a pretty good job of policing their youngsters. It just isn't fashionable to “ripoff” that which is your own.

So wouldn't an additional paragraph to the remedies you suggest—namely, the vigorous use of the new Consumer Cooperative Bank Act—be a worthy addition?

Ms. HAAS. Before I answer, I would like to quickly say: Yes, of course, but I would like to just add, that you really eloquently described the situation that we are in, which is between a rock and a hard place when it comes to competition in Washington, D.C., food retailing.

In our full statement, COIN supported vigorous use of the cooperative bank and full funding and all of that. The only concern I have is that until that is really operative, until the cooperatives grow and are effectively used—Berkely Co-op is a good example of a very effective food co-op—we still have to address the problem of two chains controlling 63 percent of the market in Washington, D.C.

I must apologize if it is left out of our testimony. It was not left out of our book “There Are Alternatives.” I would like to say one point about that. The things we have here are Band-Aid approaches, in a sense. We have to get at treating the structural problems. I am very concerned with how legislation will be developed.

Perhaps the 1970's are different than before. Perhaps we don't only need wage and price controls—my organization, CNI, and I am also president of the Consumer Federation of America, have not taken a position yet—but perhaps we need to have legislation that also recognizes these structural problems and mandates that something be done.

What I am concerned about is that wage and price controls will take care of our situation for a given period of time, but what happens when they are lifted? We are left with the same food economy that is heavily concentrated and doesn't have competition and has high food prices. So I would like some kind of discussion about wage and price controls to really look at ways we could expand the kind of legislation and legislative directions so that we really deal with those structural problems while holding prices still.

The other thing which concerns me greatly about food retailing competition is that the Federal Trade Commission had a six-city study where they were studying food retailing competition and high food prices. That has been on the back burners of the Federal Trade Commission for so very long. Your committee—the Select Committee on Nutrition—held those food price hearings and you know what it was like to get information. We don't have a real solution to the high concentration and low competition in the food industry because of the inability of Government to get the information about profits, about who controls who, and about the effect on food prices.

I think we need to really go after supporting the Federal Trade Commission and the Department of Justice in getting that kind of information and bring back recommendations. I know that the Justice Department, in particular, did have a commission on antitrust and they do have some recommendations about competition in the food industry which should be looked at very carefully.

I think it is an area where we don't have enough information at this point in time to make the best possible solutions, so what we do is approach the problem with helping consumers maintain their rights in the best possible way. That's why reversal of Illinois Brick is such an important piece of legislation today.

Representative REUSS. Thank you very much.

Senator MCGOVERN. Thank you.

Congressman WYLIE.

Representative WYLIE. Thank you very much.

I must say that this is a panel which stimulates the thought process. I don't necessarily agree with everything said this morning but you give us food for thought.

I came to about the same general conclusions as Congressman Reuss, except I don't think that wage and price controls ever worked. With that caveat, I want a copy of his speech—or statement—he made and I may want to use it as source material for a speech I have coming up.

I would like to get some timely advice from you, Mr. Flug. We have today on the House floor, as you know, a bill which will provide for a windfall profits tax. Are you somewhat familiar with the bill?

Mr. FLUG. Yes.

Representative WYLIE. Would you vote for it or against it in its present form?

Mr. FLUG. As reported out of the committee, I would vote against it.

Representative WYLIE. Why?

Mr. FLUG. Because I think it is fraudulent. I don't think it recovers a sufficient amount of the windfall. I think it masks the fact that the true way to deal with a windfall is not to create it in the first place, and I think it is deceptive in that by the time the good chairman of the Finance Committee gets through with it, it won't even be what is coming out of the Ways and Means Committee.

If it were very substantially restrictive, I would, myself, probably still be against it because I would still prefer to prevent the windfall.

By the way, today's actions—just think of what happened today in Geneva. You are talking about a \$5 increase in the price of oil. Ultimately, every barrel of oil, proved reserves in this country, will be worth \$5 more than it was a few months ago. There are 30-billion bar-

rels of proved reserves. We are talking about \$150 billion of added value to those proved reserves.

I don't think this tax is touching that. It isn't touching the past windfalls that have already accrued from the previous OPEC price increases. It isn't touching the additional windfalls that will accrue to natural gas producers as a result of the OPEC price increase. It misleads the American people into thinking there is some equity being built into the system when, in fact, there is not.

Now having said that, I have to be practical. This is why I wouldn't advise a bottom-line judgment. Each Congressman will have to decide for himself and herself whether they think it is possible to prevent the windfall from being generated in the first place by stopping decontrol. If they come to the conclusion that decontrol cannot be stopped, this may be the only way they have to moderate the inequities of decontrol. It does not moderate the inflationary impact of decontrol.

Representative WYLIE. You have demonstrated much knowledge on the subject of energy. I would ask you: How would you propose fighting the OPEC cartel? That is really what this is all about. We are trying to become self-sufficient. We are trying to provide the motivation, the incentives, to get our own domestic producers to produce more domestic oil, domestic natural gas or synthetic fuels.

I think you said you opposed the synthetic fuels bill on the floor. I was an early supporter of that concept. I come from Ohio, which has huge amounts of natural gas, according to every geological report ever made, trapped in Devonian shale. It is small pockets of gas which cannot be brought to the surface economically with the technology we now have.

But many of the companies—the gas-producing companies—say that with a little leadtime of financing, production of these reserves is economically feasible.

Anyway, I will come back to my original question. We are trying to find ways to fight the OPEC cartel right now. We are importing 50 percent of our oil needs. How do you go about it?

Mr. FLUG. In the briefest possible form, No. 1, I would stabilize our prices here in this country because the one thing—

Representative WYLIE. You mean controls.

Mr. FLUG. Initially, yes, because the one thing that does act—

Representative WYLIE. Initially; that means they would come off after a time.

Mr. FLUG. I think I indicated before that at such time as we could get sufficient competition into our energy economy to provide the price stability that controls would otherwise have to provide, then I would be willing to rely on competition.

But stability is important for production, Congressman. As long as there is the prospect of rapidly increasing prices—without a conspiracy, without any evil-mindedness—the simple fact is that there is tremendous incentive for withholding of production.

Strangely enough, Secretary Schlesinger, himself, said that the other day. Of course, he said it in the context of the OPEC producers. As long as there is a rapidly increasing world price, it is more profitable for them to keep their stuff in the ground and hold back on supplies, to produce less, than it is to produce more.

The same is true of our own producers, so stable prices help production.

No. 2, as far as OPEC is concerned, we need a change in our attitude. Our attitude has been that we are subordinate to OPEC; that we are over a barrel, if you will; that there is nothing we can do about it. We have to decide there are things we can do about it.

It is only 20 percent or 25 percent of our total energy supply that is involved. We are a large customer. Together with the other consuming nations, we can form a countervailing force to OPEC. Once we change that mental attitude, that will go a long way.

No. 3, we have to have a proliferation—well, we should not use that word—a diversification of sources of oil and other energy around the world. The World Bank is just beginning to help in that process. The oil industry is trying to stop the World Bank from helping in that process. But that is vital.

No. 4, we need to change the import mechanism we have, and the incentives to imports we provide the oil companies, and the structural conditions which operate to encourage or allow imports. We should either have some kind of bidding system or Federal takeover or other mechanical intervention into the import mechanism.

Right now, the buyers of oil imports, who, basically, are large refineries, integrated companies, do not have arm's-length transactions. They are related to companies with an interest in higher prices. They are not shopping around for lower prices. When the price goes up, they benefit. Divestiture would have a similar impact. Meanwhile, we need some kind of direct intervention.

Finally, I think that, again, we need some leadership. I think it is criminal that each time there is an OPEC meeting, the administration says thing which help an OPEC price increase. Blumenthal went over in November to Saudi Arabia and came out and said, "Gee, they will only raise prices 10 percent. We can live with that." They raised prices 15 percent. Before the April meeting, they issued a report that said we are vulnerable to OPEC and there is nothing we can do about it. The OPEC people read that and jacked their prices up.

Just the other day, the Europeans finally got themselves organized and issued a report that said we are finally going to get our stuff together and present a solid front in the face of OPEC increases. What comes out of Tokyo is what appears to be a rejection of the European initiative just before the OPEC price decision, putting our consuming nation group in disarray just before the opening.

Representative WYLIE. We invited the rejection, but I agree that leadership hasn't been all that good. I also agree that we need a goal in this regard.

Mr. FLUG. The final point is the one I mentioned before of establishing for the Nation an energy price goal in the middle and long range that becomes the ceiling for both domestic and OPEC prices because we make a policy determination that we are going to produce energy savings and energy production in this country at that price.

Representative WYLIE. This is a very fascinating panel. I would like to continue talking with you but I want to ask Mr. Brown a few questions.

He thinks there is not enough money in housing; we do not have enough subsidized housing units in the programs; if we had more, that would reduce cost and, thereby, reduce inflation; this might be vital.

Do you know approximately how much we have in subsidized housing for this year in our budget? Our housing budget is well over \$26 billion, almost \$27 billion. How much more should we put into housing?

Mr. BROWN. I think it is important to remember those figures—I believe you said \$26 billion.

Representative WYLIE. \$26.68 billion.

Mr. BROWN. It is my understanding those figures refer to the budget authority for subsidized housing.

Representative WYLIE. That's the appropriations bill.

Mr. BROWN. But the method of appropriation is to appropriate for the budget authority for the full life and full subsidized expansion for the life of the unit. The actual annual outlays for subsidized housing units are somewhere in the neighborhood of \$6 to \$7 billion on a yearly basis. First, the commitments are made to provide subsidies for the next 20 to 40 years.

Representative WYLIE. That's quite a bit of money.

Mr. BROWN. Yes. In terms of inflation, it has not been increasing. In fact, the Carter administration asked for roughly an additional 300,000 subsidized housing units. Your bill would provide for roughly that number.

Representative WYLIE. They suggested we reduce the number of federally assisted housing units this year.

Mr. BROWN. That's right. That represents a decline from the authorizations for this year, which are roughly 370,000 units. Generally, in the last several years, most of the housing groups felt that, as a minimum, you need to have about 400,000 additional units every year. So we are slowing down the increase in the number of subsidized units, adding to the shortage, which will have an inflationary impact.

Representative WYLIE. We need to increase the money for housing. Somebody ought to say how much. I would have to come up with a figure.

Mr. BROWN. As a minimum, I would say, during the next several years, we should go back to the goal of 400,000 units a year. That goal had been accepted by the Ford administration initially and they backed away from it. I think that's a solid position to take for the time being.

Representative WYLIE. Which would cost how much?

Mr. BROWN. I don't have the figures to do a calculation.

Representative WYLIE. OK.

Well, the point I wanted to make is: What other programs would that money come from? We are operating on a budget. I think the root cause of all our problems is inflation, and that is brought out by a deficit in Government spending over the last few years, and this year is no exception. If we came up with a balanced budget, it would be dramatic, and it would have a dramatic effect on the rest of the world. They would know we are sincere about fighting inflation and are attempting to do something about it. If I accept that we need more money for subsidized housing, I would have to say where I am going to take it from.

Mr. BROWN. Assuming I discard my thesis—

Representative WYLIE. You wouldn't increase the budget deficit, would you?

Mr. BROWN. It is our analysis that increasing the budget deficit has such a minimal inflationary impact that it would be more than offset by the beneficial effect of increasing supply.

Where the money would come from, assuming you want to minimize the Federal budget deficit: In our total package of proposals, one of the key solutions is to eliminate the Federal income tax deduction for mortgage interest and property taxes, which represents a \$12 billion Federal tax subsidy.

Representative WYLIE. Let me ask about that. What about the person who rents from a landlord? What about the landlord? Would you say he should not have that deduction? If he doesn't, the obvious question is: Ought it be passed on to the lessee?

Mr. BROWN. In most cases, that is a very different situation. That's a business expenditure in most commercially owned rental properties. It is a different situation.

Representative WYLIE. There is mortgage interest in financing multifamily units. At the present time, the landlord gets the deduction.

Mr. BROWN. I am only talking about the deduction for homeowners.

Representative WYLIE. Single-family.

Mr. BROWN. That in which the person is living, himself. That deduction.

Representative WYLIE. For one resident. That's a substantial modification from the implication of your original statement.

Mr. BROWN. We always viewed it as simply a deduction for the homeowner. That's what we referred to.

Representative WYLIE. Wouldn't that discourage homeownership? We have been trying to encourage homeownership. We passed many laws to encourage single-family homeownership, where the person would repair the house, take pride in his home, paint it, move the rocks around, and that sort of thing.

Mr. BROWN. It is our analysis that tax deduction does not really stimulate homeownership. It is used almost exclusively by people who would be homeowners, anyway. It is, in a sense, increasing their demand for larger, more luxurious homes. In large measure, it is a tax subsidy they receive that is capitalized into the value of the house so they end up paying more for their homes, increasing inflation in the housing sector without expanding any supply.

The marginal home buyer generally does not take advantage of that tax exemption and, therefore, the exemption doesn't stimulate moderate-income families to enter the homeownership market.

Representative WYLIE. I would like to pursue this further but I have a question for Mr. Oswald.

Mr. BROWN. Could I have one followup point? You said, where would the money come from? To get back to this, if the mortgage interest and property tax deductions were eliminated, that is an additional \$12 billion in Federal revenue. If you take the \$26 billion figure you had, which is the cost of 300,000 subsidized housing units, and increase that by one-fourth to 400,000 units, that's another \$7 or \$8 billion. It is clear that the total package of eliminating the tax subsidy of mortgage interest and property deductions would provide more

than enough revenues to increase the number of subsidized housing units up to 500,000 housing units.

Representative WYLIE. I will look at that in the record. Maybe we will pull ourselves up by our bootstraps.

Mr. ALPEROVITZ. One point: I want to call your attention to page 87 of the COIN book on the deficit question, where we have some testimony from President Nixon's Chairman of the Council of Economic Advisers, Herbert Stein. It all depends; if you are in a slack economy, the deficit may help you get to further full employment and, thereby, produce more revenues and, thereby, cure the deficit without inflation, but if you are in a tight economy, the deficit may, in fact, fuel excess heating. We think many people who now are essentially cutting the budget as an attack on inflation may be the people producing the greatest budget deficits by creating a recession. The recession would generate a tremendous deficit; short-term, penny-wise solutions may be pound foolish in terms of the deficit question in our judgment.

We agree with Mr. Stein in this regard at least.

Representative WYLIE. He said that quite awhile ago. He has modified his stand now. I read his report in the paper and he doesn't come out that way now. He thinks we should have a balanced budget. I think his latest pronouncement indicated there might be a change in the original statement or else we have a situation where the lack of productivity, high inflation rate, and employment situation is different from the statement he made when he chaired the Council of Economic Advisers under Mr. Nixon.

Mr. ALPEROVITZ. As I stated, Mr. Stein makes the broad point that it all depends on the circumstances of when a deficit is inflationary and when it is not.

As to the current circumstances —

Representative WYLIE. We ought to know what we are doing when we do it. We ought to say right now we need to pump a little credit into the economy. We need to borrow a little. But it is not going to continue for the next 40 years. I think that should be done by maybe a vote of two-thirds of each House and the signature of the President.

I would like to ask Mr. Oswald a question before we have to leave. The Joint Economic Committee has put out a statement which was signed by all members here that the lacking productivity rates in the United States are eroding real income and are the source of a very serious problem. How would mandatory wage and price controls and dividends controls improve the sagging productivity rate in the United States?

Mr. OSWALD. Congressman, I would like to address the lagging productivity and I would like to call your attention to our background statement. In the basic manufacturing sector, productivity has not been lagging. As a matter of fact, on page 41 we show that in the past year the productivity increase in manufacturing has been 4.2 percent, in the year ending the first quarter of this year. Productivity in manufacturing in the 1970's was as rapid as it was in the 1960's, except for the recession, which pulled down manufacturing productivity by a full five points and was, on the average, as good even with that recession as the 1950's.

I believe that the productivity question in the nonmanufacturing areas is open to severe question because of the inability to really

measure output in the service sector and in the retail trade sector, and that solutions that try to address productivity as if it were a manufacturing problem miss the boat. They are not really manufacturing problems and they may be largely measurement problems in terms of the service, construction, and the retail sectors of the economy.

Therefore, we see the wage and price controls as being a means of breaking the inflationary psychology that Congressman Reuss spoke about earlier. We believe the wage and price controls are a means to provide an overall lid on policies and we support the COIN notion of addressing the specific inflation problems and necessities at the same time.

Representative WYLIE. Thank you very much.

Senator McGOVERN. Thank you.

Well, I think we had an excellent hearing this morning. Our time has pretty well run out. I'm sorry that Congressman Reuss and Congressman Wylie deserted me on the wage and price control. I will have to draw what consolation I can from knowing I stand with Richard Nixon on that. [Laughter.]

I do want to say to Ms. Haas, I quite agree that temporary application of wage and price controls without some changes in parts of our economy would, if anything, grant only temporary relief. I would be in favor either of permanent selective wage and price controls or using them with the understanding that they would buy some time to carry out some of these structural changes.

There was a Federal Trade Commission study some years ago that came out roughly about 1972 or 1971 which estimated that in those industries where four companies controlled more than 50 percent of the volume, that kind of concentration alone added something in excess of \$100 billion to the consumers' bills. Those industries, where you had some degree of competition, you had a better price to the consumer.

If you can, in fact, carry out some of the structural changes, it would indeed produce real competition. Probably wage and price controls would be unnecessary. I would make you a wager that we will probably see wage and price controls mandated in this country before we actually carry out fundamental structural changes in the way industries are organized. I think the amount of understanding and interest in carrying out fundamental structural changes in the economy probably is not as hopeful as the degree of public support, and I think some of the congressional support for wage and price controls.

It may be a practical sense that led me to think we ought to at least begin wage and price restraints and then, if, in due course, we can bring about some structural changes that produce more real competition, obviously, I would do what I could to support that.

Well, many thanks for your testimony. It has been an excellent hearing.

The committee stands in recess.

[Whereupon, at 12:20 p.m., the committee recessed, to reconvene at 10 a.m., Wednesday, July 11, 1979.]

THE 1979 MIDYEAR REVIEW OF THE ECONOMY

WEDNESDAY, JULY 11, 1979

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

The committee met, pursuant to recess, at 10:05 a.m., in room 6226, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, Javits, and Roth; and Representatives Mitchell and Wylie.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC (Special Study on Economic Change); Charles H. Bradford, minority counsel; David W. Allen, Lloyd C. Atkinson, Kent H. Hughes, L. Douglas Lee, Paul B. Manchester, and M. Catherine Miller, professional staff members; and Carol A. Corcoran and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. I am very pleased to welcome Secretary Blumenthal for the third day in the Joint Economic Committee's midyear review of the American economy. Mr. Secretary, I know your time is valuable. Ours is too. We have some conflicts this morning with other meetings. We will try to keep it short if we can.

Senator JAVITS. Mr. Chairman, may I join the Chair in welcoming the Secretary as I see I am the only one here for the minority. Thank you.

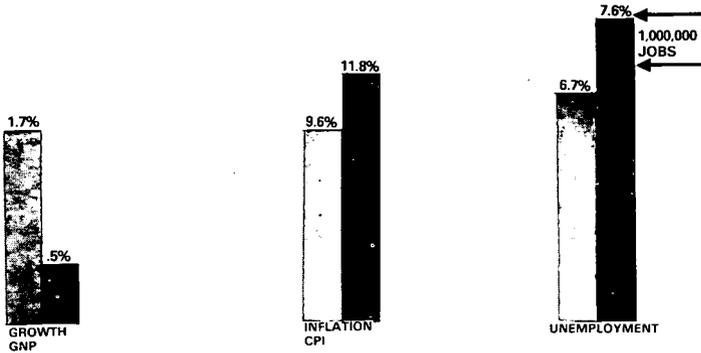
Senator BENTSEN. Mr. Secretary, there was a time when our midyear review of the economy could focus almost exclusively on domestic events. After the latest OPEC price increase, we are getting another harsh lesson in how much impact foreign economies and foreign decisions can have on the economic health of the United States.

The chart behind me paints the economic costs of the OPEC decision, as viewed by one forecaster, in stark colors.

[The chart referred to follows:]

UNITED STATES 1980

BEFORE/AFTER OPEC PRICE RISE



Senator BENTSEN. Here we are talking about 1980. The Wharton School estimate is that before the impact of OPEC we would have had a growth in GNP of 1.7 percent. After the impact of these price increases, it will be one-half of 1 percent. The CPI, without the increase by the Middle East countries would have been 9.6 percent before the price increase and they are forecasting 11.8 percent after the price rise.

Unemployment without the increase in oil price would have been 6.7, they are forecasting 7.6 percent. That will mean a million more people out of work.

Now there can be those who question these figures and argue on each side of them. But I know of no economist who isn't estimating that our economy is going to be damaged and that we are going to have more people out of work as a result of what the OPEC countries have done. So more than ever before we need a careful macroeconomic response to higher oil prices and a great deal of international coordination.

I just shared with you, Mr. Secretary, some of the meetings at Camp David. I know the concern there and some of the things that are being offered in the way of ideas to combat these problems.

We are very pleased to have you here at this time and I defer to my colleague, Senator Javits, for any comment he might have.

OPENING STATEMENT OF SENATOR JAVITS

Senator JAVITS. Mr. Chairman, I would just like to join the Chair in emphasizing the catastrophe created by the seemingly complete lack of either awareness or acceptance of responsibility by the OPEC

cartel as to what it is doing to the economy. OPEC is a part of the world economy. The rest of the world made possible this tremendous wealth and it is an act of ingratitude to now utilize that wealth in such a way as to be so harmful, when this wealth could be utilized as a world capital fund to absolutely realize everything we want to do for the needy developing countries. And OPEC says they want to help the developing world.

Senator BENTSEN. Thank you, Senator Javits.

Congressman Mitchell.

Representative MITCHELL. In the interest of time I will forgo any opening statement.

Senator BENTSEN. Mr. Secretary, we are delighted to have you here to give the first full report on the Tokyo summit. We are looking forward to your comments.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY

Secretary BLUMENTHAL. Thank you, Mr. Chairman, members of the committee. I know the time of the Members of Congress is very precious at this particular moment. You are addressing here the critical problems facing this country and facing the world. And while I cannot comment as to the precise accuracy of each of the numbers up there [indicating to a chart behind the hearing room dais], clearly there is no doubt that they depict a trend which is absolutely correct and with which I would have no disagreement at all. I think they are essentially depicting the true picture.

I would like to give you a report on the summit, and do it quite briefly, stressing some of the significant points which I think are worth noting about the summit.

Looking at the five summits which have been held, this one is different from any of the others than may have been realized at the time. I think it probably will go down in history as the most significant of the summits that have been held. They began with the summit in Rambouillet, then Puerto Rico, London, and Bonn, now in Tokyo.

If one reads the communique from the first four summits and looks back on what happened as then, one notes that essentially the leaders were preoccupied with the question of coordinating their policies to manage domestic demand, to reduce tension in the economic and monetary system by correcting divergent growth and inflation patterns, stimulating some countries, fighting inflation in others. Basically these first four summits deal with the demand side of the equation. Essentially they dealt with different growth scenarios and how to bring them under a common denominator.

I recall very vividly at London and at Bonn that this was our major preoccupation, and the communique reflects it. There was, until the Bonn summit, no emphasis on structural changes, on macroeconomic responses on the supply side of the equation.

And while, of course, energy was mentioned, these root causes of our problems were not really dealt with in any substantial way. There was a first indication, however, at the Bonn summit; a first indication that the leaders of the various countries were beginning to recognize

that just dealing with demand management and seeing that the patterns between the major countries coincided better was not enough. The Bonn communique did acknowledge and I quote:

We are dealing with long-term problems which will only yield to sustained effort. There must be sustained readiness over time to accept and facilitate structural change, measures to prevent such change perpetuate economic inefficiency, place the burden of structural change on trading partners and inhibit the integration of developing countries into the world.

That was about the only reference to that problem at the Bonn summit, but at least it was a reference.

At Tokyo, the emphasis shifted almost totally away from demand management to preoccupation with the need for structural changes in the economies of the various countries.

It shifted to great concern on the supply side in almost all of the countries. It came right upon the heels, incidentally, of the new Government of the United Kingdom having presented its economic program and my counterpart there, the Chancellor of the Exchequer having presented his first budget of the Thatcher government. It was very much preoccupied with increasing deficiency, lowering taxes, increasing supply of various products, and, of course, very much influenced by the whole energy situation. There was an emphasis on savings and on investments in order to build for the future. So, that was a very substantial change in which, interestingly enough, all seven countries' leaders agreed.

A second point worth making about the Tokyo summit is that it coincided with the meeting of the OPEC countries in Geneva, and in a rather dramatic way, as just the leaders of the seven major industrial countries were meeting in Tokyo, the OPEC countries were making a momentous decision with regard to prices, a situation which has brought about a very serious set of circumstances that I will not go into in detail, other than to remind you that it means, in fact, a 60-percent increase in OPEC oil prices since December 1978. We estimate that for the OECD countries as a group, it means a reduction of 1 to 1½ percentage points in growth that otherwise would have occurred this year, and an equal amount next year.

In other words, somewhat greater reductions in growth for the OECD countries as a whole than for the United States and more inflation for—even greater increases in inflation—the OECD countries than for the United States and, therefore, most serious implications for all of the developed world.

I would like in this connection to mention, Mr. Chairman, that these increases will, again, put serious strains on the balance of payment situations of all of the principal countries, and particularly the LDC's. In other words, the painful struggling back from the imbalance created in 1973 really has been undone again, and we will again have a much more unbalanced situation.

For the United States, we project the balance of payments for 1979 and 1980 to be quite favorable. I think that is worth mentioning. Amid all the concern, indeed, gloom, some bright spots are happy and welcome, and I do want to mention them.

It has been pointed out that on virtually the same volume of oil in the United States, we will be spending, instead of \$42 billion, \$58

billion this year, and we expect that next year on a volume which will be no larger and probably somewhat smaller, we will be spending close to \$70 billion.

So you would expect that, having moved up \$16 billion from last year to this year and expecting another \$10 billion increase in our oil bill from this year to next year, we would again have to contend with a very, very large negative situation in our accounts.

The facts are somewhat different. We now expect that in 1979 our trade account will be down from the 1978 deficit of \$34 billion to a deficit of \$28 billion.

The reason is that our agricultural exports are doing quite well; indeed they are doing better than expected. And our nonagricultural manufactured exports are doing well, partly because of the devaluation of the dollar, that occurred last year.

Unfortunately—and I say this as an unfortunate factor, but nevertheless a true one—because of the slower growth in the United States, as we grow more slowly, we will import less into the United States. Less import demand reflects itself in a better export-import figure. So the deficit on trade will be lowered from \$34 billion last year to \$28 billion this year, and we expect it to decline again slightly, maybe to \$26 billion or so, next year.

At the same time, our net investables—what we earn on our investments abroad—has increased very nicely. In fact, we adjusted the figure for last year so that in 1978 we actually earned, net, \$20 billion on our investments. This shows how important a free flow of capital has been.

We expect that investables figure to go up in 1979 by maybe 20 percent, to around \$24 billion. We expect a further increase in 1980. When you add all of those things together, we have, in fact, in the United States a current account situation where, from a deficit of almost \$14 billion in 1978, we expect a deficit that will be between \$4 and \$6 billion in 1979, and that actually for 1980, as we can estimate it now, we may be in balance or slightly in surplus.

Now, I mention 1980 with some trepidation, Mr. Chairman, since, if anything has been shown in the recent past, it is that projections more than 6 months out into the uncertain world are indeed uncertain. At any rate, for the United States, this picture, bad as it is in many other ways, does not mean that our external accounts, trade and current accounts, will be worse. In fact, they will improve.

I would say parenthetically that if we didn't have this oil problem, we would be in much better shape. That would mean that we would be making up for some of the tremendous outflows that we had over the last 2 years. Now, that will not occur.

The situation is much worse on the global current accounts. For the OPEC countries, who were virtually in balance in 1978 with a \$2 billion surplus, we estimate in 1979, OPEC will be back to a global surplus around \$40 billion or more. That will be about the same for 1980, unless they raise prices further.

The OECD countries, other than the United States, who were in surplus by \$22 billion in 1978, will be thrown into a deficit of \$16 billion in 1979, so that total shift from a surplus of \$22 billion to a deficit of \$16 billion is more \$38 billion.

Similarly, we expect that in 1980 the deficit will be \$16 billion. So, for OECD countries other than the United States, a surplus of \$22 billion current account in 1978, becomes a deficit of \$16 billion.

More alarmingly, non-OPEC LDC's, many of which really have few resources to defend themselves, who had a combined deficit of \$21 billion in 1978, we estimate will now have a combined deficit of \$29 billion, or almost \$30 billion in 1979, and \$36 billion in 1980.

While the U.S. situation of going from minus \$14 billion to a balance in 1980 is a relatively good one—partly because we are growing so slowly, or will be growing so slowly—for the other countries the situation is worse. That is what I meant when I said that the progress that we made in 1973 to redressing these imbalances really has not only been stopped, but to some extent has been reversed.

Now the next point worth making about Tokyo, Mr. Chairman, is that Tokyo summit did face these issues squarely. Recognizing the tremendous pressures that the decisions of OPEC impose on the world and on all of us, there was, first of all, the decision that there is no alternative in the short run to conservation. In other words, trying to save as much oil as possible, to reduce imports as much as possible, ought to take pressure off the market, particularly the spot markets.

Spot markets had become the engine that was pulling up all of the prices, including the OPEC price. That led to specifics—specific commitments with regard to 1979 and 1980 as to import levels for all of the countries.

I think that is a good and constructive thing, and it led to target goals for 1985 for all of the participants there. That is going to be backed up with further specification by the individual members of the EEC who were not present there. It indicates, in fact, that we will be putting a cap, as far as the United States is concerned, on oil imports because our target for 1985 is the same as our consumption at the present time for 1979, and as that to which we have committed ourselves for 1980.

Other countries are generally doing the same, recognizing that some countries like Japan, who have no domestic sources of energy at all and who, if they want to grow, will have to increase consumption, though at a more efficient rate.

The second point worth noting is a common recognition, agreed to by all, that, first, we must urgently concentrate on the development of alternative sources of energy, and second, that this requires the maximum degree of international cooperation and coordination.

A lot of discussion ensued about what the immediate forms of most likely substitutes are. There was emphasis on coal as being an abundant resource that needs to be developed with due concern for the environmental constraints. There was emphasis by some of the countries that clearly nuclear power has continued to be for them a very, very important source of energy. There was emphasis on gas, on synthetics, and on the creation of an international energy technical group in order to coordinate and to investigate how different countries can work together, so that we can move forward, as I am sure the President will urge us to do, with regard to major programs to develop substitute forms of energy. We can link ourselves, through these

mechanisms agreed upon in Tokyo, with other countries, urging other countries to do the same and have a better worldwide effort as a result.

The third point worth making is the decision on the part of the seven leaders to rather clearly express their dismay at the OPEC actions.

Now you might say, "Well, that is not a great deal because, after all, it is so obvious." Yet I think, given the fact that that has not been done in the past and that the seven leaders of the major industrial countries, each with their own particular situation, in fact, agreed on a statement which refers to this action as one that causes great concern, which calls it unjustified or unwarranted, and which points out the very serious impact it will have not only on each of our individual countries, but on the developing countries—that shows a common viewpoint.

The fourth point is the recognition that energy is not the only—although at the moment it is perhaps the critical—product that needs to be focused on when we talk about the supply side of our individual economies. It was recognized that, in countries like the United States, productivity in the 1970's has been rising at half the rate it has in the 1950's and 1960's; that tax structures, regulations, and all kinds of impediments we are facing in our economy and that others are facing in their economy, are impeding the broadening of the production base in the economies, and that this is a factor in inflation, just as much as anything else. Considerable emphasis was placed on the point that we need to deal with this in our individual economies.

So in conclusion, Mr. Chairman, let me just read the last part of my prepared statement because it deals with this issue. The supply side is not responding; productivity is lagging badly. In the United States, productivity growth in the last 5 years is half what it was in the 1950's and 1960's. Government spending has taken an ever-growing share of income and has shifted away from capital construction and expense toward income transfers. Effective tax rates have escalated sharply, tax structures and levels are such as to stultify innovation and risk taking. Industry is bound in a stifling web of regulations.

Indexation, formal and informal, tends to fix relative prices and weaken incentive for movement of resources between industries and sectors. We need, in short, to reorient economic policy to concentrate more heavily on the supply side, to reduce rigidities and inefficiencies that create supply constraints throughout the economy. This task involves rebuilding our capital stock, reinvigorating productivity growth, reducing structural unemployment—all on top of creating a new base for the energy needs of the economy.

This is true in part for every summit country. So to conclude, let me quote from the Tokyo communique:

We agree that we must do more to improve the long-term productive efficiency and flexibility of our economies. The measures needed may include more stimulus for investment and for research and development; steps to make it easier for capital and labor to move from declining to new industries; regulatory policies which avoid unnecessary impediments to investment and productivity, reduced growth in some public sector current expenditures, and removal of impediments to the international flow of trade and capital.

This was unanimously agreed to by the seven heads of government. Each of these tasks will take a long time to accomplish and will involve a great deal of sacrifice. Together, they represent a fundamental political and economic challenge. The politician's job is inherently easier—and safer—when it consists of spending heavily on quick payout projects that please the voters.

This is as true in the United States as it is in Germany or France or Japan, Canada, England, or Italy. But the time required to earn a visible return on investments made in expanding supply is much longer than the horizon that defines the political calendar in any summit country. The question is whether we have the will, wisdom and discipline to stay a medium-term course, involving short-term sacrifices for longer term gains.

We are all aware of the difficulty involved in this effort. But I believe that the American people and that our allies, as reflected at the summit table, have the strength and the patience to do the job, and that their agreement at Tokyo reflects their understanding of the necessity to do so. Thank you.

Senator BENTSEN. Thank you very much, Mr. Secretary. That will be very helpful to us.

[The prepared statement of Secretary Blumenthal follows:]

PREPARED STATEMENT OF HON. W. MICHAEL BLUMENTHAL

Mr. Chairman, you have asked for a report on the Tokyo summit.

The summit has received wide coverage in the press. I am sure that you and your colleagues and your staffs have reviewed these reports and the communique that was issued by the participating countries. If you will allow me, I prefer to concentrate my remarks not on the specifics of the summit meeting itself, but on broader meaning and significance, which I view as substantial. During the question and answer period I shall be glad to address myself to specific issues you wish to have clarified.

The Tokyo meeting was a watershed in summit history. At previous summits—at Rambouillet, Puerto Rico, London and Bonn—the focus of the deliberations was on demand management, specifically the need for greater coordination of demand management policies. The object was to reduce tensions in the economic and monetary systems by agreeing to pursue policies which corrected divergent growth and inflation patterns in individual countries. In effect, though each of these summits played a valuable role in enhancing macroeconomic coordination and dealt with the question of enhancing global energy production through World Bank lending to the less developed countries, it would be fair to say that the meetings that preceded Tokyo did not grapple head-on with the root causes of the world's energy and structural crises.

At Rambouillet in 1965 the primary focus was on stimulating recovery from the 1973-74 global recession through coordinated demand policies and improved international monetary arrangements.

At Puerto Rico in 1976, the discussion centered on managing the transition from recovery to expansion, again through traditional demand management techniques.

At London in 1977, the summit participants sought to continue the expansion through a coordinated effort in which countries with balance of payments surpluses were encouraged to grow more rapidly and deficit countries more slowly.

The Bonn summit last year continued the discussion of coordinated growth scenarios and, Mr. Chairman, I am sure you will remember that it was at this Summit that pledges were made to implement short term policies to achieve specific growth rates. Thus on the one hand the thrust of the three previous summits reached the height of refinement at Bonn. Specific ways were detailed on reaching coordinated demand management and were then successfully pursued. In the aftermath of Bonn, growth among the summit countries became less divergent and consequently payments imbalances narrowed. For this we should be grateful; the commitments made at Bonn and adhered to especially by Japan,

Germany and the United States were critical factors in reducing serious tensions in the global payments and financial systems.

But the significance of Bonn goes beyond this achievement. At the Bonn summit there became evident an awareness of the limited usefulness of demand management in addressing not just the symptoms but the causes of the constrained potential growth and of the inflation, payments imbalances and monetary instability that is plaguing the industrialized and the developing worlds. The communique issued at Bonn acknowledged that "we are dealing with long term problems which will only yield to sustained effort . . . there must be a readiness over time to accept and facilitate structural change. Measures to prevent such change perpetuate economic inefficiency, place the burden of structural change on trading partners and inhibit the integration of developing countries into the world economy."

It was at Tokyo that this awareness crystalized. At Tokyo we jointly acknowledged the shortcomings of demand management as a cure to our common economic malaise. The emphasis at Tokyo was on the need for structural adjustment and not fine tuning. We acknowledged that unless we were to permanently forgo growth, jobs and a perpetually rising standard of living, the emphasis of macro-economic management must shift to increasing directly the supply of energy and other goods.

Let me elaborate.

The immediate problem faced at Tokyo was the energy problem. With the announcement of the pricing decision made by OPEC in Geneva, the world price of oil has gone up by 60 percent since December. Although the price increases have come in stages, we have not yet seen more than a small fraction of the effect in the performance statistics. The direct, first round effect of this price increase will be to cut one percent from the average OECD growth rate in 1979, and 1½ percent in 1980. It will add 1½ percent to the average OECD inflation rate in 1979, and 2½ percent in 1980. For the U.S. alone, it will cut one percent from our growth rate, and add one percent to our inflation rate, in each year. And these estimates may not fully capture the impact of continued oil price escalation and supply uncertainty on business confidence, consumer behavior and wage demands. Thus:

The likelihood of recession in the United States has been decreased.

Non-inflationary growth in the other industrialized countries has been seriously hampered.

Severe damage may be done to the economies and political structures of the less developed countries.

The oil price increase will reverse much of the progress that had been made in improving the world balance of payments. However, even with a higher oil import bill, we expect further substantial reductions in the U.S. current account deficit—perhaps even a small surplus next year—because of slower growth in our domestic economy, extremely strong export performance, and increased earnings on our overseas investments. But the OPEC surplus, which had nearly disappeared last year, will again surge to disturbingly high levels. The OECD countries as a group will move from surplus into deficit. And the position of the non-oil developing countries, already in large deficit as a group, will deteriorate sharply, increasing the problems of some of the poorest nations.

World financing needs have been increased sharply by the oil price increase. Although the international monetary system has demonstrated its capacity to handle those needs in the aggregate, we must expect a recurrence of strains and difficulties on the part of some individual countries, notably the LDC's.

In short, the world has again been thrown into a difficult situation by oil price increases. And today we not only have the problem of oil price increases but also of limited supply.

The Tokyo summit recognized this essential fact, and acted upon it.

First, it was agreed that there is no alternative to conservation in the short-run. If we do not deliberately reduce our consumption of oil in ways that are least damaging to our economy, consumption cutbacks will be forced—capriciously and painfully—by whatever increase in price it takes to reduce demand to the level of supply.

To bring this situation under better control, the summit nations each committed themselves to limits on oil imports in 1979 and 1980, limits that will apply on a country-by-country basis. The limit for the United States is 8.5 million barrels a day in both years—equivalent to our imports in 1977.

For the medium-term, the summit countries adopted specific goals for a ceiling on oil imports in 1985, goals which—assuming reasonable rates of economic growth over the period—will require very powerful efforts to conserve oil consumption and develop alternative sources of energy.

The U.S. goal for 1985 is the same as for 1979 and 1980, 8.5 million barrels per day.

France, Germany, Italy and the United Kingdom committed themselves to limiting 1985 oil imports to 1978 levels and agreed to recommend to their European Community partners that each EC member country pledge themselves to similar specific targets.

Canada pledged to reduce its annual rate of growth of oil consumption to one percent, and to reduce oil imports by 50,000 barrels per day by 1985.

Japan adopted as a 1985 target an oil import level of 6.3 to 6.9 million barrels a day, a level substantially higher than Japan's import level of 5.0 mbd for 1978. This allowance for increase will allow Japan to continue to pursue the high rates of growth needed to overcome the massive, fundamental imbalances in its external accounts. At the same time it will mean an increase in the efficiency with which the Japanese use imported oil. Recognizing the uniqueness of this commitment, Prime Minister Ohira pledged to do the utmost to further reduce oil imports and rationalize oil usage.

Meeting these goals will require tremendous efforts of conservation. But to meet these goals and improve upon them in the future will also require a massive effort to increase the supply of alternative energy resources. To this end the summit participants launched major initiatives to make use of alternative energy sources, particularly coal, and to develop alternative sources and techniques. The participants recognized that large private and public resources will be needed for the development and commercial application of new technologies, and committed themselves to ensuring that those resources are made available. They also agreed to create an international energy technology group to review actions taken or planned in each country and to report on the need and potential for international collaboration, including in the area of financing.

For the longer run we must mobilize the resources needed to develop secure alternative supplies. The investment costs will be enormous, and resources must be diverted from consumption and other uses for this purpose. This will require an all-out effort to increase the use of other existing sources of energy, such as coal and nuclear power and natural gas, as well as the development of new technologies.

These summit actions represent a basic reorientation of policy, a joint dedication to reduce dependence on oil. Implementing these commitments will not be easy, and we cannot expect the underlying situation to improve overnight. What is implied is a basic restructuring of our economies, and we will have to preserve through some difficult times. The specifics of what will be needed are under review, and we and other participating governments will be announcing detailed measures in the weeks ahead. But the direction and the commitment have been firmly established. I believe this commitment has been recognized by at least some of the major OPEC nations, and I am pleased that Saudi Arabia has indicated a production increase that can help to ease the situation in the immediate future. But this step, while helpful, is temporary. We must reduce our dependence on oil. We have set a course, and we have to stick to it.

Mr. Chairman, I have reviewed the actions taken at Tokyo to deal with a critical commodity that is and will continue to be in short supply. Energy is symptomatic—in the extreme—of a larger problem also noted in the summit communique, and I would like to outline briefly that broader context.

It was recognized at the summit that energy is not the only supply problem we must address. In many other respects, the economies of the industrial world are not responding as they must to changing conditions. For decades we have operated on a consensus—that the major economic policy concern of governments should be to manage aggregate demand to smooth out swings in the business cycle and assure steady increases in income and employment. The supply side of the equation was largely neglected, assumed to take care of itself and respond to changing demands.

This assumption no longer holds. The supply side is not responding. Productivity is lagging badly—in the U.S., productivity growth in the past five years has been only about half what it was in the 1950's and 1960's. Government spending has taken an ever growing share of income, and has shifted away

from capital construction and defense toward income transfers. Effective tax rates have escalated sharply. Tax structures and levels are such as to stultify innovation and risk taking. Industry is bound in a stifling web of regulations. Indexation, formal and informal, tends to fix relative prices and weaken incentives for movement of resources between industries and sectors.

We need, in short, to reorient economic policy to concentrate more heavily on the supply side, to reduce rigidities and inefficiencies that create supply constraints throughout the economy. This task involves rebuilding our capital stock, reinvigorating productivity growth, reducing structural unemployment—all on top of creating a new base for the energy needs of the economy.

This is true in part for every summit country. Let me quote from the Tokyo communique:

"We agree that we must do more to improve the long-term productive efficiency and flexibility of our economies. The measures needed may include more stimulus for investment and for research and development; steps to make it easier for capital and labor to move from declining to new industries; regulatory policies which avoid unnecessary impediments to investment and productivity, reduced growth in some public sector current expenditures, and removal of impediments to the international flow of trade and capital."

Each of these tasks will take a long time to accomplish and will involve a great deal of sacrifice. Together, they represent a fundamental political and economic challenge. The politician's job is inherently easier—and safer—when it consists of spending heavily on quick pay-out projects that please the voters. This is as true in the United States as it is in Germany or Japan or France, Canada, England or Italy. But the time required to earn a visible return on investments made in expanding supply is much longer than the horizon that defines the political calendar in any summit country. The question is whether we have the will, wisdom and discipline to stay a medium-term course, involving short-term sacrifices for longer-term gains. We are all aware of the difficulty involved in this effort. But we are confident that, in the end, the American people and our allies at the summit table will have the strength and patience to do the job.

Senator BENTSEN. Let me say, those of us on the Joint Economic Committee are just delighted to see the stress on the supply side. Some of that sounds like it came right out of our annual report. We are pleased to hear it.

Mr. Secretary, I will limit myself to 10 minutes and ask my colleagues to preserve my commitment to you to get you out of here early.

In talking about the OPEC countries, there was a vigorous debate on whether or not they would have their September meeting at the last OPEC country. They finally decided to have it in Caracas on December 17, as I recall. We don't have any assurance at all that at that time they won't raise prices again, do we?

Secretary BLUMENTHAL. We do not.

Senator BENTSEN. None whatsoever?

Secretary BLUMENTHAL. None.

Senator BENTSEN. We are facing the toughest and, I think, the most vicious cartel this country has ever seen both in what it can do to the world economy and what it can do to Western nations.

What is the administration doing and what are the other Western nations doing to try to coordinate some effort to break this price fixing and to break this cartel? You know, to hand-wring and say, we view it with great dismay, is not going to work.

Secretary BLUMENTHAL. I agree with you that specific action rather than talk is needed in order to free ourselves from this burden. I believe that reevaluation of our policies with regard to energy and the economy that the President is undertaking is directed toward reduc-

ing as rapidly as possible these pressures and our dependence on OPEC. And I believe that we will have to await his proposals.

I think, quite clearly, that the points that I refer to—that is, conservation of energy in the short run, reducing our oil imports as much as possible—will mean that the price of energy will go up in this country. We are going to have to find ways to spread the burden of that evenly amongst Americans so that it's fair and equitable.

I believe that investing now, tightening our belts, investing now so that we have a bigger supply base for the future, so that within a number of years we are not dependent on every whim of these countries, is really the right way to go about economic policy, which is the only thing that I can obviously comment on.

Senator BENTSEN. Mr. Secretary, I congratulated you before. Let me speak very favorably about what you have done in the way of some of the economic policies that you have sponsored in helping stabilize the dollar. It's been effective.

But if you get this kind of a major drain from oil, I would like to know what shape we are in on that \$30 billion fund and what your plans are, if you can say at this time in case we get a further impact.

Secretary BLUMENTHAL. Yes, sir. Obviously, at a time of uncertainty—and we certainly have had uncertainty in the world as a whole—there is the same kind of nervousness in international exchange markets as there is in any one country or in all of the countries. And that has reflected to some extent in the markets in recent weeks.

I think the point worth making is that the U.S. balance of payments on current account and trade in fact, as I pointed out, is improving and improving substantially relative to other countries. So we will not have the kind of outflow and we will have no cause for the concern that that kind of outflow caused in 1977 and 1978, which in turn resulted in the severe pressures on the dollar.

That, I think, means that we can look forward to the continued strength and stability of the dollar, with some confidence.

In addition to this, of course, all countries are now, as I pointed out, under increasing inflationary pressures. Indeed, as I also mentioned in my opening remarks, the increase in the rate of inflation in OECD countries other than the United States will, if anything, be greater than in the United States. So since the markets tend to look at differentials, we are in reasonably good shape.

As to the measures that were adopted last November, they were successful. The implementation of these measures continues to be successful, in my judgment. We do not, for reasons which I'm sure you will understand, Mr. Chairman, give out progress reports on the precise numbers of what resources are or are not available. Let me say that they are ample, and I mean ample in every way.

Senator BENTSEN. So you feel you have a substantial cushion still left?

Secretary BLUMENTHAL. There is. There are ample resources available, on our part and on the part of our partners: The Germans, the Japanese, the Swiss, and others. Cooperation is growing very well between us; there is full understanding on these points. And I have no doubt, therefore, that the strength and stability of the dollar, will

reflect the strength of the American economy, which is enormous. Let us remember that we have energy resources that far exceed, if we just set about mobilizing them, even those of the OPEC countries.

Senator BENTSEN. All right. You were talking about belt tightening and quality of sacrifice by the American people. I agree they will do all of that. But they have to be able to see, somewhere down the road, that there is going to be an improvement—

Secretary BLUMENTHAL. Right.

Senator BENTSEN [continuing]. And that we are going to continue to improve the standard of living and give opportunities to people to take a step up in life.

At the Tokyo summit you said they agreed that increasing productivity throughout the world would be the only way to meet those goals. Specifically, what are you talking about the administration supporting in this country to achieve an increase in productivity?

Secretary BLUMENTHAL. I can only talk about those policies which have already been initiated. We will have to await what additional suggestions the President will have with regard to the future.

But for example, the considerable effort, at considerable cost, that the President has made and is making to reduce the degree of regulation in this country: the deregulation of crude oil, the deregulation of the airlines industry, the efforts to deregulate trucking, and a whole host of these kinds of things. The gradual deregulation, even, of interest rates with regulation Q. There is just a whole—there is a thrust of policy here that clearly is in the direction that will allow the country to increase productivity and efficiency.

I would not want to fail to mention the continued emphasis on training programs, jobs programs, to upgrade the efficiency of our labor force. These also are very positive factors.

I would finally have to say that the policy of austerity which the President initiated 1 year ago with emphasis on the budget and a lid on spending, which is designed to bring inflation under control, is very, very important, for unless inflation is under control, business in this country will not invest in the future. In the face of uncertainty and inflationary turmoil, no businessman in his right mind is going to bet on the future. I wouldn't, and I don't think you would, Mr. Chairman.

But the country is grappling with this, and the administration, backed by the Congress, is following conservative policies in that regard, careful policies and I think the investments will be made and productivity will increase.

That means tax policy. In the last tax bill, there was greater emphasis than ever before on business tax cuts to stimulate investment. That is important in the future. When taxes are looked at again, I would hope that matter would receive considerable attention. That is really what I mean when I say we have to focus on investing now, building on the future rather than spending now.

Senator BENTSEN. Thank you, Mr. Secretary.

Congressman Mitchell.

Representative MITCHELL. Thank you, Mr. Chairman.

Mr. Secretary, the Tokyo summit was a success. God knows we need some successes.

I have three questions and I only have 10 minutes. I hope that your answers are relatively brief and succinct.

I would like to focus on the impact on the domestic market as a result of the recent oil price increases. If unemployment should reach 7.6 percent or higher, as is contemplated by a number of economists, and it stays there for 3 to 5 months, would you continue to hold what you call your "medium-term course," which I call the austerity course, or would you at some point suggest some effort on the part of the Government to stimulate the economy?

Secretary BLUMENTHAL. I think, sir, certainly if we get to levels of unemployment which we are at this point not predicting, but if they rise to 7.6 percent or 8 percent, and stay there, the administration, I would hope, would take steps to counteract that kind of situation. That is a lot of people unemployed, involving human suffering greater than anyone should be expected to bear.

Now, whether or not you do it with a general stimulation of the economy or by a much more pinpointed and targeted means, as the second question, I don't know whether general macroeconomic measures to gin up the whole economy in order to get that number down but at the same time to accelerate inflation again would be the right way to go if that situation happened. I would want to look for means of reducing unemployment which are at the same time either anti-inflationary or at least not inflationary, because inflation, I think, will hurt the average American and poorer Americans just as much as these unemployment numbers will.

Representative MITCHELL. Well, I think that the present austerity policies of the administration already are hurting a whole lot of people in this country. It would be my position that any increase in unemployment would simply be intolerable and unconscionable. And I would be one who would be pushing for Government intervention to provide stimulus for the economy.

Suppose unemployment stabilizes but our GNP remains at five-tenths of 1 percent or goes lower for 3 to 5 months. Would you still hold to your medium-term course, which I call an austerity course, or would you suggest some kind of stimulus for the economy at that point?

Secretary BLUMENTHAL. Congressman Mitchell, the rate of unemployment is at the lowest level in 5 years—5.6 percent.

Representative MITCHELL. May I interrupt, just to make sure we establish a point for the record. The rate of unemployment for blacks, Hispanics, and others, still remains astronomically high. I think we must bear that in mind.

Secretary BLUMENTHAL. That's right. I fully agree with that. I think that remains a totally unsatisfactory situation. I think that is where some of the specifically targeted programs, that I was talking about, have to be applied on a continuing basis, and are being applied—perhaps not fully effectively, as reflected by those numbers.

But the point is that macroeconomics, looking at the economy as a whole, we are down from 8 percent when President Carter came into office to 5.6 percent. So austerity to the contrary notwithstanding, he has been very successful in bringing down and holding for a year the rate at that level.

Representative MITCHELL. My specific question was with reference to GNP.

Secretary BLUMENTHAL. Yes. If the rate of unemployment were to stay where it is, which I'm afraid it won't, unfortunately.

Representative MITCHELL. Now, it's going to increase.

Secretary BLUMENTHAL. But if it were in that general range, around 6 percent, say, even—two-tenths, three-tenths, or four-tenths of a percent are not that significant—and we had 13 percent inflation, then I would say, clearly, the emphasis on bringing that rate of inflation down, rather than following macroeconomic policies to get the rate of growth up faster, would have to be given priority, in my judgment.

Representative MITCHELL. All right. Obviously, I have a great deal of concern about pursuing that course of action, simply because of the hurt that it imposes on so many people in this country.

Let me shift focus for just a moment, with reference to our balance of trade deficit. Ambassador Strauss testified before this committee that a viable trade interaction with the less-developed countries is really a long-range solution to our balance of payments deficit, our balance of payments problem.

What, if anything, has the Treasury Department done, and the international financing institutions done, to assist these lesser developed countries in adjusting their external payment positions to higher oil prices? Is there anything that has been initiated by your Department?

Secretary BLUMENTHAL. Let me emphasize a point that I think was made in the Tokyo communique. There is nothing that the U.S. Government or Treasury, or all the governments of the OECD countries together can do to offset the kind of flow that OPEC is imposing on these LDC's. That is the first point.

The second point is that the Treasury has the responsibility under the law for representing the United States in the multilateral lending institutions and, of course, in the IMF. And thus we have the responsibility of urging upon, and working with, the Congress the enactment of the legislation necessary to fund our share of these.

This is no easy burden during a period of stringencies. We have worked very actively in the multilateral institutions to maintain the lending efforts. They have been maintained. I hope the Congress will approve the amounts that we have recommended, or something close to them, this year.

Of course, fortunately, the IMF is in a good financial position to assist countries with temporary balance of payments problems. I have no doubt that as a result of this OPEC situation, that balance of payments problems of these LDC's in some instances will be severe enough to require IMF assistance. We will work actively and support that, I assure you.

Representative MITCHELL. Thank you for your response. My time is up.

If you will answer it later on for me in some fashion, I really was more concerned about the access that LDC's would have to the private U.S. capital markets.

Secretary BLUMENTHAL. I see.

Representative MITCHELL. Quite apart from the International Monetary Fund. What, if any, are the impediments for those LDC's to the U.S. capital market?

My time is up, but if you could drop me a little note giving your response, I would appreciate it.

Secretary BLUMENTHAL. I will do so.

Senator BENTSEN. Thank you very much, Congressman, for your cooperation on that.

Congressman Wylie.

Representative WYLE. Thank you, Mr. Chairman, and Mr. Secretary.

According to a story in the Wall Street Journal this morning, President Carter is quoted as saying that he is determined to take steps to increase capital formation. I have a feeling that he has discussed this with you and that maybe you have had some input there.

I wonder if you could tell us what measures the executive branch now has in mind to take to increase capital formation, what authority it has. You might want to supply that information to me. If you do, that is fine with me.

But at the same time, I would like to know what Congress can do. I think this is very, very important, and you have hit on it as being very important. What can Congress do in the way of passing legislation to promote capital formation? What would you recommend?

Secretary BLUMENTHAL. I think that the support and encouragement of efforts to review and reduce the regulatory restrictions that weigh on the economy wherever possible would be very important. I have noticed in my time here in Washington, sir, that when we talk about Washington being regulation-happy, it's not just the bureaucrats that work in these offices uptown.

It is also many of the committees and Members of Congress who, once they have passed a bill, make it their pet little project and guard it zealously and have great difficulty countenancing any change in that, even when it proves excessive. That is one thing.

The second thing, clearly, is in the tax legislation that the Congress considers periodically, and will again, to pay particular attention to that. I know there will be proposals; I know that the chairman is particularly interested in this subject, and the question of changes in the depreciation schedule.

These are the sorts of things that would help capital formation considerably.

Third, I would have to say again that support of the President in keeping down spending so that we get inflation under control—and working with him in the recognition of inflation as public enemy No. 1—is equally important, because, as I said earlier, unless there is the prospect of reduced inflation, there will be no capital forming, because businessmen wouldn't invest. They wouldn't have any confidence in the future.

Representative WYLE. You mentioned deregulation twice. I think you mentioned deregulation in connection with regulation Q, deregulation of interest rates.

Won't that increase rates to the borrower and be counterproductive as far as capital formation is concerned?

What do you suggest we do about high interest rates? They are 12½ percent, I think, now for the short-term money. That is the rate in Columbus, Ohio. I don't know if that is the rate here or not, but that is unconscionably high and, I think, counterproductive with capital formation or investment. It's a real drain.

Secretary BLUMENTHAL. Except, sir, if you have to pay 12 percent or more if you want to borrow money, on the one hand, and the small saver can only get 5½ percent when he wants to save money, he's not going to save very much.

What we need in this country is more savings. I think the discrimination against the small saver is part of the problem.

Now, I fully understand the complications in this, in rectifying this situation which has existed for some time, the impact on the thrift institutions, relationship of the situation of the thrifts to the commercial banks, and you know, no single stroke of the pen can correct that.

Representative WYLIE. And on housing.

Secretary BLUMENTHAL. And on housing, of course; you are quite right. So we have proposed a gradual approach. Perhaps it is too gradual; I don't know. It has the flexibility in it to speed it up if that becomes feasible.

But I would think that to provide incentives for people to save so that more funds are available to be invested for capital formation is very important. If you are paying 5½ percent and you read in the paper or know when you go to the grocery store that prices are going up 10 or 12 percent, you don't need a Ph. D. in economics to conclude that it's not very smart to save a lot.

Representative WYLIE. Well, I'm inclined to agree with you that the small saver should get more of a break, and we are in hearings on the House Banking Committee on this very subject at this very time. So I'm taking advantage of this opportunity this morning.

I have almost come to the place where I think what we ought to do is to pay interest on any deposit anywhere, anyplace, anytime, whatever the market will bear, including checking accounts. But at the same time, I realize that might cause upward pressures, on loan interest rates. I certainly don't want that to happen.

Now, I thought maybe you might say that with this new break for the small saver Congress can provide through the deregulation of Q that more money will be made available in the process, not so many people will put their money in a can in the backyard. When more money is available interest rates will come down on loans. I don't know. Is that possible?

Secretary BLUMENTHAL. I'm not sure I totally follow the process you describe.

Representative WYLIE. If, for example, we make more money available for housing loans through paying more interest on deposits, making it more worthwhile to save as an investment then savers would be not so likely to invest in other things, maybe wouldn't be as likely to keep it in a safe or put it in a can in the backyard. There seems to be a lot of money in circulation that can not be accounted for right now, according to Mr. Miller. Maybe we can get some of that money in savings accounts.

Secretary BLUMENTHAL. The problem is that in that area, as well as most other areas, the ingenuity of the human mind exceeds the imagination of the regulator. So the market creates different kinds of instruments and circumvents the regulations. People go to the Euromarket and borrow money.

If you can't pay money on checking accounts, you create other kinds of accounts that are really almost like checking accounts but on which you can pay interest. All this happens.

I don't know, on housing, whether or not the—greater investment in housing is our highest priority. I may differ in that regard from other people.

We have been running at 1.8 or something. In fact, the market has found ways to provide the resources; people have been buying houses. That doesn't mean we have enough housing, but it means this has by no means been a disaster area.

I am concerned, however, with capital formation and productive plant and equipment growth, which has been doing all right but should be doing even better.

Representative WYLIE. In your prepared statement you refer to the increased likelihood of inflation as a result of the 60-percent OPEC oil price increases we have had since December. The economic data I have been reading points to a recession with or without the OPEC price increase.

Would you say that is a fair analysis of the situation, that we may be pointing to OPEC as an excuse rather than a reason?

Secretary BLUMENTHAL. No. I, in all sincerity, sir, would say that without that OPEC price increase we would have had the slowdown that we were predicting. There was no evidence that we were moving into a recession, negative growth numbers. We were somewhere above that, and I think we would have had a very good chance to stay there.

While clearly, the rate of inflation has been disappointingly large, there would have been every expectation that we are getting this under control. Food prices at the wholesale level are beginning to come down, stabilize. We were moving in the right direction.

I think it's clearly true, therefore, that with the OPEC actions, the chances of a recession have been substantially increased. I think that the forecaster who would forecast a recession under those circumstances may turn out to be right. I would not say that that would have been the case without OPEC price increases.

Representative WYLIE. Well, this is not necessarily in your area of expertise, but we need to get away from our dependence on OPEC.

What do you think of some sort of a Manhattan-type project to develop coal liquefaction? South Africa is doing it; West Germany is doing it.

I say it's not in your area of expertise, but you are a member of the Cabinet and, I know, of the inner circle. You have talked to the President, and you discuss these things.

Secretary BLUMENTHAL. I favor—and that is no secret—a major effort and a high level of investment by the United States, regardless of the cost, in developing substitute energy sources. I believe that synthetic fuels are a very, very important substitute fuel.

I would further say that it is obvious to me that shale and coal, which are the two sources of energy which we have in abundant supply in the

United States, are therefore the most likely candidates, although perhaps not the only candidates.

Precisely whether or not you go to liquefaction or gasification then liquefaction, or whether you emphasize shale more than coal or gas more than either of the two, that I defer to those more expert than I.

Representative WYLIE. Thank you.

Senator BENTSEN. Thank you very much, Congressman Wylie.

Senator Roth, we are operating under a 10-minute rule and we assured the Secretary we would get him out early. We are glad to have you and recognize you at this time.

Senator ROTH. Thank you, Mr. Chairman. It's nice to be with you again, Mr. Secretary. I'm sorry I missed your opening statement, but I was listening to Mr. Schlesinger in the Finance Committee.

I was very much interested and pleased with your prepared statement where you say the supply side of the economy has been largely neglected. I agree. In your prepared statement, you said the supply side is not responding. Productivity is lagging badly in the United States. Government spending has taken an ever-growing share of income and shifted funds away from capital construction and toward income transfers. Effective tax rates have escalated sharply.

To be perfectly candid, this sounds to me like a very strong endorsement of Roth-Kemp. As you know, I feel a major tax cut is essential if we are going to move this country forward.

My question to you, Mr. Secretary, in view of your statement: Are you recommending to the President that there be a major tax cut at any time in the near future?

Secretary BLUMENTHAL. Senator, I hope you will forgive me and excuse me from discussing in public what I recommend to the President in private before he has made up his mind whether he is going to take my advice, because either way I lose. If he takes it, I am accused of boasting; if he doesn't take it, I am accused of ineffectiveness.

Moreover, the obvious fact that with high rates of inflation people are pushed into higher brackets needs stating. But it does not necessarily mean that massive tax cuts are the answer, because the weight of what I say in the end of that testimony is that we've got to figure out how to expand the supply side of the equation, how to invest today to have more to consume tomorrow, rather than to consume today.

So it's really a question of when, how much, and what kind of tax cut. Obviously, there are going to be tax cuts. But it's really that question is begged, and it's begged with a reason at this point. But only when that question has been answered will we see whether or not it will reflect the philosophy of Kemp-Roth. I would have some doubts that it will, but one never knows.

Senator ROTH. Well, I didn't expect you to support that particular piece of legislation. I'm not so much interested in that, Mr. Secretary, as I am interested in seeing this country move once again. The fact is that our savings rate is the lowest of any industrialized nation. Somehow we have to build some incentives to get the American people to save for future growth and productivity. Our productivity is growing at a meager rate.

So I think that the administration is making a serious mistake if it isn't considering right now a major tax cut.

Now, did you say in your statement that there will be some kind of tax cut?

Secretary BLUMENTHAL. At some point or other.

Senator ROTH. Is that sooner, or later?

Secretary BLUMENTHAL. Sooner or later there will be a tax cut. [Laughter.] But I cannot predict that. I really don't know.

Senator ROTH. Mr. Secretary, if I might just make a comment, because I think the time has come to quit stalling on some of the basic decisions that have to be made for this country. The President has spent several weeks up at Camp David meeting with various people. If we are going to turn this economy around, I think we have to get some certainty into the picture. I think part of the solution has to be to reduce the tax drag, I think nothing is more important. You can argue the exact dimensions or how or where, but the fact is that with the present taxes on the books, we are going to take an additional several hundred billion dollars of additional taxes in the next 3 years, almost double that figure in 6 years. Inflation is pushing taxes up higher. I think the American people are on the short end of the stick, to be perfectly candid, and the Federal Government is not doing enough to hold down its taxes and spending.

I would hope, that as the chief financial adviser to the President, that you would urge the President to come out with some kind of a general tax reduction. If we don't get productivity up, we are never going to compete in the world markets. That is what bothers me. We are just tinkering. We are really not making the basic decisions that have to be made for the welfare of this country. I would urge you, as a man I hold in great respect, to do so, because this is not a partisan problem.

Secretary BLUMENTHAL. I agree.

Senator ROTH. I think the chairman has come out for some sort of tax reduction. I'm not sure whether he's come out for Roth-Kemp or not, but, nevertheless, there is a growing consensus.

Secretary BLUMENTHAL. I fully understand what you're saying. Clearly there is a need. I do want to make this point, and that is that I still believe that the most urgent problems of this country are related around the questions of energy and inflation, and the two are so closely interlinked that it's hard to keep them separate. We've got to bring inflation under control, and we've got to get on with the task of providing our own energy. Budgetary, fiscal policy, monetary policy, must be designed to achieve these goals. That means a tax action, when and whatever it's for, has to be such as to seek to achieve these goals. The trick will be whether you can find tax action, whenever that is indicated—and I don't know whether or when the President will decide to do it—to find tax cuts that, in effect, don't add to inflation.

For example, if you said, well, let's just give a lot more money to the consumer—\$30, \$40, \$50 billion—put it up, because you could make a good case for that. Say people have suffered; inflation is higher. Just give it back, large amounts of money. We will have a large budget deficit; it's unavoidable, as a result of that, at least for a while.

Some people will argue, you have the famous curve, Laffer curve, who proves to us we shouldn't worry about all that because it all will evaporate.

So, yes, we will have large deficits. We will put a lot more spending into the hands of people. I would think that that kind of deficit would exacerbate inflation, and spending would not need to expand the supply base of the economy.

Now, there may be other ways of dealing with the tax problem at some point in the future that doesn't do that, and whatever we do, whenever the President decides to act in this area, it would clearly be, in my judgment, in a way that is not inflationary rather than inflationary.

Senator ROTH. I would just point out, Mr. Secretary, while I agree energy and inflation are key parts of the problem, one of the basic problems of this country is productivity. I don't know that you are ever going to eliminate inflation or unemployment until we do something about productivity.

And talking about tax cuts, I'm talking about marginal tax rates. Sure, some people are going to spend more; that is true. But what we are really trying to do by reducing the marginal tax rates is to provide incentives to save, invest, and grow. Somewhere along the line, somewhere down the road we are going to have to take a step in that direction.

One thing I can certainly say—I don't think you will disagree—is that what we are doing isn't right. Nothing we have been doing with the economy in the last 20 years has been correct.

But I see my time has expired. I again, Mr. Chairman, would just like to urge the Secretary to speak with a strong voice to the President as for the need to take steps to promote savings and investments so that we can do something about productivity.

Secretary BLUMENTHAL. I can assure you that I have not in the past and promise you that I will not in the future be shy from expressing myself as long as I'm here.

Senator BENTSEN. Thank you, Senator Roth.

Mr. Secretary, the President yesterday, I understand, issued regulations on temperature controls in buildings. Feeling the temperature here this morning, I can't help but think that in a city like Washington, which is high on humidity and low on humility, we are now prepared to sweat this think out. We are delighted to have you here this morning.

Secretary BLUMENTHAL. Thank you.

Senator BENTSEN. The committee stands in recess.

[Whereupon, at 11:10 a.m., the committee recessed, to reconvene at 9:30 a.m., Friday, July 13, 1979.]

THE 1979 MIDYEAR REVIEW OF THE ECONOMY

FRIDAY, JULY 13, 1979

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

The committee met, pursuant to recess, at 9:30 a.m., in room 5110, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, Sarbanes, and Roth; and Representative Wylie.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC (Special Study on Economic Change); Lloyd C. Atkinson, Kent H. Hughes, L. Douglas Lee, Paul B. Manchester, Deborah Norelli Matz, and M. Catherine Miller, professional staff members; Charles H. Bradford, minority counsel; and Carol A. Corcoran, Stephen J. Entin, and Mark R. Polinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. The hearing will come to order.

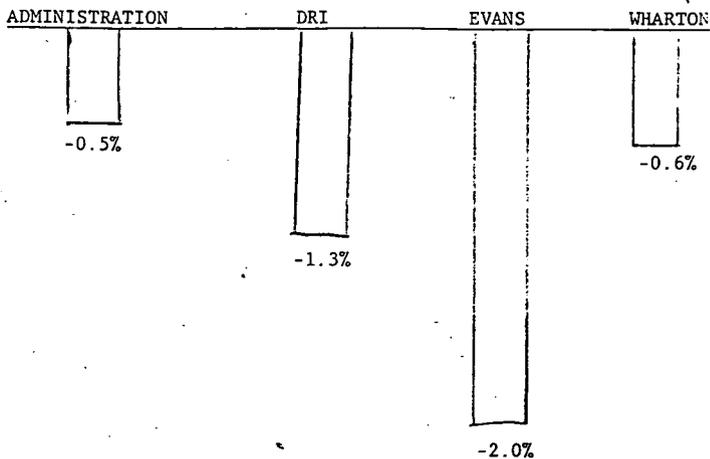
This morning the Joint Economic Committee convenes to review the most recent forecasts of the economic outlook for 1979 and 1980. Since we reviewed the situation last January, it has deteriorated markedly. Both the administration and private forecasters have revised their projections down substantially.

The administration is now in agreement with most of the other economic forecasters in predicting a recession. Depressingly, all four forecasters represented on the chart behind me show economic contraction instead of growth for this year. All of them show our GNP below the line. All of them, in other words, show recession.

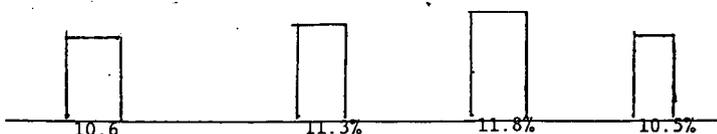
[The chart referred to above follows:]

ECONOMIC FORECASTS
FOR 1979

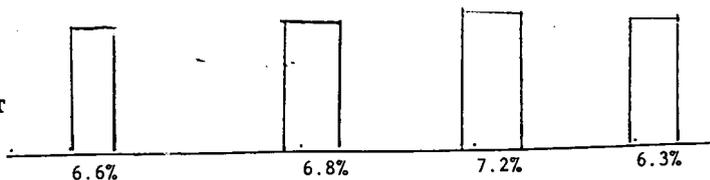
GNP GROWTH



INFLATION



UNEMPLOYMENT



Senator BENTSEN. In my view, we can turn this situation around, but we cannot fall back on the old remedies. Certainly, I don't think we ought to go back to the traditional way of trying to spend our way out of recession. We ought to continue to hold down Government spending.

I believe the best way to produce a recovery that propels the American economy on a long-run growth path, that gets the economy out of its boom-and-bust pattern, is to have a tax cut. But not a conventional tax cut. We should make people whole for what inflation has done to them by bumping them into higher tax brackets.

But in addition, we need some supply side tax cuts to help modernize our manufacturing capacity, things that will really—in the long run—cut down on inflation and increase productivity in this country.

I am firmly convinced that if the American economy is ever to get off its roller-coaster pattern, we must face the facts now. We must embark off the new set of economic policies designed to achieve our long-run economic goals.

This morning, we will try to get some other ideas on this subject.

The Council of Economic Advisers will have an opportunity to present their current views to the committee. But before that, we feel it is vital and in the public interest to have the evaluation of independent, private experts.

Gentleman, I was one of the many who was at Camp David. The message I urged strongly was that we get to work on a tax cut. Frankly, I don't see the downside risk to it, but I see risks if we don't do it.

We've got about a \$50 billion fiscal drag on the economy now. If we add a \$20 billion tax cut, I don't see how anyone could argue that that is really inflationary. If we put one-half of that on the supply side, and the other side tried to make up some of the problems of inflation, I think that would go a long way to insure that the recession doesn't become a deep one, and that the downside risk would be minimal in that type situation.

We are very pleased to have Mr. Michael Evans, president of Evans Economics, Inc., and Professor Paul McCracken of the University of Michigan to give their evaluation.

Later we will have Mr. Barry Bosworth and Mr. Lyle Gramley to present the administration's views.

Senator Roth, would you care to comment?

OPENING STATEMENT OF SENATOR ROTH

Senator ROTH. Thank you, Mr. Chairman.

As you well know, I feel very strongly that this country does have to strike out in a new direction; I mean that we have to have a changed tax policy that will reduce the tax drag on the American people and on the economy.

I agree very strongly with you, Mr. Chairman, that we should take action. And I think we should take action now. I don't think time is on our side. To the contrary, I think time is of the essence, and it is important for Congress, hopefully with the cooperation of the White House, to move along in the direction of providing more incentives for people to save, invest, and produce.

I would also say I would like to go further than merely cutting taxes for 1 year, because, to me it is important that we not only set the framework for this new policy for the next several months, but for the next several years. So I would hope that the Joint Economic Committee, as well as the Finance and House Ways and Means Committees would take some crucial steps to provide for, at least, a \$20 billion tax cut. I believe the chairman has already come out in support of that approach.

Senator BENTSEN. Yes, I have made that recommendation.

Senator ROTH. I am fearful there are those that will want to increase Federal spending as a way to working our way out of the recession. That would be a mistake.

I agree with your statement that increased government spending would return us to the roller-coaster effect that we have seen too often.

So I am pleased to see that we are beginning to develop a consensus here in the Congress. I would like to say this is not a partisan matter when we are talking about the economy; that I am hopeful that we can get many to work along the lines the chairman has outlined, and I applaud him for his statement.

Senator BENTSEN. Mr. McCracken, we are delighted to have you.

**STATEMENT OF PAUL W. MCCRACKEN, PROFESSOR OF ECONOMICS,
UNIVERSITY OF MICHIGAN, ANN ARBOR**

Mr. McCracken. Mr. Chairman, first I want to express to you, and to the members of the committee generally, my appreciation for this opportunity to appear once again before the Joint Economic Committee. This is a committee over the years with whom I have had what I consider to be a special relationship.

There is, I think by now, a growing conviction that the economy is moving downward, and that we are probably past the upper turning point. In other words, the downturn of business activity.

I suppose the key question, at this point, in assessing the state of the economy has to do with whether it is going to be an essentially bland and benign affair, or whether it may be somewhat more serious. Earlier the case that it would be an essentially sidewise or lateral movement seemed to be fairly strong. In essence, it was based on the assumption that the perceived sluggishness in retail sales, together with some decline in residential construction, would essentially make room for the very strong gains that were projected in capital outlays, and also for substantial strength in exports.

And, by the way, even in this economy we must not overlook an assessment of our external trade position, in terms of its implications for the domestic economy. There was a time, 25 years ago, when a respectable speech on the economic outlook could be given without reference to our external position. This is obviously no longer the case. I need not belabor that here, however.

Now, it seems to me we are facing a confluence, or a conjuncture, of developments which suggests that what we are moving into is going to be a little more difficult readjustment than this essentially lateral type movement. The decline in retail sales has been much more pronounced. It has been more than just sluggishness.

There is evidence that other countries, particularly countries representing our import and export markets, are themselves becoming concerned about emerging inflationary pressures within their own economics; and here I refer particularly to Japan and Germany. Canada, if past patterns follow is apt to lag our own position by a little bit. Of course, they are our most important export market.

Under the circumstances, therefore, production schedules cannot continue at recent levels without an unacceptable buildup of inventories. And there is the key danger that this could emerge at a time when the Federal Reserve is going to have to take some actions to slow down the rate of monetary expansion which resumed at an unacceptably high rate beginning about March this year—after an interlude when these rates of expansion were quite low—say from November to March.

Therefore, we have, coming into the picture, somewhat the same conjuncture of circumstances which, in the past, has tended to produce a relatively more severe decline in business activity. We face this, however, with the great advantage of less of an imbalance in inventories than we had in 1974—an imbalance which, I think, was not widely perceived at that time.

I should mention that, so far as retail trade is concerned, we know, of course, what the trend is through June in real terms. It was downward, with the rather minor exception of March, all during this year.

The oil situation—particularly the way we've handled this—has produced a maximum dislocating effect upon our economy. And these factors are now causing some real problems.

In concluding my own summary comments, I would like to make just two or three quick observations in regard to economic policy.

I think we have to recognize, reluctant as we may be, that most of our problem carries with it the unmistakable label "made in U.S.A."; It would be very convenient to be able to offload the responsibility for our problems on OPEC and the substantial rise in oil prices. And obviously, many of our problems would have been less complicated if we had continued to have a decline in real oil prices, as we did during much of the 1950's and the 1960's. But we do have to face this fact. This country still produces one-half its oil, and we are having more dislocation, as a result of this, than countries such as Japan, or Germany which produce no oil and therefore where the full impact of this has tended to be absorbed in their economies.

Now, I'm not pointing those problems out in any partisan sense. We have plenty of blame to share with past administrations, including the one in which I served for 3 years. But I would like to make three sets of general observations, in regard to policy; and these very much follow along the lines of your comments, Mr. Chairman and Senator Roth, and the positions that you've taken in other connections.

I think we ought first to keep our eyes fixed on what might be called the historical track record of the American economy. There are three important elements to this record. It has been a record of gains in productivity that would double material levels about every 30 years. Since the middle part of this decade, the rate would require about 90 years, almost. Essentially, we are getting virtually no gains in real incomes.

Second, if we omit the two major war periods, and the Great Depression, the average annual rate of inflation from 1900 to 1965 has been about 2 percent per year.

And finally, during the same period, and with the same years excluded, the average rate of unemployment has been 4.9 percent. This is the track record of the American economy. And something like this would seem to be a reasonable objective to try to regain.

If this is true, then clearly what we face is more than just zipping and zagging economic policies in the conventional cyclical sense. We face far more fundamental problems than that. And certainly one of these problems—one of these matters that we must face—is that the strategy that fundamentally has been pursued over the last 15 years of accommodating to whatever rates of inflation are prevailing or in prospect, is a loser.

It finally brings us to a situation where we have both high rates of inflation and high rates of unemployment.

And now I would like to quote two sentences from an OECD report of a committee of economists which I served on 2 years ago. And the two sentences are as follows:

We believe that in the future Government should make it clear when framing, explaining, and executing their policies, that they will not, and in the end cannot, pursue policies which will permit or accommodate high rates of inflation. Somewhat paradoxically therefore, we believe the route to sustained full employment lies in recognizing that governments cannot guarantee full employment, regardless of developments in prices, wages, and other factors in economic life.

We would be much closer to price stability and lower rates of unemployment today, if we had been willing to face this issue frontally earlier, after the problem emerged in the mid-1960's.

The second point that I would like to urge is that surely the time has now come for the Congress and the administration to face the realities about an energy policy that would be more consistent with an orderly economy. This is a complex subject, I realize, but we ought not to forget that countries for whom oil imports are much more of a serious problem than the United States have managed this in a much more orderly way than we.

The third point gets to the supply side—a point which you made, Mr. Chairman. The time has surely come for a careful and sober and systematic reevaluation of a wide range of problems that in the aggregate undoubtedly have played a major role in this increasing arthritis with which the American economy seems to have become afflicted.

Now, if the 1980's are not to be known as the coming to fruition of an American disease, akin to the earlier British disease about which we used to be so unctuous we must find some way to restore order in these areas of national policy.

Now, I want to conclude with this comment. This committee, throughout its history, has had I think an awesome performance in public education about the requirements of good economic policy. The immediate agenda for this year, and for the years ahead, of course, remains long. But the opportunity for this committee to move in a fundamental way the cause of national policy along has never been greater or more urgent than right now.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you, Mr. McCracken.

[The prepared statement of Mr. McCracken follows:]

PREPARED STATEMENT OF PAUL W. MCCRACKEN

Mr. Chairman, I appreciate the invitation to appear before this Committee again as it evaluates the condition of the U.S. economy at mid-year. These evaluations are never easy, but they become particularly difficult when the economy is beset with special problems, such as oil, and may be approaching a turning point.

I

There is a growing conviction on the part of analysts that the economy may be near, or at, or even past another upper turning point, with the next phase a recedence in business activity. And there seems to be a growing conviction that this phase will be a well-defined decline rather than an essentially lateral or side-wise interruption of the economy's normal, long-run, basic expansion trend.

The internal structural changes that have occurred in the economy during recent months themselves do suggest that we are at or near such a turning point. One of the most well-defined general measures of these structural changes, suggesting a forthcoming turning point in the economy, is the ratio of the index of so-called coincident economic indicators to those that lag. When elements in the economy which tend to move with the general pattern of business conditions show less strength than indicators which lag the economy generally, the economic weather is usually starting to undergo a definitive change. If we look back at the index derived from this ratio, we find that during the last quarter of a century just over a year after this index dropped below 100 the economy generally reached its upper turning point and started down. This index broke below 100 in May last year, and it has thus been on a persistently declining trend for over a year. The lead has not been of invariant length, of course, having ranged from roughly three quarters to seven quarters, but this overall measure of structural changes that occur as the economy moves through the cycle has not dropped this low without an ensuing downturn.

II

There is by now a wide measure of agreement that an interruption to the long expansion which began in early 1975 is now emerging. The question is whether it will be essentially just an interruption, a rolling readjustment without any consequential overall decline, or whether it is apt to be something more severe. Earlier this year the case seemed to be strong for expecting the more benign and bland outcome. Our export markets were expanding rapidly. Total exports were rising at a 30 percent per year pace, an expansion in which our exports of manufactured products have fully participated. The combination of strong economies in our major export markets (Canada, Japan, Germany, the U.K.) and the delayed effect of earlier declines in the dollar's exchange rate augured well for a continuation of this strong expansion. Even for the large U.S. economy, these swings in external markets are important. From the first quarter of 1978 to the first quarter of 1979 the rise in our exports (on a national income accounts basis) was equal in magnitude to 18 percent of the rise in the domestic demand for output.

Businesses were also beginning to lay out ambitious plans for enlarging their basic capacity. That square footage of floor space involved in new construction contracts was rising at a 50 percent per year rate during the early months of the year; and unfilled orders of the capital goods industries (excluding defense) were shooting upward at a 47 percent per year pace. That pressures of demand were heavy was evident. The proportion of companies reporting lengthening deliveries rose to levels seen only in 1950-51, with the acceleration of defense spending incident to the Korean Conflict (in 1951) and the Viet Nam Conflict in 1966, and during the world-wide inflationary frenzy of 1973. This index, incidentally, is a far better measure of pressures on the economy than the unemployment rate because it reflects not only the level of demand relative to productive capacity but the rapidity with which demand is building relative to the capability of businesses to accelerate production schedules.

Here then seemed to be the raw material for a benign rolling readjustment. Declines in residential construction and sluggish consumer demand would in essence make room for exceptionally strong gains in exports and in business outlays for new facilities—gains that were urgently needed to strengthen our external payments position, and to get our plant capacity more in line with the size of the labor force. If a bit of slack emerged, so much the better for its hopefully disciplinary effect on inflation.

III

The probability that things will not work out with such benignity is now rising. For one thing consumers' demand is weaker than what usually has been assumed for an interlude of essentially no change in economic activity. Actually this weakness has been emerging all during 1979. With the exception of a minor rise in March, the physical quantity of stuff consumers have been buying from retail outlets has been declining steadily since December at roughly a 7 percent rate. This probably reflected two sets of influences. Increasingly concerned about the purchasing power of their money, consumers had "overspent" during much of 1978 (as indicated by abnormally low saving rates), and inventories of hard goods in the hands of consumers are probably now high. Moreover, last year

brought the proportion of consumers' income that was spent to exceptionally high levels by the final quarter, and some rehabilitation of their financial situation was to be expected.

The dominant factor causing a cessation of the growth in consumer spending, however, has been the oil situation in the United States. Higher prices would have caused consumers to use oil products more sparingly, and in ways that would vary from family to family and would not necessarily be predictable or foreseeable (as is often the case with price changes for products generally), and the long trend of demand toward more fuel-efficient cars would certainly have accelerated. In this country, however, government management of the market for oil and its products produced the queue-line society that usually is the result of government-managed markets. And the resulting uncertain availability has had a serious disorganizing effect on auto sales, tourist outlays, and retail trade more generally in selected areas.

Moreover, the explosive growth in our exports cannot be expected to continue. Our production costs are rising more rapidly than those in Japan and Germany and probably those in Canada and France also. And in some of these countries steps have already been taken to slow down the rate of their domestic economic expansion—partly because of signs that domestic inflation is accelerating, and partly because of reluctance to accept the balance of payments consequences of the additional oil imports that would be generated by further rapid economic expansion.

Businesses are, therefore, now at the stage where continued expansion of production, or even production schedules sustained at current levels, will mean an accelerated accumulation of inventories. Unlike in 1974, when inventories were already high relative to sales when the recession began in the third quarter, this time these stocks are not generally heavy relative to current sales, and that is an obvious advantage.

A problem, however, remains. Since March rates of monetary expansion have again moved into the double digit zone—e.g., an 11 percent per year rate for M₁. If monetary policy were to remain on this track, there would be little reason to hope that present rates of inflation would abate, and the Federal Reserve must therefore slow down these rates of expansion. If these moves to slow down the rate of monetary expansion were to coincide with a rapidly growing uneasiness on the part of businesses about their inventories and production schedules, we would have a conjuncture of developments that would produce something sharper than the more benign side-wise movement expected earlier—something, in short, more like the V-shaped decline of 1974–75, though probably less severe.

The probability of this conjuncture has been rising in recent weeks.

IV

What are the implications of these developments for policy? We must candidly recognize that most of our current problem bears the unmistakable label: "Made in the U.S.A." While it is obvious that our problems would have been simpler if other nations (including OPEC countries) had behaved differently, the responsibility for converting these problems into near or outright crises is ours and ours alone. This is not a partisan observation. These problems have roots back in history, and the Congress and Administrations of both political parties (including the one in which I once served) contributed to it. That this legacy from history is making the current problems more difficult for the present Congress and Administration seems undeniable. The present Congress and Administration are the current government, however, and theirs is the responsibility for dealing with these matters.

As we turn to what seems now to be required for economic policies, it may be useful to keep in mind what might be called the normal track record for the American economy historically. This track record has had three characteristics during the twentieth century. First, the American economy has delivered sustained gains in productivity large enough to double the material level of living of the average family about every 30 years. By contrast at rates that have prevailed since the mid-1970's, at least 90 years would be required—giving the U.S. the dubious distinction of having the most arthritic rate of gain in productivity of any major economy in the industrial world. Second, ours has historically been an economy with a good price-level performance. Excluding the two major wars and the Great Depression, our average annual rate of inflation from 1900 to 1965 was 2.1 percent. Third, the average unemployment

rate from 1900 to 1965 (again excluding the two major wars and the Great Depression) was 4.9 percent.

Clearly the policies that we deploy must deal with more than the conventional shifts in demand management required to deal with a short-term cyclical interruption of the economy's normal expansion trend. While far more than demand management policies will be required, careful demand management policies will be essential if the American economy is to regain its historical vitality. If the history of the last 15 years has taught us anything, it is that accommodating increases in the demand management policies (for fear that otherwise the economy might soften) is a loser. It brings us to high rates of inflation with unacceptable levels of unemployment, and facing a more severe cyclical reversal—to, in short, precisely where we now are. The O.E.C.D. international committee of economists which I chaired, after studying experience internationally, concluded in its Report:

We believe that, in the future, governments should make it clearer where framing, explaining and executing their policies, that they will not—and, in the end, cannot—pursue policies which will permit or accommodate high rates of inflation. * * * Somewhat paradoxically, therefore, we believe the route to sustained full employment lies in recognizing that governments cannot guarantee full employment regardless of developments in prices, wages and other factors in economic life. Only when our demand management policies create markets in which outsized price increases mean lost sales and out-sized wage demands means lost jobs, and where these costs are an evident reality, will we be on the road to lower rates of both inflation and unemployment.

In spite of the uncertain short-term economic outlook, therefore, demand management policies should begin now to move the economy toward steadily smaller rates of expansion in nominal terms until, again in nominal terms, the money demand for output is rising at the 5-6 percent per year pace that would give us a reasonably stable price level and still accommodate the slow growth (perhaps 3 percent per year) in our productive capacity. Demand management policies must begin to blaze a steadier and less inflationary trail for the economy to follow. Experience has taught us that the old strategy of zigging and zagging these policies to accommodate predicted zags and zigs in the economy, and announcing to the world that demand management policies would never be permitted to cause a recession, in practice gives us the worst of all worlds.

Second, surely the time has now come for the Congress and the Administration to face the realities about an energy policy that would be consistent with an orderly economy. We would all have preferred, of course, ample oil supplies at the old low prices—just as most Americans would prefer a college education at the old, lower tuition rates, or for that matter government services at the old lower salaries representing smaller costs to taxpayers. The present economic disarray from oil, however, is not caused by O.P.E.C. and its higher prices but by the policy response of this country to these higher prices. That should be evident from the fact that nations which must import all of their oil (e.g., Germany and Japan) have had less economic disruption than the U.S., which still produces half its own requirements.

Two things should now be clear from our experience of recent years. Government management of the details of economic life will produce queue-line societies, shortages, and economic arthritis whether it is Washington trying to manage oil markets or Moscow trying to manage its economy generally. And central to any viable energy policy must be prices at levels that clear the market. Only then do we bring demand into balance with supply, and at the same time provide each consumer with assurance that he can make a purchase if he is willing to pay the price. It is that individual assurance of availability, still in the context of prices that encourage all to economize, which is essential if the present disarray in industries from autos to tourism is to abate. With prices held by controls below levels that clear the market, the inevitable resulting shortages confront each consumer with capricious uncertainties that paralyze his spending decisions.

Finally, the time has surely come for a careful, sober, and systematic evaluation of the so-called social regulation programs that have grown at an explosive pace during the last decade or so. While a prudent regard for the environment, industrial safety, or good medicine is essential for the good society, there is growing evidence that for many of these programs their present requirements extends far into the zone where costs in terms of what is given up elsewhere exceed benefits. The governance of a nation almost at a political crisis because

of queue lines at gasoline stations still would probably not permit the construction of a new refinery. We seriously lag the world in productivity gains, therefore denying Americans the hope for sustained increases in the purchasing power of their pay checks, but we require the diversion of growing amounts of investment away from projects that could deliver these productivity gains.

If the 1980's are not to be known as the coming to fruition of an "American Disease" (akin to the earlier "British Disease" which we used to discuss so unctuously) we must find some way to restore order in these areas of national policy. This Committee throughout its history has had an awesome performance in public education about the requirements of good economic policy. The immediate agenda for it this year, and for the years ahead, remains long, but the opportunity for it to move the cause of fundamental national policies along has never been greater or more urgent.

Senator BENTSEN. Other than proceeding with questions at this moment, I will proceed with Mr. Evans.

**STATEMENT OF MICHAEL K. EVANS, PRESIDENT, EVANS
ECONOMICS, INC., WASHINGTON, D.C.**

Mr. EVANS. Thank you very much, Mr. Chairman. It is always a pleasure to testify in front of the Joint Economic Committee.

This morning I would like to discuss three issues briefly. First, the current state of the economy and the severity of the current recession; second, the extent to which this recession has been brought on by OPEC; and third, the various fiscal policy responses which might occur next year, particularly when the administration realizes their 6.9 percent unemployment forecast is unrealistically optimistic.

The latest forecasts for the economy are given on the chart to which the chairman has already referred.

Just very briefly, I might say that I think this recession can no longer be called a mild one. I think the appellation of "severe" is now more appropriate. The decline of real GNP from peak to trough is now expected to be 2.8 percent. This is not as bad as 1974-75, but it is much more severe than the average postwar recession.

During 1979, as shown on the chart, the real GNP is expected to decline 2 percent, and furthermore, is expected to increase only 1.3 percent in 1980. The unemployment rate will start rising sharply in the second half of the year, and reach a level of 7.5 percent by year-end. It will then continue to increase during the first half of next year, reaching a peak of 8.6 percent around midyear, and averaging 8.5 percent for all of 1980.

So we have a fairly severe recession, and unless steps are taken, a rather sluggish recovery.

I have prepared a few tables in my prepared statement. Table 1 gives some more of the details of the forecast. I won't go over all of them, except to say that all major sectors of the economy will be hard hit. Car sales will be down, housing starts will be down, fixed business investment will be reduced, and so forth and so on.

This recession is not the usual type of recession, in the sense that it was not brought about by a credit crunch. It was not brought about by inventory overspeculation and stockpiling. It was not brought about by overexpansion of capacity utilization, and so forth and so on. What seems to have caused the recession is consumers were simply overextended. And as long as real disposable income grew faster than

the rate of inflation, as it did for the past 4 years, consumers spent everything they had and some of them spent a little more than that.

The personal savings rate dropped almost to a postwar low in 1978 and early 1979. But, for the past few months, the rate of inflation has been so high that the real disposable income has declined at an annual rate of 4 percent. And when this happens, consumers have no financial reserves. The debt to income ratios are very high, and they are out of line. Savings are very low. Consumers simply have to pull in their horns.

So one of the causes of the recession has been the higher inflation, and one of the reasons for higher inflation has been energy prices. But it is not appropriate, nor is it correct, to say that OPEC is the only reason that we have a recession. Because of the decline in productivity over the last six quarters, a point to which I will return later, inflation has accelerated for the past 1½ years and the consumers have definitely been hurt by this.

Now, as far as the inflation outlet goes, it is currently running at a rate of about 14 percent. I do think the rate of inflation will decline to about 9 percent by yearend, and 8 percent by 1980. These are very unsatisfactory numbers. The only reason 8 percent sounds good is when we compare it with 14 percent these days.

But I think we will have a decline in food prices. I think OPEC increases will level off. I think that the recession will cause some decline in the rate of inflation, but we will still only get down to 8 percent as long as we have the underlying problems with productivity increases being close to zero. And for the last six quarters—

Senator BENTSEN. Let me make sure of one thing you said, now. You stated that this is not a mild recession, and should not be characterized as a mild recession; isn't that correct?

Mr. EVANS. That's correct. I think that the rate of inflation will slow down only to about 8 percent next year; and I say that is not due to energy problems, it's not due to food price problems. It's due to the slowdown in productivity. In fact, in 1978 when the rate of inflation steadily accelerated all year long, the United States was the only country in which that happened. In the rest of the industrial world the rate of inflation was diminishing.

So we can't turn around and look for scapegoats this time. We have to look in our own backyard, and see what has happened.

Now, the rate of productivity used to be about 3 percent per year. And now it has slowed to about 1 percent per year. This is due to a number of factors. We have done some work to try and break these out, and we find that this decline can be explained as follows: About one-half percent is due to a decline in investment ratio, one-half percent due to the cost of government regulation, one-half percent due to demographic shift in labor markets, one-fourth percent due to higher energy and raw material costs, and one-fourth percent due to less R. & D. spending.

So the list is fairly long and fairly extensive; but it seems to me, if we are going to reduce the rate of inflation we have to attack these fundamental underlying problems.

Now, I have prepared a table 4, which is shown in my prepared statement. There are a lot of numbers in that table, but what I tried to do there is to break out why we had so much inflation. In other words,

how much was due to energy? How much was due to food, and so forth? And how much was due to labor cost?

Back in 1968 labor costs were rising at about 4 percent a year. Not too surprising with the rate of inflation then about 4 percent. Now labor costs are rising at about 8 percent. The rate of inflation this year is higher than that. As shown on the chart, which you used in your opening statement, Mr. Chairman, it will be almost 12 percent. That is due to some short-term factors, but I think the rate of inflation will return to 8 percent next year because of the underlying increases in unit labor costs.

Now, Mr. Chairman, if we have an unemployment rate that even approaches the numbers which has suggested namely 8 percent or more, we are going to have a tax cut. The administration for reasons best known to themselves, and I am sure that they will explain it later this morning, sort of selected 7 percent as the magic number. In other words, if we can keep unemployment below 7 percent then we don't need a tax cut. And if it is over 7 percent, then I guess they would admit that we do. But their forecast for unemployment is 6.9 percent, so clearly we are going to be able to ride this torment without having to do anything about it.

Those are not my opinions. I believe that this economy is in far worse shape than the administration perceives, and although they call for a mild recession, I think it will be much more severe. So, I think we will have a tax cut next year. It seems to me that in line with your opening comments we ought to have the right type of tax cut. We don't need another old style of tax cut which simply encourages consumption at the expense of savings and investment. We don't need another rebate like we had in 1975. That rebate hyped up retail sales for 4 or 5 months and then disappeared without a trace leaving in its a way a new round of inflation. We don't need that. We need a tax cut which is simply targeted toward savings and investment. We've got to get the investment ratio up. We have got to get productivity up or else we are simply going to continue on this roller-coaster and under this same set of monetary and fiscal policies that we've had for the last decade, there is no reason to expect that inflation will moderate over the course of the next business cycle.

I think we could have two types of tax cuts to target upon savings and investment. One type would be simply further liberalization of the depreciation allowances. One idea which has been suggested by others but which I endorse would be to change the accounting lives of the depreciation so that you can write off all structures in 10 years and all equipment in 5 years.

I think we should also try to do something to help the small saver. The United States is the only industrialized country in the world that doesn't help the small savers some way or the other. Britain, France, Italy, Germany, Japan, all these countries allow a partial tax exemption for savings. And these countries have savings rates which are twice the U.S. productivity growth rates which are three times the United States. They are doing something right and we're not. We need to have some type of incentive for savings.

Now, there are a number of ways in which this could be accomplished. One possibility would be to create an analogue to the individual retirement account which we might call an individual savings

account an ISA, which would permit individuals to take the first \$1,500 of interest income, dividend income and capital gains roll over and exempted from their personal income tax, provided of course that they kept their assets fully invested. And this, I think, would provide a boost for savings. It would also create an incentive among many smaller savings who now do not have that incentive. I think that that is one possibility.

There are other ways to influence the possible savings, but that is one which I have suggested. I think this type of tax cut would not be expensive. The best estimates that congressional staffers and I have been able to come up with would suggest that the liberalized depreciation allowances would cost \$5 or \$6 billion the first year, that the ISA accounts would cost perhaps \$6 or \$7 billion the first year, and that would leave room for another cross-the-board income tax cut similar to the one which went into effect in the beginning of 1979 in order to readjust down for the fiscal growth after inflation, and what putting these packages together would have a balanced tax cut which would stimulate savings and investment, which would amount to \$20 or \$25 billion.

I believe that if we have a tax cut of this sort it will be stimulatory for the economy, but it will not raise the rate of inflation at the next business cycle peak if we go back to another old style tax cut. It will help us get out of a recession, but at a much greater cost later on.

So, in conclusion, Mr. Chairman, the economy is now at the beginning stages of a recession which promises to be fairly severe, but the unemployment rate rising to 8½ percent next year. As this happens, the pressures for another tax cut will be irresistible.

While the usual type of tax cut designed to increase consumption at the expense of investment will provide some moderate short-term stimulants. It will worsen the problems of inflation the next time the economy begins to approach for employment and full capacity.

What is needed next year is a combination of new style, personal and business tax cuts, which stimulates savings investment and productivity growth. While the stimulus for this approach might not be as great in 1980, it would lay the groundwork for a more durable recovery and lower inflation rates in 1981 and later years.

Senator BENTSEN. Thank you very much, Mr. Evans.

[The prepared statement of Mr. Evans follows:]

PREPARED STATEMENT OF MICHAEL K. EVANS

INTRODUCTION

My testimony today covers three interrelated topics. First, we discuss the current state of the economy and the severity of the current recession. Since the Administration is now claiming that any downturn is solely the fault of OPEC, we then examine the incremental effect of the higher level of oil prices this year. Third, we discuss the various fiscal policy responses which might occur next year—particularly when the Administration realizes that their forecast of 6.9 percent unemployment for 1980 is unrealistically optimistic.

ECONOMIC OUTLET

The latest forecasts for the economy, based on the CEAI macro model, are given in Table 1. In particular we note that this recession can no longer be

characterized as a "mild" one; the appellation "severe" is now more appropriate. The decline in real GNP from peak to trough is now expected to be 2.8 percent. On a fourth-quarter-to-fourth-quarter basis, real GNP is forecasted to decline 1.8 percent this year and increase only 1.3 percent in 1980. The unemployment rate will start rising sharply in the second half of the year and reach a level of 7½ percent by yearend. It will then continue to increase during the first half of next year, reaching a peak of 8.6 percent around midyear and averaging 8½ percent for all of 1980.

TABLE 1

	1979 (quarters)				1980 (quarters)				Annual		
	1st	2d	3d	4th	1st	2d	3d	4th	1979	1980	1981
Real GNP (percent change).....	-0.8	-2.3	-2.6	-3.0	-3.1	2.6	2.4	3.2	1.3	-0.8	3.3
Index of industrial production (percent change).....	4.7	-0.5	-7.4	-7.7	-9.4	2.9	3.8	5.9	2.8	-3.6	5.1
Unemployment rate (percent change).....	5.7	5.7	6.3	7.2	8.1	8.5	8.6	8.6	6.2	8.5	8.2
CPI, (percent change).....	11.1	12.8	12.8	8.8	8.0	8.0	8.3	7.6	10.8	9.0	7.7
PPI, industrial commodities (per- cent change).....	12.7	15.9	16.2	12.1	9.1	8.3	8.5	8.7	12.2	10.6	7.8
Federal budget surplus or deficit (billion dollars).....	-16.9	-17.6	-31.7	-40.7	-45.7	-40.7	-39.3	-47.3	-26.7	-43.3	-33.1
Prime commercial bank rate (percent).....	11.7	11.7	11.9	11.5	10.5	9.6	9.0	8.7	11.7	9.5	8.5
New car sales (millions).....	11.6	10.7	9.7	8.8	8.3	8.4	8.6	9.1	10.2	8.6	10.1
Fixed business investment (bil- lions of 1972 dollars).....	146.7	146.4	144.8	141.3	137.5	135.2	134.6	136.0	144.8	135.8	141.4

The comparison of key economic indicators with other postwar recessions is shown in Table 2. It can be seen that while the current downturn is not expected to be as severe as the 1974-75 debacle, it ranks as far more serious than the recessions of 1960 and 1970. The current recession is now well established, with even the Administration conceding that real GNP will decline in the second quarter. Yet this decline has surprised many forecasters in the sense that few if any of the traditional causes of recession were at hand at the upper turning point.

For example, no credit crunch has occurred during the past few months. While interest rates have been high by historical standards, the real rate of interest is very close to zero if not negative, and both consumer and business loans are in ample supply. While a few bottlenecks have occurred and lead times for delivery have lengthened, these problems have not reached epidemic proportions as they did in early 1974. Furthermore, world markets are still far from full capacity and import capability is available where needed. The general financial condition of the business community is strong, and loan/deposit ratios have not advanced into dangerous territory as they did 5 years ago. The inventory/sales ratio has remained low all through the current upswing and fell from 1.41 in February to 1.37 in March, although it did increase to 1.43 in April as sales fell. Capital spending has followed a balanced pattern, leading neither to a reduction in investment in the near future nor an overexpansion of capacity.

TABLE 2.—KEY ECONOMIC INDICATORS FOR POSTWAR RECESSIONS

Peak/Trough	Decline in real GNP	Decline in industrial production	Increase in unem- ployment	Change in CPI
1948 (4th quarter)/1949 (4th quarter).....	-1.4	-6.6	3.2	-2.2
1953 (2d quarter)/1954 (2d quarter).....	-3.3	-8.1	3.3	.8
1957 (3d quarter)/1958 (1st quarter).....	-3.2	-9.5	3.2	3.4
1960 (1st quarter)/1960 (4th quarter).....	-1.2	-6.2	1.9	1.6
1969 (3d quarter)/1970 (4th quarter).....	-1.1	-5.6	2.3	5.7
1973 (4th quarter)/1975 (1st quarter).....	-5.7	-13.9	4.1	11.3
1979 (1st quarter)/1980 (1st quarter) ¹	-2.8	-6.3	2.9	10.6

¹ Estimate.

Note: All figures are actual changes except CPI, at annual rates. All figures are based on quarterly data.

The one major exception to this litany is the position of the consumer, which leads us to characterize the opening stages of this recession as consumer-based. Here we find a far different story. In particular, the ratio of consumer debt to income is seriously out of line with past trends; if we consider the ratio of debt to discretionary income,¹ the jump is even more alarming. Although this ratio has turned down slightly thus far in 1979, it is still well into the danger zone. In addition, much of the purchasing of durable goods which took place in late 1978 represented buying only for inflation's sake—the buy now because it will cost more later syndrome. The last gasp of this symptom was the rush to buy new cars in March and early April; while some of this was spurred by the realization that gasoline prices were starting to skyrocket, big car sales also increased during that spurt.

This pattern of consumer overbuying has resulted in a decline in the personal savings rate from 7.6 percent in the 1973-1975 period to 4.8 percent in 1978; the rate rebounded to 5.4 percent last quarter only because of the \$15 billion personal income tax cut. With debt levels overextended and financial reserves pared to the bone, it logically follows that consumer buying patterns would be more vulnerable to swings in real disposable income than is normally the case.

As long as income outpaced the rate of inflation, consumers felt comfortable in spending all of their income—in some cases a little more besides—and the economy continued to advance at above-average rates. This was the pattern throughout 1978, as disposable income rose 11.3 percent compared to the 9-percent rate of inflation. Real income also rose in January 1979 as a result of the tax cut, but this pattern then came to an abrupt end. During the past 4 months disposable income has increased at an annual rate of about 10 percent; inflation, on the other hand, has risen at an annual rate of 14 percent over the same period, so real disposable income has declined at a 4-percent rate. Given this sharp reduction in purchasing power, it is not surprising that retail sales have exhibited a thoroughly lackluster pattern during the second quarter.

Hence the sharp decline in real disposable income, coupled with an already anemic savings rate and vastly overextended levels of debt, have been sufficient to lead the economy into a consumer-based recession. Yet that does not answer the question of why the turnaround struck so sharply in April; since the generally weaker stance of the economy and reduced confidence of consumers and businessmen had been ongoing for several months.

The key psychological factor causing the turning point is the gasoline shortage. While the higher price of petroleum products has had some effect on disposable income, the initial reaction to higher prices was to buy more rather than less. However, when long gasoline lines started forming, the plunge in orders and sales began. Clearly the psychological impact of not enough gasoline has been far worse than the economic impact of higher energy prices.

In fact, both consumers and businessmen see the second energy crisis as potentially much more long-lasting and damaging than the first one. There is little question that the ineptness of DOE, reflected both in the shortages themselves and the apparent inability to respond effectively to the problems at hand, encouraged the more militant OPEC nations to tack further surcharges on the price of imported oil. Thus faced with the triple whammy of continued gasoline shortages, sharply higher oil prices, and an Administration and Congress with no ability or even real interest in solving our energy problems, the business community decided it was time to retrench.

As a result, we see an economic downturn lasting through the first quarter of next year. After declining 2.3 percent this quarter, real GNP is expected to fall at almost a 3 percent annual rate for the next three quarters. New car sales will decline from the 11.6 million rate of 1979.1 to a trough level of 89.3 million in the first half of 1980 and average only 8.6 million for the year. Fixed business investment will decline 8 percent from peak to trough. Further forecast details have already been given in Table 1.

INFLATION OUTLOOK

Whether or not the guidelines remain in force, our forecast calls for a reduction in the rate of inflation from its present level of 14 percent to 9 percent by

¹ Defined as personal income less other labor income and transfer payments less purchases of housing services, fuel, electricity and natural gas.

yearend. However, inflation will remain above 12 percent during the third quarter because of the June 27 increase in OPEC prices. The reduction in the fourth quarter will be caused by the following factors:

1. A reduction in retail food price gains from 14 percent to 8 percent. This will slice about 1.2 percent from the overall rate of inflation, since food accounts for about 20 percent of the overall CPI. The Russian wheat scare did push grain prices up dramatically, but prices in future markets have not retreated somewhat, and we do not expect another repeat of 1972 or 1974-75.

2. In view of the latest OPEC pronouncements, we expect imported oil prices to average \$20/bbl. this quarter and \$21/bbl. next quarter, up from \$13.30/bbl. at the end of 1978. Even these astronomical figures represent a much slower rate of increase than the gains during the first half of the year, however. Thus, for example, gasoline and fuel oil prices rose an actual 5 percent in May, accounting for 0.25 percent of the total 1.1 percent increase in the CPI. If fuel prices rise "only" 2 percent per month later in the year, this will slice 1.8 percent off the overall rate of inflation.

3. The stabilization of the dollar should contribute to a lower rate of inflation later in the year. Right now this factor is not very much in evidence, but if one argues that depreciation raises the rate of inflation, it does not seem logical to argue that appreciation has no positive effect on the price level. Because of the recent weakening of the dollar in spite of generally lower trade deficits and claims that OPEC may be planning to dump the dollar as a reserve currency, our estimate of the improvement in inflation is only about 1 percent by yearend. Furthermore, we cannot rule out the possibility that with domestic prices increasing at such a rapid rate, foreign firms will be content to raise their prices at about the same rate and pocket the extra profits.

4. The recession should reduce the rate of inflation by about 2 percent by yearend through the following channels, none of which is very large individually. The price of cyclically sensitive materials, mainly metals and building materials, will grow much more slowly during the second half of the year; this will be reflected primarily in smaller increases in the prices of consumer durables. Second, the decline in interest rates will lead to somewhat lower mortgage rates, thus reducing the cost of home financing. Third, wage rates should begin to moderate later in the year; although, the published data on average hourly earnings may not reflect this easing. Fourth, profit margins will diminish as firms will find it more difficult to pass along all of the increase in costs.

Thus we do expect inflation to moderate—but only to 9 percent by the end of this year and approximately 8 percent during the course of 1980. We return to the underlying factors keeping inflation at this high level after discussing how the 1979 OPEC price increases have affected the economy.

THE ECONOMIC IMPACT OF HIGHER OIL PRICES

We have prepared the results in this section by simulating the CEAI macro and international models together for the following three scenarios:

(a) No increase in imported oil prices in real terms.

(b) An increase to \$20/bbl. in 1979.3 and \$21/bbl. in 1979.4. We now consider this the most likely scenario.

(c) Continuing rapid increases in oil prices for the rest of the year, leading to \$24/bbl. oil by the end of 1979.

The general conclusions that can be drawn from our simulations are as follows:

1. The hike in OPEC prices intensified but did not cause the 1979 recession. According to our calculations, real GNP would have declined during the latter three quarters of this year even if oil prices had remained constant in real terms. Under that set of assumptions the unemployment rate still would have risen enough that the Administration and Congress would have enacted some fiscal stimulus during 1980 in any case.

2. Even if OPEC prices were to rise a full \$10/bbl., which is even more than the \$9/bbl. hike in 1974, the ensuing recession would not be as severe as the 1974-75 downturn. The reasons for this include the facts that inventory investment is not out of balance, the general financial condition of the corporate sector is much stronger, worldwide shortages of commodities (other than energy) are not present this year, grain prices are not likely to skyrocket although they have gone up substantially in recent weeks, and the U.S. economy is not suffering the debilitating effects of just having ended 2½ years of price controls.

3. Every additional \$1/bbl. hike in the price of imported oil will lower real GNP by about 0.3 percent, raise the rate of inflation by about 0.4, and increase the unemployment rate by about 0.15 percent.

More specific forecasts for these three scenarios are given in Table 3. These results are summarized by the following:

Real growth will diminish by 0.8 percent this year and 2.2 percent next year. Without any increase in oil prices in real terms, the peak to trough decline in real GNP would have been -0.5 percent; the most likely estimate is now -2.8 percent.

The index of industrial production will fall 3.6 percent next year, instead of remaining unchanged.

The rate of unemployment would have risen from 6.1 percent this year to 7.3 percent in 1980. Now it will soar to an average of 8.5 percent, representing a loss of 1.2 million jobs.

The rate of inflation will average 10.8 percent in 1979 instead of 8.6 percent, and 9 percent in 1980 instead of 6.3 percent.

Net exports of goods and services will average -\$2.3 billion next year instead of the +\$17.7 billion which would have otherwise occurred.

TABLE 3.—EFFECT OF HIGHER OIL PRICES ON U.S. ECONOMY

	1979	1980	1981	Peak to trough decline
Real GNP (percent change):				
No increase in real terms.....	2.1	1.4	4.3	-0.5
Standard forecast.....	1.3	-0.8	3.3	-2.8
\$10/bbl increase in 1979.....	1.2	-1.8	3.3	-3.7
Industrial production (percent change):				
No increase in real terms.....	3.5	-0.1	6.3	-3.8
Standard forecast.....	2.9	-3.6	5.1	-6.3
\$10/bbl increase in 1979.....	2.6	-5.1	5.4	-7.5
Unemployment rate (percent):				
No increase in real terms.....	6.1	7.3	6.5	-----
Standard forecast.....	6.3	8.5	8.2	-----
\$10/bbl increase in 1979.....	6.4	9.0	8.9	-----
Consumer price index (percent change):				
No increase in real terms.....	8.6	6.3	6.3	-----
Standard forecast.....	10.8	9.0	7.7	-----
\$10/bbl increase in 1979.....	11.4	10.4	7.4	-----
Wholesale price index, industrial commodities (percent change):				
No increase in real terms.....	9.1	6.3	6.5	-----
Standard forecast.....	12.2	10.6	7.8	-----
\$10/bbl increase in 1979.....	12.7	11.8	7.1	-----
Net exports (billions of dollars):				
No increase in real terms.....	7.3	17.7	18.0	-----
Standard forecast.....	-5.9	-2.3	-4.6	-----
\$10/bbl increase in 1979.....	-12.0	-7.1	-10.9	-----
Federal budget deficit (billions of dollars):				
No increase in real terms.....	-30	-43	-31	-----
Standard forecast.....	-27	-43	-33	-----
\$10/bbl increase in 1979.....	-27	-46	-36	-----
Prime commercial bank rate (percent):				
No increase in real terms.....	10.6	8.4	8.2	-----
Standard forecast.....	11.7	9.5	8.5	-----
\$10/bbl increase in 1979.....	12.0	9.9	8.1	-----

FISCAL POLICIES FOR 1980

Judging from recent Administration testimony, government economists still hope that some fortuitous turn of events will keep the unemployment rate under 7 percent next year. However, once that level is exceeded, the pressure for additional fiscal stimulus will be irresistible. Consequently, we expect a tax cut of \$20 to \$25 billion to be enacted sometime during 1980. As a result, the budget deficit, which will balloon to \$45 billion in 1980 because of the recession even in the absence of any tax cut, will probably range as high as \$60 billion, depending on when tax reduction takes effect.

While another old-style tax cut, designed primarily if not exclusively to stimulate consumption, would raise the growth rate by about ½ percent next year, it would do nothing to attack the fundamental underlying problem of decreased productivity. What is needed is a new-style tax cut, one which stimu-

lates saving and investment. For this is the only type of tax cut which will increase productivity, which is the key to reducing the long-term inflation rate.

As shown in Table 4 and Figure 1, the principal underlying cause of inflation has been the almost steady increase in unit labor costs—a result of higher wage rate gains and lower productivity growth. The wage gains are simply a reflection of higher inflation, since the real wage over the past 5 years has actually declined. Hence it is the decline in productivity growth from 3 percent per year earlier to about 1 percent now which is at the root of our inflation problems. This decline can be explained by the following factors: $\frac{1}{2}$ percent due to a decline in the investment ratio; $\frac{1}{2}$ percent due to the costs of government regulation; $\frac{1}{2}$ percent due to the demographic shift in labor markets; $\frac{1}{4}$ percent due to higher energy and raw material costs; $\frac{1}{4}$ percent due to less R & D spending.

TABLE 4.—DETERMINANTS OF THE CONSUMER PRICE INDEX

	1968	1969	1970	1971	1972	1973	1974	1975	1976	1977	1978	1979 ¹
Wages.....	6.2	6.8	6.3	6.7	7.5	6.4	7.6	7.0	7.3	7.8	8.5	8.3
Fringe benefits.....	.3	.3	.5	.6	.7	1.2	.6	.9	1.0	.8	.9	.8
Normal productivity increases.....	2.7	1.8	1.3	2.0	1.5	1.9	1.2	1.1	1.1	1.1	1.7	1.1
Normal unit labor costs.....	3.8	5.3	5.5	5.3	6.7	5.7	7.0	6.8	7.2	7.5	7.7	8.0
Energy.....	-1	-1	-3	-3	-3	.2	1.4	0	-2	0	-2	1.2
Food.....	-1	-1	0	-7	-4	1.8	1.4	.2	-8	0	.5	.5
Interest rates.....	.2	.5	.5	-3	0	0	.2	.2	-1	0	.3	.4
Dollar weakness.....	0	0	.2	.4	.5	0.5	-1	-1	-3	-2	.4	.5
Calculated total.....	3.8	5.6	5.9	4.4	6.5	8.2	9.9	7.1	5.8	7.3	8.7	10.6
Actual total.....	4.2	5.4	5.9	4.2	3.3	6.2	11.0	9.2	5.7	6.5	7.7	10.8

¹ Estimate.

According to our estimate, the core rate of inflation has moved up from 2 percent before 1970 to about 8 percent today at the same time that productivity growth has moved down from 3 percent to 1 percent. We also estimate that even if productivity growth were to move back to 3 percent, the equilibrium rate of inflation would go no lower than 4 percent because of higher costs of regulation, energy, and other raw materials. This suggests that each 1 percent increase in the productivity growth rate would lower inflation by about 2 percent. How much of this can we reasonably expect to accomplish during the next three to five years?

The increase in the investment ratio could be brought back to levels of the 1960's, we believe, through the two new-style tax cuts which we discuss next. This would involve an increase in the ratio of productive fixed business investment to GNP in constant prices from its present level of about 9 percent to a range of 10½ percent to 11 percent. Note that these figures are calculated after excluding investment undertaken to meet federally mandated standards, and as such are well below published NIPA estimates.

We have long argued that while it is not possible to turn back the clock on the massive changes in social policy which produced the federally mandated standards of the 1970's, it would at least be possible to rationalize these regulations so that firms are charged with attaining the ends rather than the means. If, for example, one national goal is to reduce air pollution, utilities ought to be able to decide on their own whether this is to be accomplished through choice of fuel, use of scrubbers, less production during "air alerts," building plants in new locations, and so forth, rather than by administrative fiat. Our best guess is that the use of common sense in these areas could reduce the loss in productivity growth due to regulation from $\frac{1}{2}$ percent to $\frac{1}{4}$ percent per year, thus reducing the overall rate of inflation by about $\frac{1}{2}$ percent per year.

With respect to the other two factors, labor markets will change dramatically during the 1980's; we will shift from labor surplus to labor scarcity, and teenage workers will represent a decreasing rather than increasing part of the labor force. This combination of factors should increase productivity by about $\frac{1}{2}$ percent per year from current levels. On the other hand, higher energy and raw materials costs are a fact of life for at least the next decade, as discussed below. Thus on balance productivity could improve at most from 1 percent to 2½ percent, thus reducing the long-term rate of inflation to 5 percent. Please note that this is a best reasonable estimate and not our standard forecast.

From the point of view of the standard forecast, the investment ratio probably will improve somewhat in the next decade, for the economic and political climate

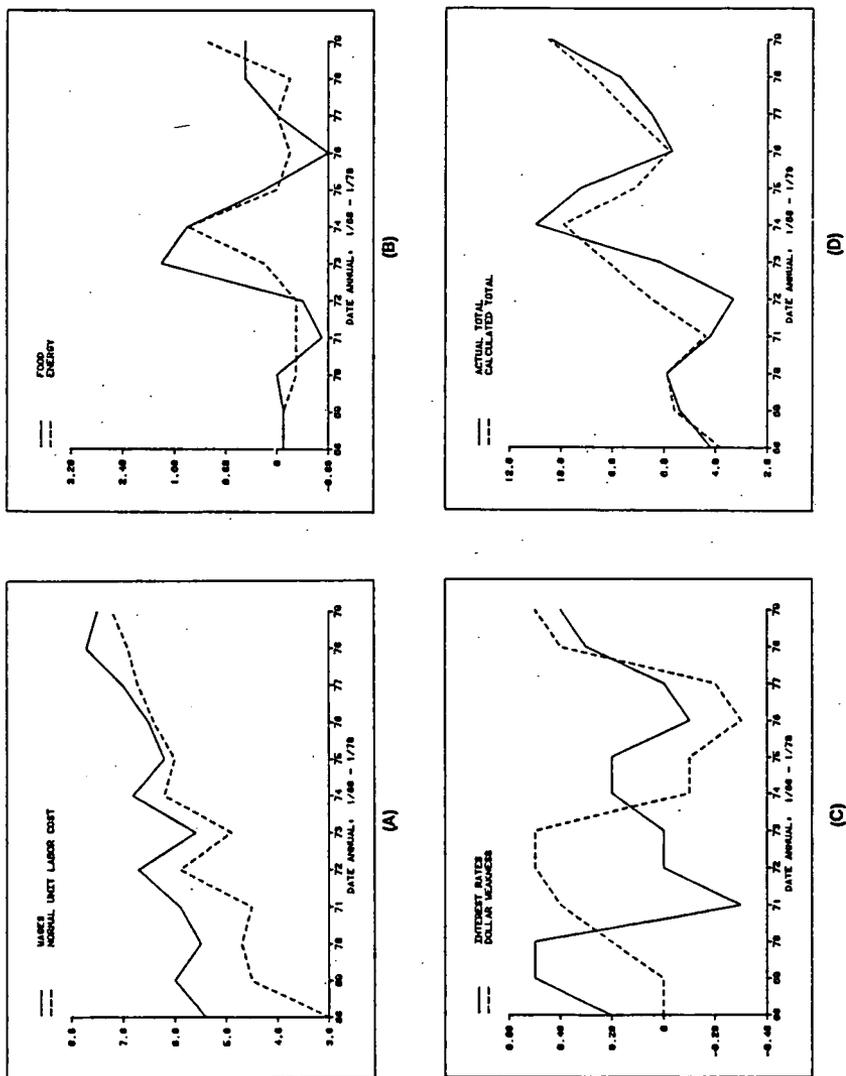


FIGURE 1

which nurtured the dream that all problems could be solved by higher levels of government spending is dead for at least the 1980's. Thus we might well get a $\frac{1}{2}$ percent improvement from that factor. We are also likely to step up productivity gains in labor markets even without explicit government action. These two changes would raise productivity growth to about $1\frac{1}{4}$ percent per year, thus bringing the equilibrium rate of inflation down to about $6\frac{1}{2}$ percent per year, which remains our most realistic estimate.

Even this modest inflation target cannot be met, however, if the Administration and Congress insist on a mix of fiscal policy which favors consumption over investment. Instead we must move to new-style tax cuts. In our opinion, the two most promising ideas are (a) further liberalization of depreciation allowances

and (b) exemption of some interest income, dividend income, and capital gains rollover from personal income taxes.

The theoretical approach to reforming depreciation allowances would introduce replacement cost instead of historical cost accounting for all new investment. The drawback to this plan, as we understand it, is that it is deemed to be unduly complicated and not easily understood by a majority of small businessmen, many of whom still use straight-line depreciation. The substitute plan which has been introduced is to shorten the accounting lives for all structures to ten years, for all equipment except motor vehicles to five years with a full 10 percent investment tax credit, and to three years for motor vehicles with a 6 percent investment tax credit.

There is little question that such a bill would stimulate investment after the usual 1-year lag. Furthermore, the so-called tax expenditure would be quite modest the first year, for it too would apply only to new investment. Estimates prepared by congressional staffers indicate the cost would be about \$6 billion the first year, although this figure would rise to \$30 to \$40 billion ten years hence.

While this plan has its undoubted merits, it should be perfectly obvious that no one is going to vote for a tax bill in 1980 which benefits only businesses. Some reduction in personal income taxes will obviously accompany this plan to reduce depreciation, if indeed it is considered seriously, and the partial tax exemption of savings is an obvious companion bill.

The formation of Individual Retirement Accounts (IRAs) 4 years ago permitted individuals not covered by pension plans to invest \$1,500 each year tax-free, providing the money was not withdrawn before retirement age. The planned Individual Investment Account (IIAs) would have some elements in common with this general idea, in that they would encourage savings, but the scope would be much more broad-based. Each taxpaying unit could treat up to \$1,500 per year in interest income, dividend income, or capital gains rollover as tax-exempt income. Thus, for example, if an individual had a savings account of \$10,000 on which he earned an average interest rate of 9 percent and dividend income of \$1,000, \$1,500 of that \$1,900 income would not be included in his gross taxable income. The plan would have certain strictures; taxpayers would have to keep their principal fully invested, although they could switch assets just as is the case for IRAs now. Any capital gains would have to be reinvested (rolled over) into other similar investments in order for that part of the exemption to qualify. However, the basic idea of an IIA would be that income generated from stocks, bonds, savings accounts, money market funds, or similar assets would be tax exempt as long as the principal remained invested in this class of assets. The Treasury estimates that this would cost about \$6 billion per year in ex ante revenue loss.

This idea is a fairly new one for the U.S. economy but virtually every other industrialized country already gives some tax breaks to the small saver. In fact, this one reason goes far to explain why the personal savings rate in the U.S. is so much lower than in other major countries. It also explains why personal savings is so much more attractive even in those countries where the rate of inflation is well above normal U.S. levels.

In Britain, for example, individuals may buy National Savings Certificates in amounts up to £1000 with the interest income completely free from income tax. Other plans, including British Savings Bonds, the various Save As You Earn schemes, and National Savings Bank accounts all pay interest which is partially or totally free from income tax.

Germany does not offer quite as wide a scheme of tax-free saving incentives, but the overall effect is much the same. Deposits at savings and loan associations and insurance companies are deductible up to a maximum which varies based on the size of the family, veteran status, and several other factors.

Japan treats interest income even more favorably. In fact, any person receiving either interest or dividend income can choose to have all of this income taxed at the flat rate of 35 percent, compared to a maximum income tax bracket of 75 percent. Compare this to the U.S. tax tables, where interest and dividend income are taxed at a maximum rate of 70 percent instead of the 50 percent cap on earned income.

Small savers in Japan receive even further incentives to save. Interest income from a savings deposit of up to ¥3 million (about \$15,000) is totally exempt. Furthermore, life assurance premiums are totally deductible from income tax

up to an amount of ¥25,000 per year, and partially deductible up to ¥100,000 per year. Virtually no capital gains are taxed unless (a) the taxpayer has regularly engaged in security dealings during the year (b) the gains are from the sale of shares accumulated with the object of manipulating their market price, or (c) the sales are a substantial part of a corporation.

Clearly the establishment of IIAs would have many advantages. It would reduce the tax burden for savers, particularly smaller savers, and thus would be politically as well as economically popular with the vast majority of voters. It would stimulate savings and investment, and would pull the U.S. closer to being able to compete with other major industrialized nations in terms of gains in investment and productivity.

The disadvantages which are likely to be raised are threefold. First, such a move would definitely increase the size of the Federal budget deficit; no backward-bending supply curves would operate here. Second, it could be argued that most of the tax break would simply go to taxpayers who would save and invest in any case; i.e., it would attract very little new savings. Third, someone is sure to complain that most of the tax breaks will go to the "rich," which to a certain extent cannot be refuted because most of the poor don't save.

These objections suggest an alternative plan which would affect marginal savings more directly. Under this alternative, taxpayers would not receive an exemption or credit unless their savings in any given year were greater than the average savings rate for that income bracket. For example, if the average savings rate was 5 percent for a \$25,000 per year income, taxpayers at that level would not receive any exemption unless they saved over \$1,250 in that year. It is difficult to estimate the ex ante revenue loss, but it would certainly be under \$5 billion per year.

In conclusion, the economy is now in the beginning stages of a recession which promises to be fairly severe, with the unemployment rate rising to 8½ percent next year. As this happens, the pressures for another tax cut will be irresistible. While the usual type of tax cut, designed to increase consumption at the expense of investment, will provide some moderate short-term stimulus, it will exacerbate the problems of inflation the next time the economy begins to approach full employment and full capacity. What is needed next year is a combination of new-style personal and business tax cuts which stimulates savings, investment, and productivity growth. This can be accomplished through further liberalization of depreciation allowances and partial exemption of savings-generated income from personal income taxes. While the stimulus to this approach would not be as great in 1980, it would lay the groundwork for a more durable recovery and lower inflation rates in 1981 and later years.

Senator BENTSEN. Mr. Evans, you have been talking about a tax cut. I am in total concurrence with that and your comments about the supply side increasing productivity. That is what we have to do, otherwise we just continue to ratchet it up to another higher level of inflation after we get through our recession, and other level of unemployment, and we don't stabilize the situation.

Mr. McCracken, I will try to keep my comments down here because I know Senator Roth has some questions to ask and we have some other witnesses.

You made the point about inventory and balance not being as nearly as bad as it was in 1974, and everyone tells me that. But you also said something else. You said and perhaps not—it was not perceived at that time, as I understood you, as being that much in balance. Why is our perception so much better now?

Mr. McCracken. That is a very good point. I think the basic problem the last time around was that we were focusing heavily on inventory sales ratios in nominal dollars. Now, if you stopped to think of that ratio inventories as being the numerator and sales the denominator, inflation immediately translates into the denominator, but because of the conventional accounting purposes, only more slowly

into the numerator, and, therefore, paradoxically inflation itself will tend to produce seemingly more benign inventory sales ratios.

Now, we do have much better data on inventories.

Senator BENTSEN. Does that mean it would reflect more replacement costs of that inventory now?

Mr. McCracken. In terms of constant dollars. Later getting data in constant dollars we saw that problem in mid-1974. This inventory-sales relationship was already well above the zone of what might be considered normal. That is not evident this time. However, production schedules can't remain at the rates at which they've been without starting to produce a heavy inventory problem. So, at least we move into that problem with less of a basic imbalance than we did in mid-1974.

Senator BENTSEN. Let me ask about a couple of other things. We were talking about personal savings. And Mr. Evans, you were speaking a few minutes ago about how low they are and you were speaking about the consumer credit and how far it was extended. How do they relate to 1974, the numbers? Are we more extended on consumer credit now than we were in 1974, and if so, that could be on the other side of that equation as far as the cause of this recession. Are savings less than they were in 1974? Have we gone into that problem, if so, that could be on the other side.

Mr. McCracken. I don't have the figures in mind. These can be checked on the data. I am sure that old relationships, such as installment debt repayment relative to personal incomes are relatively higher today than was true back there. Of course, we have a problem today which we had gotten beyond already in 1974, and that was the adverse effect of the uncertainties about the availabilities of gasoline on the automobile industry. Naturally, coming from the State of Michigan, I am rather acutely aware of that problem, and it is having a very disorganizing effect.

This occurred last time, but a little earlier in the game.

Mr. Evans. Mr. Chairman, if I might follow up on that—the personal savings rate for the period 1973 to 1975 was at 7.6 percent and now it has declined. It was 4.8 percent in the last quarter of 1978, so, the personal savings rate has definitely declined. The ratio of consumer installment debt to income was about 16 percent in early 1974, and that was considered too high, which it was. Now it is about 19 percent.

In fact, at the risk of some oversimplification, we can almost say that in 1974 the business sector was out of balance. In 1979 it is the consumer sector that is out of balance.

Senator BENTSEN. That is the point that I was trying to make in getting these numbers from you. One has a tendency to balance off the other. So, there is a question of how serious a recession we have, and it could certainly be influenced by those numbers.

One of the things that concerns me—and I am for keeping down spending and not trying to spend our way out of the recession—I get the feeling that the administration, at least from their public announcements so far, is talking about steady on course insofar as their recommended policies. But I don't see how it is steady on course when the events have overtaken that course, and you have a lot more fiscal

drag today than you had when we started out on that course. Certainly, the OPEC oil prices are substantially more than we anticipated. The inflation factor is more than was anticipated; so, that is a further fiscal drag.

It seems to me you have to adjust to those kinds of conditions just to be steady on course if you leave the same kinds of policies in force. Events have overcome that situation and conditions have changed; then you have changed the course and you have to adjust to it.

Additionally, in this country we are too late on the tax cut. By the time you crank that thing through the Congress and listen to all the diverse and competing groups who want their piece of relief, we see the thing coming out in a recession. That happened pretty much in 1974-75. We were late.

Mr. McCracken. May I make a comment, Mr. Chairman?

At the moment I stand a bit at the interface between economics and business. I do think we have an opportunity right now to take some actions which could be very helpful. It might be said with some oversimplification, that last time it was a business recession, and this time it is a consumer recession.

My impression is that a good many corporate executives, looking back at that experience, concluded that in the pessimism of the moment, they canceled out on some of their capital projects that later they wished they had continued.

Senator Bentsen. There is no question about that.

Mr. McCracken. Now, with capital budgets still pretty strong in the business sector, and with this general evaluation, I do think, myself, that this is a very good opportunity for some actions, tax actions on the supply side of that situation, to get a substantial bang from the buck. I am sure it would be much more effective now than it would have been 5 years ago as we were moving into that 1974 recession.

Senator Bentsen. Senator Roth.

Senator Roth. Thank you, Mr. Chairman.

As I understand your testimony, Mr. Evans, you said there is a need for a substantial tax cut, and that we ought to be creating some incentives for savings. As you know, for many years I have strongly advocated that we should try to take the tax drag off the private sector by reducing marginal tax rates, not only for 1 year, but for several years, looking into the future.

I also feel, at the same time, that we should be slowing down the rate of growth of Federal expenditures. Would you support today—I know you have in the past—an across-the-board tax cut, say in the area of roughly 30 percent over the next several years?

Mr. Evans. Yes, I would, provided that the tax cut was coupled with holding the line on government's expenditures in real terms. In other words, let expenditures rise at the rate of inflation, but no new programs for the next 5 years. Under a program like that, I certainly would support it.

Senator Roth. I have coupled my tax cut proposal with a proposal which would decrease Federal spending from 22 percent of GNP to 18 percent over the next few years so that there is a two-prong effect. Do you feel that would be a positive move, adopting that approach today?

Mr. Evans. Yes, I do. I think it was a positive move last year, and I

certainly think it would be appropriate at this time. People were all in favor of the abstract, but when it came to holding government spending, they voted against it, as you are well aware, of course.

From an economic point of view, multiyear planning with the two-pronged approach would be a very good idea. I would certainly support that, as I have in the past.

Senator ROTH. Mr. McCracken, would you?

Mr. McCracken. Yes, I would certainly support that. I think it is part of this concept which has emerged in this committee and which has been mentioned here already today. What we need at this juncture in history is not to be looking through the bottoms of our bifocals at what may be happening in the remainder of 1979, although, of course, we cannot ignore that. We have to be looking down the road and asking ourselves what has gone wrong with the American economy in the fundamental sense, because obviously it has not been performing well for some time. Then we must lay out a course of strategy that gets beyond the conventional business side and starts to deal with these fundamentals.

Senator ROTH. Well, what concerns me is that Congress has not been willing to make a commitment for more than 1 year ahead. It seems to me that today's economy calls for strong medicine, and I think a 1-year tax cut is fine, but we have to go further if we are really going to make some substantial changes. The only way we can do it is by making the commitment today for long-term reductions in tax rates and restraints on the growth rate of Federal spending.

Isn't it true that, if we are really going to get this economy going, we have to put some certainty into the spending and tax picture? Isn't that a must?

Mr. McCracken. I wholly agree.

Senator ROTH. Now, we've been wrestling with this problem of savings. As you gentlemen have stated, our savings rate is the lowest of any industrial country in the world. You testified, and I strongly agree, that we have to help the little investor save for the future.

One of the things that bothers me is that interest costs are deductible, but you pay income tax on interest earned.

Would it make any sense, for example, to phase out income taxes on interest over the next several years? Would that action promote savings in any substantial nature among the little people, or among people generally?

Mr. Evans. It certainly would have some positive effect. There is some argument as to what the elasticity of the savings figure is, but if you basically phase out the income tax on savings, thereby increasing the after-tax rate of return on savings by some 30 or 40 percent, you could probably hope to generate an additional \$10 to \$20 billion in savings over the next several years.

Certainly the treatment of savings these days is rather unusual, in the sense that the maximum income tax rate on real income is 50 percent, but the interest on earned income is 70 percent. That seems to be an anomaly that serves no useful purpose. People don't really pay 70 percent. They invest in transferring municipal bonds anyhow. So, when you get up in those tax brackets, you are not even talking about revenue loss to the Treasury. So, it seems to me that that anomaly

should be fixed, and we would indeed call for an extra \$10 to \$20 billion in savings over the next several years.

So, I think the answer to your question is that it would have a definite positive effect.

Senator ROTH. Mr. McCracken, would you care to comment?

Mr. McCracken. Yes; I think that ought to be explored.

Could I make one further comment. There is always an advantage when striking when the iron is hot.

I have a rather specific suggestion for the Joint Economic Committee. We are at a juncture here where finally, I think, it is being recognized that conventional accounting procedures do a miserably poor job of measuring profits generated in the current accounting period during inflation. Let me put it the other way. They do a miserable job of accounting for the economic cost, during the current accounting period.

This is at least now finally being recognized. There does seem to be a great danger that both some professionals in the accounting profession and government people here in this town are now going to seize that issue and produce an absolutely God awful solution—trying to index everything and produce an end result that nobody understands.

My suggestion would be that the Joint Economic Committee look at this issue because I think it is very closely related to this whole problem of lagging investment in the U.S. economy, and this is the time when this issue is urgent.

Senator ROTH. Mr. Chairman, I understand my time is at an end.

Senator BENTSEN. I would say to Mr. McCracken, I am not quite sure where you came out on that, but if he is talking about being concerned about inadequate replacement costs, causing profits to be too high—if that is what he says will be a horrendous problem, I would totally agree with him.

I have been a businessman before, and I have chosen to go with modifying the tax treatment of depreciation, which would at least moderate the problem. I would say to my friend, Senator Roth, if he is not a cosponsor of my \$500 interest exemption from savings accounts, he ought to be. We have an awful lot of cosponsors on that, and we will welcome him.

Congressman WYLIE, they have completed; would you care to ask any questions?

Representative WYLIE. I would like to just ask one question, Mr. Chairman. I know I'm a little bit late. I'm sorry for that.

The Congressional Budget Office's economic outlook update assumes that the price of imported oil will increase to about \$20 per barrel in July 1979, and rise thereafter at a rate that is 3 percent higher than the rate of inflation. This is lower than the rate of increase in the price of imported oil during the past 5 or 6 years, and it's much lower than the rate of increase during 1979, of course.

What would be the economic outlook for the four calendar quarters of 1980 if we had another oil price increase in the magnitude of 50 percent, like we had in the autumn of 1978, or if we had this increase in the autumn of 1979 like we had in 1978, which would raise the price of imported oil to \$30 a barrel?

Now, I realize that may be a difficult question to answer, but is it realistic to assume that the increase in oil would be only 3 percent higher than the rate of inflation?

Mr. EVANS. Congressman Wylie, we have made calculations of that general sort, and it works out about like this: Every dollar per barrel increase in OPEC prices lowers real GNP by four-tenths of a percent, raises inflation by 0.5, and raises unemployment by 0.15 percent. Oil at \$20—let's say it did go to \$30 a barrel, a \$10 a barrel increase. That means that real GNP would be 4 percent lower than our forecast, and the rate of unemployment would be 1½ percent higher, and the rate of inflation would be 5 percent higher. So these are very serious numbers.

In other words, it would send the economy almost into a catatonic fit. It would be the worst recession we've ever had.

As far as whether oil prices will go to \$30 a barrel, I guess the only thing I can say is, I hope not. We have no way of knowing what the Arab nations will do. I think if I testified here in December that oil prices were going to be \$20 a barrel by midyear, people would have thought I had gone off the deep end. I mean, I wouldn't have said that then because I didn't think so, and that is why some of these forecasts have been more bearish.

I would hope that the worst is over at OPEC and the more reasonable heads will prevail, but certainly on the basis of what has happened in the first half of 1979, there is no very firm ground from which to make that prediction.

Representative WYLIE. Well, I raised that question because Secretary Blumenthal indicated on July 11 that he felt that we were in for a recession now, and that the major thrust of that recession was the big increase in OPEC oil prices.

I think there are other factors involved. But I think it is a sad commentary when we are dependent on the situations in other nations for our economic survival.

Well, thank you very much.

Mr. McCracken. Mr. Chairman, could I make a comment on that? Senator BENTSEN. Please do.

Mr. McCracken. Obviously, this kind of a rise in oil prices is not good news. There's no question about that. And our current economic situation would have been easier without it. And I have no idea what—I would refuse even to guess at what oil prices may be at the end of the year, because this is inherently almost unpredictable.

I would, however, want to take strong exception to the idea that somehow, if oil prices go up, it just produces the problems we now have. It depends a great deal on how we respond to these developments. In that sense, therefore, I would disagree with my fellow Ann Arbor townsman, Mr. Blumenthal.

It is very comfortable to be able to offload this responsibility on OPEC, and, of course, we all wish it hadn't happened. But I don't think it is an accurate analysis of the problem.

And I would state once again what I have stated, I think, twice here this morning: If that is true, why aren't we seeing these effects in magnified form in Germany and Japan, where they have to import all of their oil? I think the major impact of oil on the American economy

right now is not so much the higher price, although it is serious; it is the fact that we have managed it in such a way as to produce the maximum disorganization in the economy by creating uncertainty about the availability.

I assume I don't need to emphasize that in Washington, D.C.

Representative WYLIE. You don't need to emphasize it to me, either. But you will both agree that we must move away from dependence on OPEC oil and very soon.

Mr. EVANS. Oh, yes.

Representative WYLIE. Thank you very much, Mr. Chairman.

Senator BENTSEN. Thank you, Mr. Evans.

And Mr. McCracken, we appreciate very much your contribution.

The next two witnesses will be Mr. Lyle Gramley and Mr. Barry Bosworth, to present the administration's views. Gentlemen, we are very pleased to have you here this morning.

I would like to have Mr. Gramley proceed first.

STATEMENT OF HON. LYLE E. GRAMLEY, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Mr. GRAMLEY. Thank you very much.

I am here today because Charlie Schultze is still ill. He would prefer to be here rather than where he is.

Senator BENTSEN. How is he, Mr. Gramley?

Mr. GRAMLEY. We don't have a firm diagnosis yet, but we are beginning to hone in on where the problem lies. It is not a critical problem, as far as we know, at this juncture. He has made some improvement in the past few days. He has been relatively free from abdominal pain, and that is a hopeful sign.

I am going to read just excerpts of my prepared statement this morning, and I will try to be brief.

The long and vigorous economic recovery that we have enjoyed over the past 4 years has come to an end. In the first quarter of 1979, real GNP grew by only 0.8 percent. Developments in the second quarter indicated that the slowdown has become more pervasive. Retail sales in real terms dropped approximately 5 percent from March to June. Unit auto sales in June fell 15 percent from their May levels. Housing starts in May were about 12 percent down from the average level in the fourth quarter of last year.

Businesses have responded rather quickly to the weakening of consumer spending, by adjusting their production schedules downward to avoid an undesired buildup of inventories. That meant that industrial production in May was no higher than in March, and industrial output in June may well have declined. This production response will help avoid the weakness later that would inevitably be created if inventories were allowed to get out of line with sales. But it has added to weakness in the economy now.

We know that employment growth has slowed substantially since March, yet the unemployment rate still remains close to the 5¾ percent figure that has prevailed since last fall. We do not as yet have sufficient data to estimate the change in real gross national product during the second quarter, but it seems likely that a small decline occurred.

The principal source of the current weakness is not hard to pinpoint. Consumer purchasing power is being cut back drastically by rapidly rising prices.

There is a chart labeled chart 5 at the back of my prepared statement which illustrates that, over the first 5 months of this year, consumer prices have risen at an annual rate of 13½ percent, with increases concentrated in three areas: Food, energy, and home purchase and finance. All other items in the Consumer Price Index have increased at an annual rate of 7½ percent.

These increases in consumer prices have far outstripped the rise in wage rates. During the past year, average hourly earnings, which are shown in chart 6 of my prepared statement, have risen 7.6 percent. The annual rate of increase since last December has been even less. Real wages, that is, wages adjusted for inflation, have therefore declined sharply. With growth in employment also slowing, growth in personal income has fallen behind rising prices. The consumer has therefore had little choice but to reduce his expenditures.

Long gaslines have added to the problem. Concerns about the availability of gasoline have had a very negative impact not only on sales of large cars, vans, recreational vehicles, and small trucks, but also on shopping at department stores and on travel.

I can't stress strongly enough the relationship between the energy crisis we face and the current state of our economy. Last December the OPEC countries announced a schedule of crude oil price increases that we knew would raise our inflation rate and take a toll on economic growth. Actual and announced OPEC price increases since then have made the situation vastly worse.

A second underlying source of the current weakness is in the housing sector. The decline in housing sales and starts since late last year stems in some measure from the further sharp increase in home purchase prices and in the cost of home financing. In addition, some potential home buyers are experiencing difficulty in obtaining financing. But we have managed to avoid the severe drying up of mortgage credit availability that has characterized past periods of tight money.

Let me turn now to the outlook for economic activity and prices this year and next. Consumer spending, as I mentioned a moment ago, was depressed in the second quarter by long gaslines. The availability of gasoline has recently improved, and increased oil production from Saudi Arabia is likely to improve it further. Gaslines, we hope, will become only a grim memory. Some improvement in the trend of consumer buying may therefore occur.

Nevertheless, consumer spending is likely to remain weak during the second half of this year because the growth of personal income has slowed.

Moreover, housing starts are likely to decline somewhat further over the remainder of 1979.

On the other hand, business fixed investment is still relatively strong, and the weight of the evidence suggests it will remain so. Exports are also strong. Nonagricultural exports in the first 5 months of this year were up one-third in value and about 16 percent in volume from a year earlier. Expansion abroad, led by investment, the effects of depreciation of the dollar in exchange markets, should sustain the growth in our exports.

It will take some time before the resolution of these divergent trends becomes fully evident, but it is clear that the forces of expansion are substantially weaker than we had expected last January.

Over the four quarters of 1979, we are now forecasting a decline in real GNP of about a half a percent. As I mentioned earlier, real GNP probably declined in the second quarter and we think it may fall again in the current quarter. Late this year or early 1980, growth is expected to resume, but at the relatively modest rate of 2 percent for the 4 quarters of 1980.

This would mean growth in 1979 and 1980 at a pace well below our long-term potential economic growth rate of around 3 percent. The unemployment rate is therefore expected to rise to 6.6 percent by the fourth quarter of this year and 6.9 percent by the end of 1980.

We expect inflation to moderate during the second half of this year. Food prices are likely to rise less rapidly than in the first half, in part because supplies of pork and poultry are improving.

The weakness of the economy will lead to reductions in some raw materials prices and to a squeeze on corporate profit margins, as more resistance to price increases develops. Mortgage interest rates, moreover, are likely to level out relatively soon, so the increase in the cost of home financing should moderate. While energy prices will continue to rise faster than other prices, they may rise somewhat less rapidly in the second half than the rapid rate of the first half.

For the year as a whole, the Consumer Price Index is expected to increase by 10.6 percent, which is less than the 13.4 percent annual rate of increase we have seen in the first 5 months.

Next year we expect further progress in reducing inflation. However, the expected rise in the CPI during 1980 of 8.3 percent is still much too high. Our country is still a long way from our national goal of bringing an end to inflation.

The administration's forecast is rather similar to those published recently by private forecasting services, describing an economy that undergoes a brief and mild recession and then begins a process of slow recovery. The recession is mild because the typical imbalances of some earlier recessions are not present.

Next year growth is expected to resume, but at a moderate pace. That is mainly because continued high inflation, particularly rising energy prices, will tend to dampen the pace of economic growth.

The outlook for economic activity and prices that I just described is a sobering one. Economic growth in 1979-80 will be much slower than any of us would like. Unemployment will increase significantly. Inflation, while moderating somewhat, will stay at a level that is entirely unacceptable.

What, then, should be our economic policy in light of these expectations? We face a cruel dilemma. If policy actions are taken to offset slow growth and a rising unemployment rate, we will lose some of the gains we expect on inflation. If we tighten budgetary policy to dampen inflation further, we will lower growth and raise unemployment. Macroeconomic policy has no fully satisfactory solution to this dilemma.

Inflation is still our Nation's principal economic problem. We do expect a significant moderation in the rate of price increase; but that

expectation of progress against inflation is still a forecast and not an accomplished fact.

Last January the administration set forth a course of economic policy for fiscal 1980 designed to slow the rate of economic expansion and thereby create an environment in which inflationary pressures could gradually unwind. We knew then and we know now that the battle against inflation will be long and arduous.

True, the economy is weaker this year than we expected. We cannot, however, afford to change the basic course of economic policy at the first sign that economic growth is not proceeding along the lines we had anticipated. A premature switch in economic policy from fighting inflation to stimulating a sluggish economy would only feed inflationary expectations and reduce significantly our chances for progress on the inflation front over the long run.

The administration firmly believes that our best chance for bringing inflation down lies in maintaining a steady course of economic policy. The midyear budget update therefore is based on the same basic course of budgetary policy outlined in January. Growth in expenditures is limited and the deficit in 1980 is held down to \$28.7 billion, approximately unchanged from the January and March estimates.

The progress against inflation we hope for next year will not be achieved if past increases in prices were to spill over into wage increases. The squeeze on real wages of American workers has been severe. Naturally, workers want to make up for the loss of real income and will seek to do so by pressing for larger wage increases.

Such an effort, however understandable, would be self-defeating. Costs would simply rise faster and so would prices. The underlying inflation would then worsen, and it would take many years to bring it back down again.

Expectations of American workers must be based on a realistic appraisal of the difficulties our Nation faces. Real wages are declining. But obtaining larger increases in nominal wages will not help. We cannot make everyone whole in the face of large increases in the price of energy and food and low growth of productivity. Bigger increases in nominal wages will not provide real gains for American workers as a whole. They will simply add to the rate of inflation.

Expectations of businesses must also be realistic. Efforts to protect profit positions by raising prices even faster will not avail. They will exacerbate the decline in real wages, increase the pressure for larger nominal wage gains, and thus force up business costs. Profits, as well as real wages will be severely constrained over the next year and a half.

We are in the process of developing standards for wage and price increases for the second year of the anti-inflation program. We are doing so in consultation with representatives of labor, business, and the Congress. We are still some distance from arriving at answers. There is broad agreement, however, that continuation of a program along the general lines laid down last October is needed, and that it will make a constructive contribution to progress against inflation.

In conclusion, Mr. Chairman, our Nation's economy is encountering problems this year that are testing our national will. We face a very difficult period ahead. I am convinced, however, that the American people are prepared to do what is necessary to deal effectively with our two most serious problems, inflation and energy.

As you know, the President has been meeting this past week with leaders from all walks of life to obtain their counsel and guidance on how our country should confront the challenges that face us. He will shortly announce a bold and effective energy program to reduce our dependence on foreign sources of oil and thereby to limit the devastating effect that OPEC pricing actions presently have on our economy.

It is the administration's firm intention to stick to a course of economic policy that is our best hope for bringing down inflation. We recognize fully that modification of our economic policies may at some point be needed to deal with the heavy drain of consumer purchasing power imposed by increasing energy prices and the impact that has on economic growth and on employment.

We also know, however, that an abrupt change in economic policy when economic conditions are still highly uncertain could destroy our chances for progress against inflation. We do not intend to let that happen.

Thank you very much, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Gramley, and certainly your testimony is welcome. It has brought some questions to mind, but I would like to defer those until Mr. Bosworth has testified.

[The prepared statement of Mr. Gramley, together with the attached charts, follows:]

PREPARED STATEMENT OF HON. LYLE E. GRAMLEY

Mr. Chairman and members of the Committee, I am pleased to appear before you today to discuss the Administration's mid-season economic forecast and budgetary update for 1979 and 1980.

My testimony will discuss the sources of the recent acceleration of inflation, why economic growth has slowed this year, the outlook for growth and prices in 1979 and 1980, and the Administration's view on the appropriate course of economic policy.

REVIEW OF 1977-1979

Our economy has enjoyed substantial gains in output, employment, and incomes during the past two and a half years, extending the progress begun in early 1975. Chart 1 attached to my testimony depicts those economic gains graphically. Since late 1976, real Gross National Product has grown 10½ percent. Real business fixed investment has risen twice as fast as real GNP. That is especially encouraging in light of our need for capacity expansion and improved productivity growth. There has been a healthy rise of corporate profits after taxes—even after adjustment for the effects of inflation. Improved profits have helped to provide both the incentive and the financing for larger business capital outlays. Employment, moreover, has grown by an astonishing amount—9 percent, or 8 million jobs. This very large rise in employment, however, has occurred partly because productivity growth has been very weak, and that is an ominous development.

As Chart 2 shows, growth in employment during the first 2½ years has been greater for minorities than for others, but the unemployment rate among minorities, especially minority youth, is still disturbingly high. The current unemployment problem in our country is principally a structural one and the Administration is attempting to deal with it through carefully targeted employment programs. Efforts to solve it with traditional macroeconomic policies would worsen an already very serious inflation problem.

The recovery in our economy from the 1974-75 recession has been much more complete than that of other major industrial nations, as Chart 3 indicates. Output in the U.S. dropped more in early 1975 than it did abroad, but our recovery was much stronger. As a consequence, while the unemployment rate in the U.S.

has fallen to the lowest figure since August 1974, the rate for the other six major industrial countries combined is actually higher today than it was at the trough of the 1975 recession.

RECENT DEVELOPMENTS

Unfortunately, the long and vigorous recovery that we have enjoyed over the past 4 years has come to an end. In the first quarter of 1979, real GNP grew only 0.8 percent. In part, the abrupt slowdown from rapid expansion in the 4th quarter of last year stemmed from adverse weather, but in large measure it reflected a significant weakening in consumer spending and a downturn in housing starts.

Developments in the second quarter indicate that the slowdown has become more extensive and pervasive.

Retail sales in real terms fell $1\frac{1}{4}$ percent from December 1978 to March of this year, and dropped approximately 5 percent further from March to June.

Unit auto sales in June fell 15 percent below May levels. Sales of large domestic cars in June were 40 percent below their level in the fourth quarter of last year.

Housing starts in May were about 12 percent below the average level in the fourth quarter of last year.

Businesses have responded rather quickly to the weakening of consumer spending by adjusting their production schedules downward to avoid an undesired buildup of inventories.

Industrial production in May was no higher than in March, and may well have declined in June because of cutbacks in auto production. This production response will help avoid the weakness later on that would inevitably be created if inventories were allowed to get out of line with sales, but it is adding to weakness in the economy now.

Employment growth has slowed substantially since March.

Payroll employment at nonfarm establishments is still rising, but much more slowly than in the first quarter.

Total civilian employment, as measured by the household sample survey, actually declined a little during the second quarter.

The unemployment rate, however, still remains close to the $5\frac{1}{4}$ percent rate that has prevailed since last fall.

We do not, as yet, have sufficient data to estimate the change in real GNP during the second quarter. It seems likely, however, that a small decline occurred.

SOURCES OF THE CURRENT WEAKNESS

The principal source of the current weakness in our economy is not hard to pinpoint. Consumer purchasing power is being cut back drastically by rapidly rising prices.

Two years ago, prices in the nonfarm business economy were rising at a rate of about $5\frac{1}{4}$ percent (Chart 4). During the year ended in the first quarter of 1979, the rise in these prices was $8\frac{3}{4}$ percent. Most of this acceleration stemmed from a speedup in the rise of unit labor costs. The rise of wages and fringe benefits accelerated only a little, but productivity growth declined sharply.

In recent months, the rate of inflation has accelerated further. Over the first five months of this year, consumer prices (Chart 5) have risen at an annual rate of $13\frac{1}{2}$ percent. Increases have been concentrated in three areas: food—up at almost a 15 percent annual rate; energy, more than a 37 percent rate; and home purchase and finance—an $18\frac{1}{2}$ percent rate. "All other" items have increased at an annual rate of $7\frac{1}{2}$ percent.

These increases in prices have far outstripped the rise in wage rates. During the past year, average hourly earnings (shown in Chart 6) have risen 7.6 percent, and the annual rate of increase since last December has been even less. Real wages have therefore declined sharply. With growth in employment also slowing, and the length of the workweek in manufacturing being cut back, growth of personal income has fallen behind the rise in prices. The consumer has therefore had little choice but to reduce his expenditures.

Long gas lines have added to the problem. Concerns about the availability of gasoline have had a negative impact not only on sales of large cars, vans, recreational vehicles and small trucks, but also on shopping at department stores and on travel. Taxi drivers, florists and cleaners who deliver have lost time and money. Shopping centers in suburban areas and resorts are suffering.

I cannot stress strongly enough the relationship between the energy crisis we face and the current state of our economy. Last December, the OPEC countries

announced a schedule of crude oil price increases that we knew would raise our inflation rate and take a toll on economic growth. Actual and announced OPEC price increases since then have made the situation vastly worse.

Chart 7 shows the drain of purchasing power on the American economy because OPEC prices have risen more than we expected last December. The figures in this chart assume no further increase in *real* OPEC oil prices from now until the end of 1980—that is, they assume that OPEC prices will rise over the next year and a half by no more than the world rate of inflation. On this assumption, the drain of purchasing power from the economy would be about \$40 billion, at an annual rate, by the second half of 1980.

Some of those funds would be respent in the forms of increased exports to OPEC countries, additional investments by oil companies, and expenditures from the energy security trust fund. There is no doubt, however, that a major drag has been placed on the growth of the U.S. economy—a drag that we had not expected when we presented the 1980 budget in January.

Energy prices—and particularly the price of gasoline—have been rising because of tight supplies as well as increasing OPEC prices. Since last September prices of refined petroleum products have therefore risen much faster than the average price of a barrel of crude oil.

In our country, we consume roughly 100 billion gallons of gasoline per year. An increase of one penny in the price of a gallon of gasoline at the pump is thus roughly equivalent to a 1 billion dollar tax increase on the American consumer. During the first 5 months of this year, gasoline prices at the retail level rose by 14¢ per gallon. This increase has imposed a tax on the American consumer roughly equal to the reduction in individual income taxes provided by the Revenue Act of 1978.

A second underlying source of the current weakness in the economy is in the housing sector. The decline in housing sales and starts since late last year stems in some measure from the further sharp increase in home purchase prices and the costs of home financing. In addition, some potential homebuyers are experiencing difficulty in obtaining financing. Inflows of deposits to thrift institutions—the principal mortgage lenders—have declined this year, and mortgage loan commitments at the Nation's savings and loan associations have fallen somewhat. We have, however, avoided the severe drying up of mortgage credit availability that used to characterize periods of tight money, largely because of major regulatory changes that have improved the ability of thrift institutions to bid for deposits. Relaxation of usury ceilings in a number of states has also helped.

OUTLOOK FOR ECONOMIC ACTIVITY AND PRICES

Let me turn now to the outlook for economic activity and prices during 1979–1980.

Consumer spending for large cars and a wide range of other goods and services was depressed in the second quarter by the effects of long gas lines, as well as by other factors. Availability of gasoline has recently improved. With increased oil production from Saudi Arabia likely to improve supplies of gasoline in coming months, the long gas lines of the recent past will, we hope, be only a grim memory. Some improvement in the trend of consumer buying may therefore occur. Nevertheless, consumer spending is likely to remain weak during the second half of the year because the growth of personal income has slowed. Moreover, housing starts are likely to decline somewhat further over the remainder of this year. On the other hand, business fixed investment is still relatively strong, and the weight of the evidence suggests it will remain so. For example, new capital appropriations of manufacturers in the first quarter of this year rose by 15½ percent, a solid increase. Businessmen appear to be planning their capital outlays for the long term; they were anticipating a slowdown in consumer spending, and are unlikely to make major alterations in their capital spending plans because of it.

Exports are also strong. Nonagricultural exports in the first 5 months of this year were up one third in value, and about 16 percent in volume, from a year earlier. Expansion abroad—led by investment—and the effects of the past depreciation of the dollar in exchange markets should sustain the growth in our exports.

It will take some time before the resolution of these divergent trends becomes fully evident. It is clear, however, that the forces of expansion are substantially weaker now than we had expected last January.

Over the four quarters of 1979, we now forecast a decline in real GNP of about $\frac{1}{2}$ percent—with weakness in consumer spending and housing offset by continued growth in business capital outlays and exports. As I mentioned earlier, real GNP probably declined in the second quarter and may fall again in the current quarter. Late this year or in early 1980, growth is expected to resume, but at the modest rate of 2 percent for the four quarters of 1980.

Thus, growth over the two years 1979 and 1980 is forecast to be well below our long-term potential economic growth rate of around 3 percent. Even though productivity increases are likely to be small, thereby helping to strengthen labor demand, the unemployment rate is expected to rise—to 6.6 percent by the fourth quarter of this year, and to 6.9 percent by the end of 1980.

We expect inflation to moderate during the second half of this year. Food prices are likely to increase less rapidly than in the first half, in part because supplies of pork and poultry are improving. The weakness of the economy will lead to reductions in some raw materials prices—some declines have already occurred—and to a squeeze on profit margins, as more resistance to price increases develops. Mortgage interest rates, moreover, are likely to level out relatively soon, so that the increase in costs of home financing should moderate. Energy prices will almost certainly continue to rise faster than other prices, but less rapidly than in the first half of the year. For the year as a whole, the Consumer Price Index is expected to rise by 10.6 percent—less than the 13.4 percent annual rate of the first five months.

Next year, we expect further progress in reducing inflation. However, the expected rise in the CPI during 1980—8.3 percent—is still much too high. Our country is a long way from our national goal of bringing an end to inflation.

The Administration's economic forecast for 1979–80 is similar to those published recently by a number of private forecasting services. It describes an economy that undergoes a brief and mild recession, and then begins a process of slow recovery. The recession is mild because the imbalances typical of some earlier recessions are not present. Apart from stocks of large cars, inventories are in relatively good overall balance with sales. While inventory investment will decline in the second half of this year, a deep rate of inventory liquidation is unlikely. A credit crunch has also been avoided, and therefore housing and other expenditures heavily financed by borrowed funds will not drop sharply.

Two factors are expected to contribute to the resumption of real growth in 1980. First, as the pace of inflation slows, consumer purchasing power will begin to improve, setting the stage for an upturn in consumer spending. Second, interest rates are expected to decline moderately because of a sluggish economy and reduced inflation, brightening the outlook for housing. As these categories of final sales begin to move up, inventory investment will also increase—adding to employment, incomes and purchasing power.

The rate of economic expansion next year, however, is likely to remain relatively moderate. Since inventory liquidation is unlikely to proceed on a large scale this year, inventory rebuilding will provide only a modest stimulus as the economy turns up again. And since the decline in housing this year will be relatively mild, there will not be large backlogs of demand to fill in 1980. The basic problem, however, is that continued high inflation, and particularly the effects of rising energy prices, will continue to dampen the pace of economic expansion.

THE COURSE OF ECONOMIC POLICY

The outlook for economic activity and prices that I have just described is a sobering one. Economic growth in 1979 and 1980 will be slow, much slower than any of us would like. Unemployment will increase significantly. Inflation—while moderating somewhat—will stay at a level that is entirely unacceptable. What should our economic policy be in light of these expectations?

We face a cruel dilemma. If policy actions are taken to offset slow growth and a rising unemployment rate, we will lose some of the gains we expect on inflation. If we tighten budgetary policy to dampen inflation further, we will lower growth and raise unemployment. Macroeconomic policy has no fully satisfactory solution to this dilemma.

Inflation is still our nation's principal economic problem. We do expect a significant moderation in the rate of price increase over the next year and a half. At this juncture, however, progress against inflation is still a forecast, not an accomplished fact.

Last January, the Administration set forth a course of economic policy for fiscal 1980 designed to slow the rate of economic expansion and thereby create an environment in which inflationary pressures could gradually unwind. We

knew then, and we know now, that the battle to defeat inflation would be long and arduous. True, the economy is weaker this year than we expected. We cannot, however, afford to change the basic course of economic policy at the first sign that economic growth is not proceeding along the lines we had expected. A premature switch in economic policy from fighting inflation to stimulating a sluggish economy would only feed inflationary expectations and reduce significantly our chances for progress on the inflation front. The Administration firmly believes that our best chance for bringing inflation down lies in maintaining a steady course of economic policy.

Our international economic responsibilities also require that we continue to give top priority to fighting inflation. Last November 1, we took actions to shore up the value of the dollar in foreign exchange markets by raising interest rates and assembling a large volume of foreign currencies for purposes of intervention. Three of our trading partners—Japan, West Germany, and Switzerland—joined with us in our efforts to strengthen the dollar. Those actions were an outstanding success; between October 30 and mid-May the trade-weighted value of the dollar rose by 11 percent.

During the past two months, however, the dollar has come under renewed pressure, for several reasons. Uncertainties associated with the runup of OPEC oil prices have been one factor. Rising interest rates abroad—while interest rates in the United States have been stable or have declined somewhat—have induced outflows of short-term capital, and thereby also contributed to the dollar's weakness. But a major reason has been that inflation has accelerated more in our country since last fall than it has abroad. If we are to have any real hope of maintaining the value of the dollar in foreign exchange markets, we must not waver in our determination to bring inflation down.

The mid-year budget update, therefore, is based on the same basic course of budgetary policy outlined in January. Growth in expenditures is limited, and the deficit for fiscal 1980 is held to \$28.7 billion—approximately unchanged from the January and March estimates.

Estimates of both outlays and receipts for fiscal 1980, however, have been increased about \$10 billion from the levels estimated earlier. Over half of the increase in estimated expenditures results from the higher unemployment, higher inflation rates, and higher interest rates in our current economic forecast. The remainder stems from a variety of smaller increases, including initiatives under the energy security trust fund and increases in outlays related to the Middle East peace treaty. The increase in estimated receipts reflects revised estimates of nominal incomes, the inclusion of the windfall profits tax, elimination of the real wage insurance proposal, and technical reestimates based on recent collection experience.

Progress against inflation will require, also, that we maintain an effective program of standards for price and wage behavior. We firmly believe that the pay and price standards enunciated last October have been of benefit in holding down the rise of wage rates, costs, and prices. During the past nine months, increases in average wage rates have not accelerated; in fact, the rise in average hourly earnings during this period was less than in the same period a year earlier. And while the rise of prices has clearly accelerated substantially, the acceleration has occurred mainly in areas beyond the reach of the price standards—that is, in prices of food, energy, and the costs of home purchase and financing.

The progress against inflation we hope for next year would not be achieved if past increases in prices were to spill over into wage increases. The squeeze on real wages of American workers has been severe. Naturally, workers want to make up for the loss of real income and will seek to do so by pressing for larger wage increases. Such an effort, however understandable, would be self-defeating. Costs would simply rise faster, and so would prices. The underlying inflation would then worsen, and it would take many years to bring it back down again.

The expectations of American workers must be based on a realistic appraisal of the difficulties our nation faces. Real wages are declining, but obtaining larger increases in nominal wages will not help. We cannot make everyone whole in the face of large increases in the prices of energy and food, and low growth of productivity. Bigger increases in nominal wages will simply add to the rate of inflation.

Expectations of businesses must also be realistic. Efforts to protect profit positions by raising prices even faster will not avail. They will exacerbate the decline in real wage, increase the pressure for larger nominal wage gains, and

thus force up business costs. Profits, as well as real wages, will be severely constricted over the next year and a half.

We are in the process of developing standards for wage and price increases for the second year of the anti-inflation program. We are doing so in consultation with representatives of labor, business, and the Congress. We are still some distance from arriving at answers. There is broad agreement, however, that continuation of a program along the general lines laid down last October is needed, and that it will make a constructive contribution to progress against inflation.

CONCLUDING REMARKS

Our nation's economy is encountering problems this year that are testing our national will. We face a very difficult period ahead. I am convinced, however, that the American people are prepared to do what is necessary to deal effectively with our two most serious problems—inflation and energy.

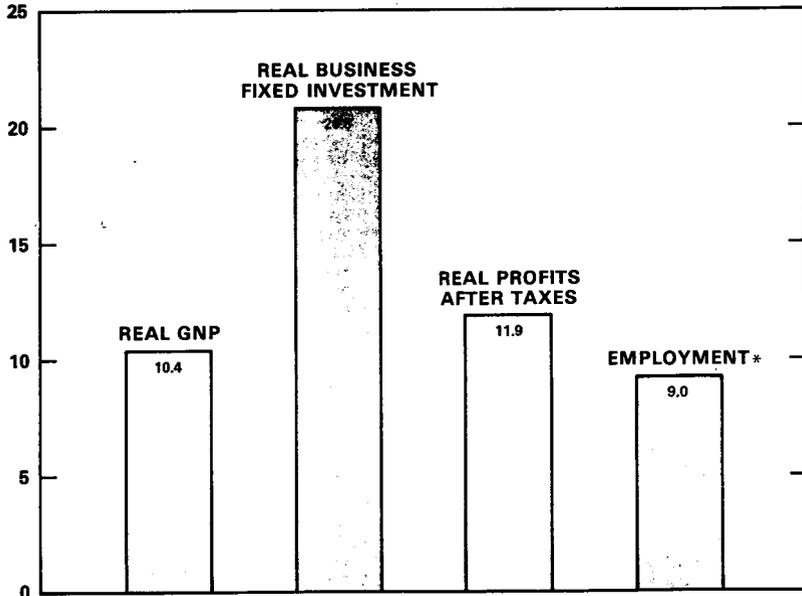
As you know, the President has been meeting this past week with leaders from all walks of life to obtain their counsel and guidance on how our country should confront the challenges that face us. He will shortly announce a bold and effective energy program to reduce our dependence on foreign sources of oil, and thereby to limit the devastating effects that OPEC pricing actions presently have on our economy.

It is the Administration's firm intention to stick to a course of economic policy that is our best hope for bringing down inflation. We recognize fully that modification of our economic policies may at some point be needed to deal with the heavy drain of consumer purchasing power imposed by increasing energy prices, and the impact that has on economic growth and unemployment. We also know, however, that an abrupt change in economic policy when economic conditions are still highly uncertain could destroy our chances for progress against inflation. We do not intend to let that happen.

CHART 1

ECONOMIC GAINS, 1977 — 1979

PERCENT CHANGE,
1976 Q4 TO 1979 Q1

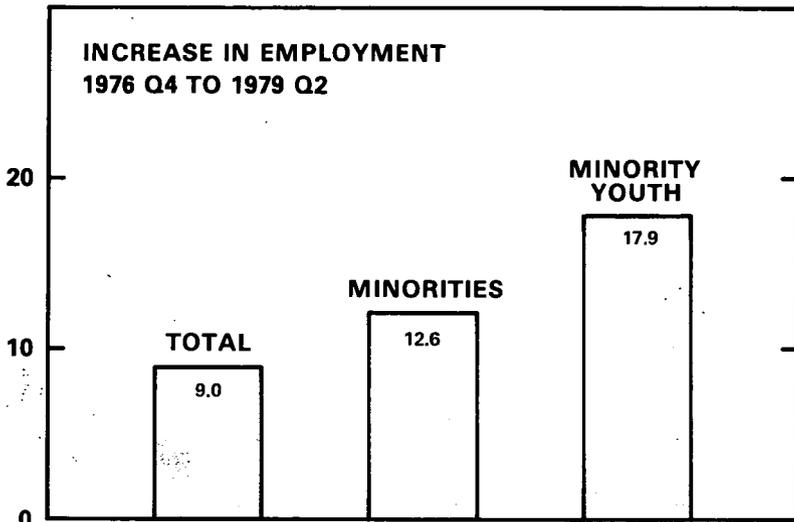


* PERCENT CHANGE FROM 1976 Q4 TO 1979 Q2

CHART 2

EMPLOYMENT AND UNEMPLOYMENT

PERCENT



PERCENT

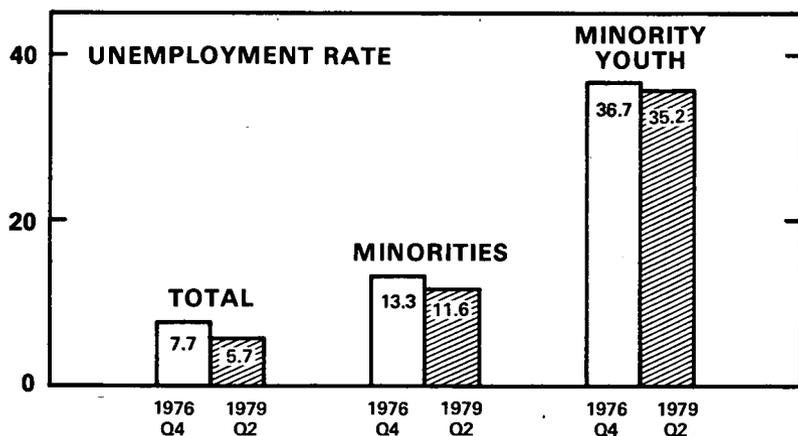


CHART 3

INDUSTRIAL PRODUCTION, U.S. AND OTHER LARGE INDUSTRIAL COUNTRIES

INDEX, 1973 = 100

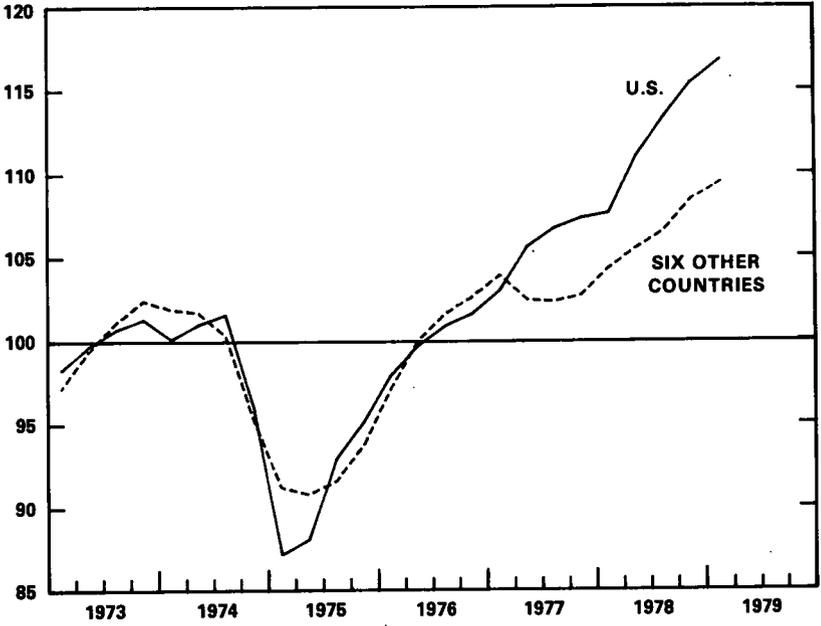
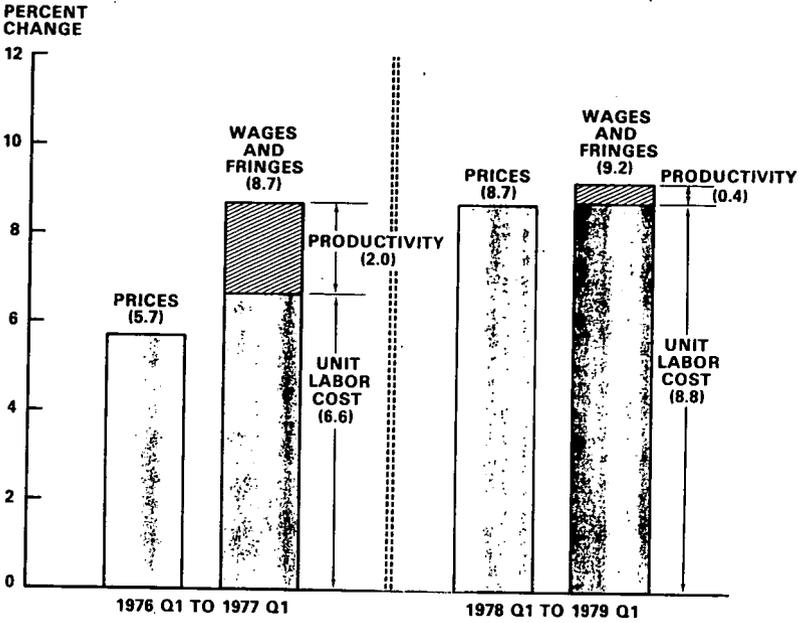


CHART 4

COSTS AND PRICES ^{1/}

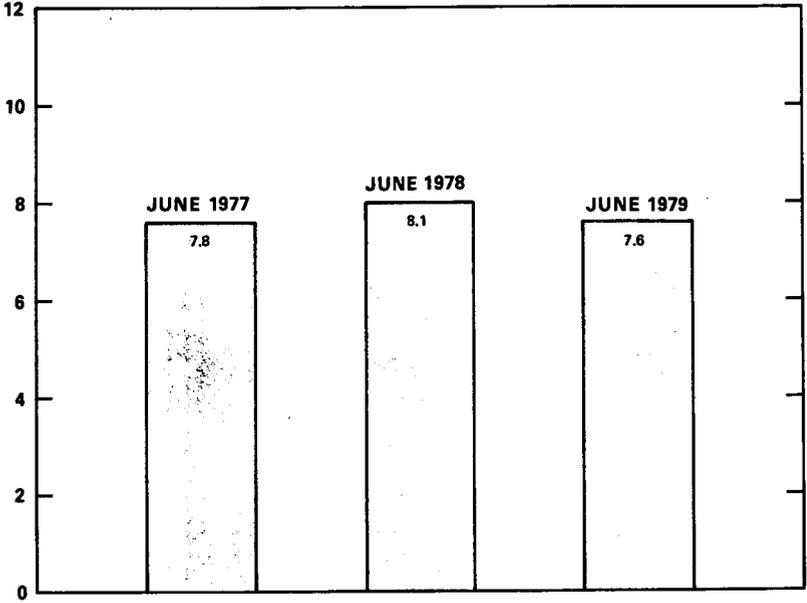
1/ NONFARM BUSINESS.

CHART 5

**CHANGES IN CONSUMER PRICES
(PERCENT CHANGE, ANNUAL RATE)**DEC 1978
TO
MAY 1979

ALL ITEMS	13.4
FOOD	14.7
ENERGY	37.4
HOME PURCHASE AND FINANCE	18.4
ALL OTHER	7.5

CHART 6

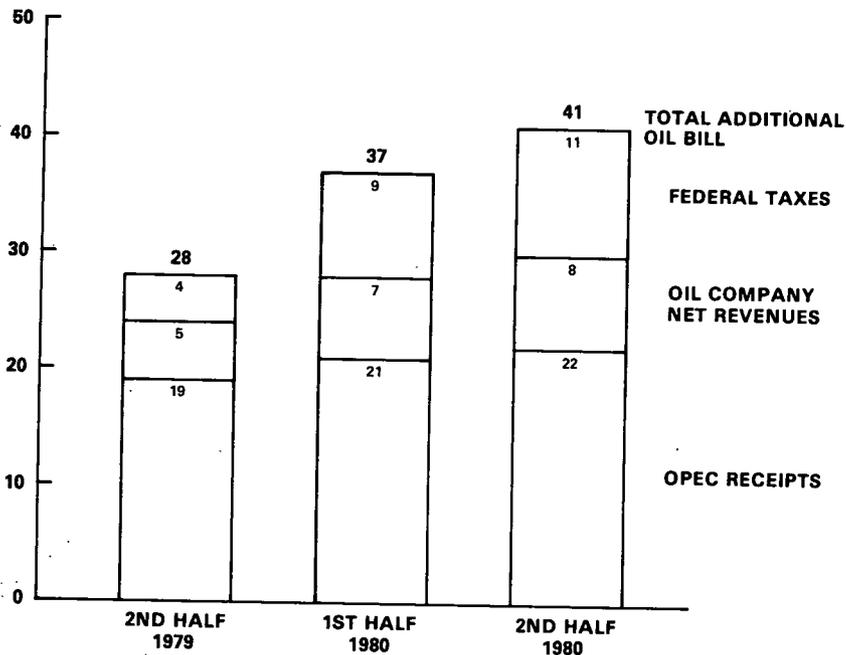
AVERAGE HOURLY EARNINGS*PERCENT CHANGE
FROM YEAR EARLIER

* ADJUSTED HOURLY EARNINGS INDEX.

CHART 7

DRAIN OF PURCHASING POWER BECAUSE OF HIGHER OPEC PRICES

BILLIONS OF DOLLARS,
ANNUAL RATE



Senator BENTSEN. Please proceed, Mr. Bosworth.

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

Mr. BOSWORTH. Thank you, Mr. Chairman.

I have a prepared statement which I would like to insert into the record.

And in order to save time, I would just like to take a moment at the beginning to draw your attention to two tables in my prepared statement.

It is clear that the causes of the current inflation are not simple. And too many Americans are confused by the proposals being made today of ways to deal with inflation.

Yet it is very important that we try to find a better understanding of the fundamental factors behind this inflation if we are going to deal with it in a positive fashion.

But the first point I would like to make is illustrated by chart 12 figure of my prepared statement. This chart takes the increases over about the last 8 years of the Consumer Price Index and shows the influence of different components.

What is startling about the graph is that from the period of economic expansion since late 1975, with some fluctuations, there has been

an enormous acceleration in the rate of increase of consumer price inflation.

Yet almost all of that acceleration of inflation is traceable to three major areas: Food, energy, and home purchase.

The basic industrial sector of the economy, the one where we normally look for evidence of excess wage increases and accelerating excess demand pressures, has, in fact, been measurably restrained.

And the underlying rate of inflation, even today, despite the enormous deterioration in people's relative incomes and the sharp increases in overall inflation, still has not accelerated greatly from where it was in 1976.

But the major cause for concern is to look back to the similar period of 1972, 1973, and then 1974, when this country went through almost the identical experience.

In 1972 and 1973, we also had an explosion of food prices and an explosion of energy prices. And for a period of time, through most of 1973, in fact, there was restraint in the rest of the economy. Wage increases did not accelerate sharply. There were wage and price controls during that period. Most Americans in the industrial sector continued to cooperate.

But in 1974, under continued pressure from enormous increases in energy and food prices, that restraint in the private sector finally broke down. Everyone went out and tried to get his own back, and we had an enormous acceleration, not just of the food and energy prices, but of prices and wages throughout the entire economy.

I think the major risk we run over the next few years is that we could be in for a major acceleration of the underlying rate of inflation, which is now limited to food, energy, and housing purchases, throughout the economy.

The major challenge we face in the year ahead is to try to develop policies and a willingness in the country to share the burden so that this sort of explosion of prices and wages everywhere, does not happen as it did in 1974, and does not necessitate that this country pay the tremendous costs that it paid in 1975 in an attempt to reduce that inflation.

Another way of looking at the contribution that these three factors have made is illustrated in table 6 of my prepared statement.

If you take the period from 1976 to the present, we find that the rate of inflation in this country has accelerated from 5 percent to something over 11 percent annually.

In looking at it, we find food prices went from an absurdly low rate of less than 1 percent a year to over 14 percent a year today. Energy prices went from 7 percent to 33 percent rates of annual inflation in the last 6 months. Home purchase and financing has increased from 3 percent a year in 1976 to 16 percent in the last 6 months.

Yet, since neither food, energy, nor home purchase have heavy labor components in them, and much of the home purchase is financing cost, you find that in the other items of the Consumer Price Index, a vast majority of American business and labor, there has been a very modest acceleration of inflation. From about 6.4 percent in 1976, it crept up last year to about 6.5 percent, and this year it is running somewhere between 7 and 7.5 percent.

In other words, there still has been major restraint shown throughout the U.S. economy on both the part of labor and on most business firms.

And our opportunity to get a major and significant lowering of the rate of inflation is very great if this country can find a way to deal with the problem of food, and energy, and housing. In my view, the three fundamental short-run problems that we face are in trying to deal with those three areas.

And second, we must try to continue to get the type of restraint we have had over the last year in getting people to cooperate with the wage and price standards and other exercises of restraint.

The final chart that I would like to discuss briefly is chart 2 of my prepared statement, which shows the contrasts over a much longer period of time, the sixties and seventies. This is a very striking chart.

We see there has been a very substantial acceleration over this two-decade period of the rate of increase of nominal wages and nominal hourly compensation. In the decade of 1958 to 1968 it averaged something less than 5 percent a year; it has gone to almost double-digit rates of wage increase at present.

Yet real hourly compensation, which is a measure of real improvements in people's standard of living, increased at an annual rate of about 2.7 percent in the 1958 to 1968 period, and it has steadily declined ever since then.

In fact, we have had a decline in real compensation per man-hour in the last 6 months.

Then I'd like you to compare that chart to the striking parallel between that and productivity growth in this country, which has fallen from an average of 3 percent to something in the last 5 years of less than 1 percent a year.

And in the last 6 months, we have actually had a decline of more than a percentage point a year in the rate of growth of productivity in this country.

And what we realize is that improvements in the American standard of living have absolutely nothing to do with the rate of nominal wage increase. In the absence of productivity growth, higher wages simply lead to increased unit labor costs and the cost of production and higher prices and no one in the economy as a whole benefits from that.

If we want to improve the real standard of living of Americans, it is necessary to find some way to turn around this enormous decline in the rate of growth of productivity that has now continued over two decades.

And in the long run, if we are going to focus not just on inflation but rather the real meaning of it, which is deterioration in people's standard of living, it seems to me one of the crucial issues that we have to address is the problem of productivity growth. We need to know what Government can do and what can be done in the private sector to try to stimulate productivity growth.

I would summarize our inflation problem broadly as follows: In the short run the overwhelming problem is what to do about energy prices, the continued uncertainty about food prices, and these remarkable increases in housing inflation the next year or two. We must try to

prevent the explosion of prices that has already occurred in these areas from translating through into the rest of the economy.

And over the long term, we must try to find a way to improve productivity performance in this country so that in fact we can have improvements in real income.

Certainly, if we have to face steady increases in the relative price of energy and food in future years, strong increases in productivity growth can provide room to do so without necessarily implying a decline in everyone's standard of living.

Thank you.

Senator BENTSEN. Mr. Bosworth, I totally endorse that.

[The prepared statement of Mr. Bosworth follows:]

PREPARED STATEMENT OF HON. BARRY BOSWORTH

Mr. Chairman and members of the Committee, I am pleased to appear before you today, on the occasion of this mid-session economics review, to discuss the current inflation situation.

In the first half of this year, the U.S. economic situation has suffered a dramatic worsening because of the inflation problem. The costs of inflation are now becoming vividly evident as the continued drain on real income has brought to an end the economic recovery that had stretched over the previous four years. We now face the ominous prospect of continued high inflation and rising unemployment.

The basic causes of the worsening inflation are not simple, and the wide range and apparently contradictory nature of many of the proposed remedies are confusing to many Americans. Yet, an intelligent discussion of the options for future policy requires an understanding of the basic sources of the current inflation.

I believe that the problems that must be addressed can be grouped into three categories for which the appropriate solutions are sharply different. First, we have a very high underlying rate of inflation, pervading the entire economy, that is fueled by everyone's efforts to catch up with past inflation and their expectations that the merry-go-round of continued high wage and price increases by others will continue in the future. Thus, we are all part of the problem—our own defensive efforts to protect ourselves against the inflationary demands of others sustain the inflation that has built up over prior years.

Second, there are severe special problems in individual sectors of the economy, such as food, energy, and housing, where sharp price surges have recently pushed the overall rate above double-digit levels. These price increases have had a dramatic direct impact on the overall inflation. But their implications for the future are even more ominous if everyone now seeks a higher wage increase from their own employer as a means of restoring these losses of real income. We cannot solve the problems in these special sectors by granting higher nominal pay increases everywhere else. The result can only be a passthrough of those pay increases into higher industrial prices and an escalation of the underlying inflation rate for the overall economy.

Third, the sharp deterioration in productivity growth is seriously affecting our ability to absorb higher food and energy prices without declines in real income and is contributing to the escalation of the long-run inflation trend. Improvements in productivity are the only means of raising the average level of real incomes. Yet, in the last decade there has been a major and dramatic slowdown in productivity growth. We must either develop a means of accelerating productivity growth or we must adjust our expectations and pay practices to a lower rate of growth in real incomes.

In the remainder of my testimony, I will go over some charts and tables that support, in more detail, the above points.

1. PROBLEM AREAS AND THE UNDERLYING INFLATION RATE—SUMMARY

The marked acceleration in consumer price inflation during 1978 and 1979 is almost entirely attributable to explosive surges in *three problem areas: food, energy, and home purchase costs.* (See figure 1 and table 1).

Food prices surged in late 1978 and early 1979, increasing at an annual rate of over 14 percent during the last 6 months.

The long-anticipated (but still slight) moderation in food-price increases in recent months has been offset by the concurrent explosion in *energy prices*, rising at an annual rate of more than 33 percent during the last 6 months.

Also contributing significantly to the overall acceleration during 1978 and 1979 has been the sustained sharp increases in *home-purchase costs*, rising by 10 percent in 1977, 13 percent in 1978, and at a annual rate of 16 percent the last half-year.

The large price increases in these problem sectors have not yet spilled over into the industrial and service sectors of the economy.

The contribution to the overall inflation rate of industrial-commodity and service price increases has not increased significantly during 1978 and 1979.

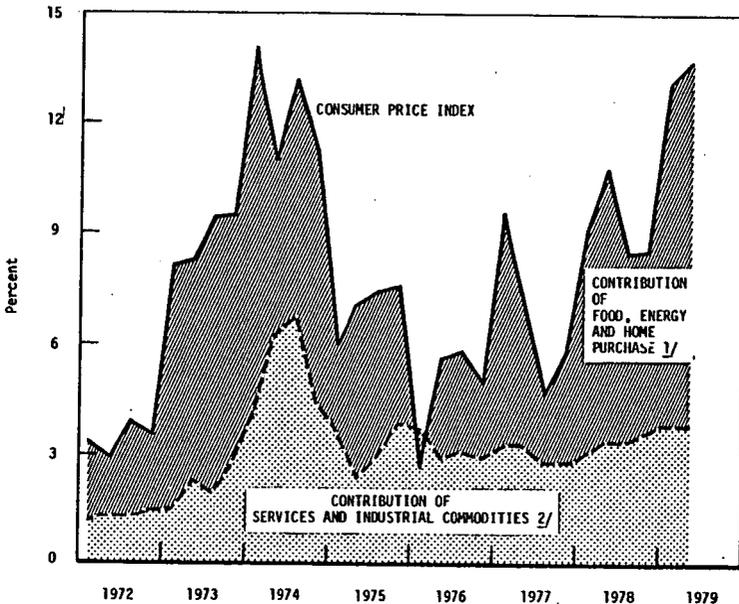
The *underlying inflation rate* (basically industrial-commodity and service prices) has accelerated only slightly, from 5.9 percent in 1977 to 6.5 percent in 1978, and to an annual rate of 7.0 percent over the last six months.

The moderate wage and price increases in the industrial and service sectors, in the face of skyrocketing prices of food, fuel, and home purchase, contrasts vividly with the experience of 1973-74, when similar price surges in these problem sectors caused a ratcheting up of the underlying inflation rate as workers attempted (futilely) to "catch up" with these increases in the cost of living.

FIGURE 1

COMPONENTS OF THE CONSUMER PRICE INDEX

(ANNUAL RATES OF CHANGE)



Source: U.S. Department of Labor, Bureau of Labor Statistics
 1/Food, energy, home purchase, home finance, insurance and taxes, and used car components of the Consumer Price Index.
 2/All other items of the CPI.

In the light of the 1973-74 experience, however, the price surges in the problem sectors are ominous. If workers attempt to recapture the lost income due to the productivity collapse and the food and fuel price increases, the result will be an acceleration in the underlying rate similar to the one that occurred in 1974, followed by a severe recession.

TABLE 1.—COMPONENTS OF THE CONSUMER PRICE INDEX

	All items	Food	Energy	Home purchase and finance	Other items
1976	4.8	0.6	6.9	3.0	6.4
1977	6.8	8.0	7.2	9.8	5.9
1978	9.0	11.8	8.0	12.9	6.5
Last 6 mo.	11.4	14.3	33.3	16.0	7.0
Relative importance (percent).....	100.0	18.2	8.5	19.8	50.4

2. FOOD PRICES

Food-price increases, combined with housing, has been the major factor behind the steady acceleration of inflation during the last four years. The food inflation rate has escalated from a very low rate of less than one percent in 1976 to an annual rate in excess of 14 percent in the last six months (see Table 2).

TABLE 2.—FOOD PRICES
[Annual percentage rates of change]¹

	December 1978 relative importance (percent)	1976	1977	3-Month changes		
				1978	November-February	February-May
Food	100.0	0.6	8.0	11.8	17.3	11.3
Food at home.....	69.3	—9	8.0	12.5	19.5	10.6
Domestically produced.....	57.1	—3.2	5.1	14.2	26.8	10.9
Farm value.....	22.5	—11.8	6.3	22.2	68.3	—5.6
Farm/retail spread.....	34.6	2.6	4.4	9.6	4.8	23.8
Imported.....	12.1	16.5	25.5	5.1	9.9	4.9
Food away from home.....	30.2	6.1	8.0	10.3	14.1	13.1

¹ Annual value changes are December to December.

Source: U.S. Department of Labor, Bureau of Labor Statistics, and Economic Research Service, Department of Agriculture.

Earlier this year, the problem was concentrated in the area of domestic farm prices, which rose to an annual rate of 68 percent in the November-to-February period. Those increases were concentrated in the areas of beef prices (a 30-percent annual rate), where supplies were declining; vegetable prices (326 percent) and fresh-fruit prices (39 percent), where weather factors and a West Coast labor strike had disrupted supplies; fats and oils (76 percent); and dairy prices (15.2 percent).

Recently, these farm-price increases have been reversed, but the benefits have not been evident at the consumer level because of a sharp widening of distributor and/or processor margins.

The aggregate increases in margins exceed the voluntary gross-margin standard; they have increased at a 24-percent annual rate in the February-to-May period, at a 15-percent annual rate since last September, and 14-percent in the last year.

Some expansion of margins would be expected during a period of falling farm prices since retail price changes typically lag behind farm prices, but the current margin growth is larger than would be expected if the lag response were normal.

Moreover, unlike earlier cycles in food prices, distributor margins were not squeezed during the period of sharply rising farm prices.

We can anticipate substantial reductions in food inflation during the next few months since

farm prices will probably decline a little further, and competitive forces should ultimately force a reduction of margins from their current high level.

However, over the longer term the situation is highly uncertain because of the potential for a serious run-up of grain prices.

Export demand has been very strong and is expected to rise further on the basis of pessimistic reports on the Russian and European supply situation.

In the short-run, the impact on prices can be moderated by a withdrawal from U.S. reserves.

Decisions on acreage restrictions for next year's crops will have a dramatic impact on food prices next year, if stocks are drawn down this year.

3. ENERGY PRICES

In recent months, energy has replaced food as the major inflation problem. While we had expected a major moderation of food-price inflation and consequently of the overall inflation during the summer months, soaring costs of energy now require a major reevaluation of virtually all inflation forecasts. At the retail level, energy prices have been rising at an annual rate of more than 25 percent in 1979 (see Table 3). In the last three months, the rate has increased to over 50 percent. Thus, energy costs are rising today at a rate comparable to the post-embargo period of 1973-74.

TABLE 3.—ENERGY PRICES
[Not seasonally adjusted, annual rates]

	December 1978 relative importance (percent)	Average annual rate; 1976-78	1979; year-to- date ¹
Consumer price index:			
Energy	8.5	5.0	25.6
Energy commodities	5.2	4.7	35.3
Gasoline	4.2	4.4	36.9
Fuel oil, coal and bottled gas .....	.9	5.6	30.6
Gas (piped) and electricity	3.3	5.5	11.4
Producer price index:			
Fuel, related products and power	11.0	9.0	38.3
Gasoline	2.7	7.6	51.5
Diesel .....	.4	6.6	70.0
Electric power	2.3	8.3	16.1
Coal .....	.7	6.1	3.5
Natural gas	1.2	30.3	41.4
Domestic crude oil	1.0	6.0	30.1
Residual fuels .....	.7	3.7	66.6

¹ CPI changes are for the period from December to May. PPI changes are December to June.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

Thus far, the increases in posted OPEC prices have been a minor contributor to the overall price rise at retail.

Instead, *major shortages* of crude and refined products drove spot-market prices far above the posted level of OPEC prices.

These shortages resulted from the curtailment of production in Iran at a time when inventory stocks were relatively low.

Much of the increase in prices is the result of a widening of refiner and distributor margins in response to the excess demand at retail.

These increased margins have occurred despite the existence of mandatory controls.

Approximately 3-4 cents out of the 13-cent increase in gasoline prices between January and May can be attributed to higher crude-oil costs.

If this adjustment in prices is accompanied by a sufficient increase in supply to relieve the shortages and reduce spot-market prices to the posted price or below, much of the rise in crude-oil costs will be offset by lower distributor margins.

There will, however, be an upward adjustment of domestic crude-oil prices under decontrol.

If the current tight market conditions continue, the OPEC price increases will add a further 5-7 cents/gallon to gasoline prices by year-end.

TABLE 4.—SOURCES OF CHANGE IN PETROLEUM PRICES

	January to May change	
	Cents	Percent
Average retail gasoline prices.....	12.7	18.3
Tax.....	0.	0
Wholesale/retail margin.....	3.6	48.0
Dealer tank wagon price.....	9.1	18.9
All refined products.....	9.2	21.2
Refiner margin.....	4.5	40.5
Crude and refined product costs.....	4.7	14.6
Crude acquisition costs.....	3.4	10.7
Domestic.....	1.7	6.3
Imported.....	6.3	17.1
Imported refined products.....	5.6	42.9

Note: The current high level of refiner and distributor margins creates considerable uncertainty about the impact of the higher announced level of OPEC prices.

The direct impact on overall consumer prices would approximate two percentage points by the end of 1980.

While gasoline price increases have attracted the greatest attention, the increased costs of *heating oil* will have a dramatic impact on some consumers during the next heating season. Fuel-oil costs

are presently 28 percent above year-earlier levels, and have increased an average of 5 percent in each of last three months ending in May.

4. HOME PURCHASE

Much of the rise of housing prices is a reflection rather than a cause of the general inflation, since consumers view investment in their homes as an effective *inflation hedge*. However, several other factors can be cited.

The *postwar baby boom* has resulted in a current bulge in the age brackets where families attempt to purchase their own homes.

Repeated past efforts to control inflation with monetary restraint have had a disproportionate impact on the housing industry.

Episodes of severe recession have resulted in a loss of capacity in many of the building-materials industries as small producers have been driven into bankruptcy.

Consequently, today those industries are plagued by *capacity shortages* and sharp price increases.

Changes in local zoning laws and other restrictions have led to substantial *increases in-site costs*.

The general rise in *interest rates* has sharply increased financing charges.

The influence of the rise in home-purchase costs is magnified in the Consumer Price Index because the index focuses on the cost of *purchasing* a new home and does not measure the cost of *maintaining* a previously purchased home.

5. PRODUCTIVITY AND LABOR COMPENSATION

Figure 2 illustrates some fundamental and disconcerting facts about the long-term trends within the American economy—particularly about the prospects for the growth of workers' real wages.

Improvement in real incomes does not come from increases in hourly compensation but rather from increases in productivity.

This is reflected in Figure 2 by the parallel collapse of real income growth and of productivity growth.

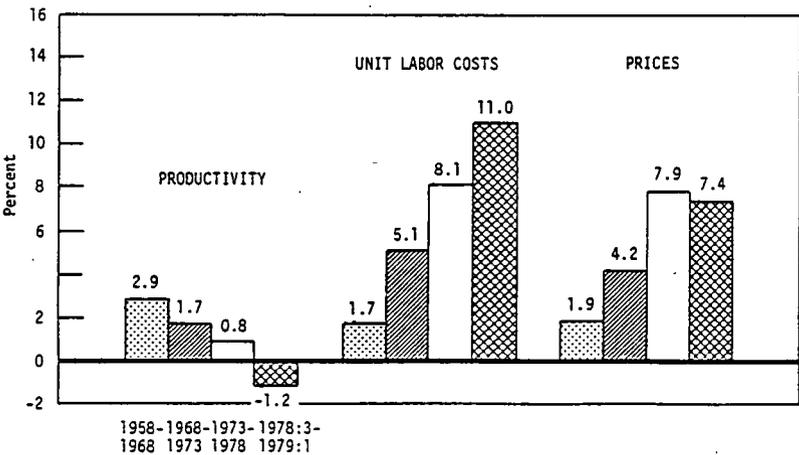
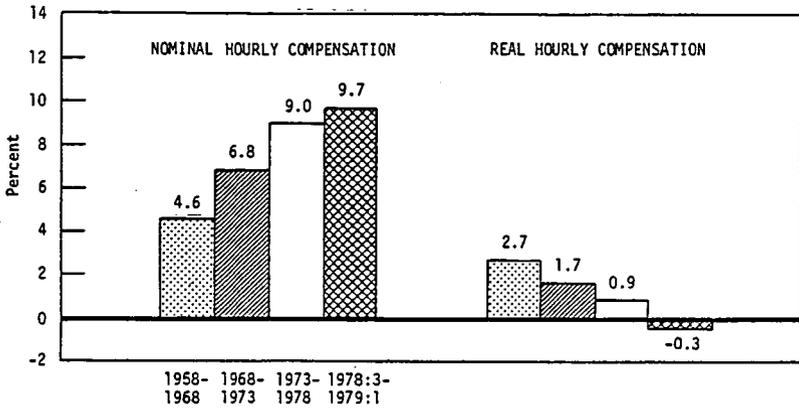
While nominal hourly compensation increases have accelerated, they have simply resulted in accelerating unit labor costs and ever higher rates of inflation.

This acceleration in the inflation rate has more than eroded the apparent gains in nominal hourly compensation, generating the decline in real hourly compensation.

In fact, prices have not increased during the last two quarters by as much as we would have expected on the basis of the rise in unit labor costs. This is shown by the fact that the 1.2-percent decline in productivity over this period has not been matched by a similar decline in real hourly compensation. But what

FIGURE 2

PRICES, UNIT LABOR COSTS AND PRODUCTIVITY
(ANNUAL RATES OF CHANGE)



Source: U.S. Department of Labor, Bureau of Labor Statistics

this means is that profits have borne a relatively greater burden of the recent productivity decline.

Hopes of reviving the growth rate of real compensation depends critically upon our success in reviving the growth rate of productivity.

6. CONCLUDING REMARKS

This review of the current situation leaves me with some reasons to be optimistic, some reasons to be pessimistic, but, mostly, with a great deal of uncertainty about the inflation outlook. If my reading of the situation is correct, there is a grave danger of an explosion in the underlying rate of inflation—similar to that in 1974—as everyone attempts to recoup the losses in real income caused by slow productivity growth and rapidly rising food and energy costs.

Thus far, however, there is no evidence that the price surges in the problem sectors have been built into the industrial wage/price structure. Perhaps there is a better understanding now than in 1974 of the futility of such a response to these problems. Perhaps, also, the pay and price standards have contributed to this enlightenment.

I do feel that widespread compliance with the voluntary standards, except for a few highly visible groups, has helped to prevent a difficult situation from becoming worse. That was not the original objective of the program. The standards were designed to operate in an environment of modest food and fuel price increases, and slow growth in the economy. In that environment the standards would have brought about a gradual deceleration of the inflation rate. Yet, the program does continue to offer the opportunity for future moderation if food and fuel prices increases can be brought under control. The underlying inflation rate for the industrial sector has changed very little from the original projections of the Administration. The developments in food and energy, however, have been far worse than anticipated.

We are, however, encountering strong pressures to relax the standards in the second program year: that is, a pay standard that endorses a worsening of the underlying inflation rate as the price for maintaining continued compliance.

The prospects for bringing the inflation under control in the short run depend initially on our success in

- keeping in place an effective set of pay and price standards,
- taking advantage of the decline in farm prices and adopting rational farm policies that prevent another surge in grain prices, and
- coming to grips with the energy problem.

In the long run, the control of inflation requires that the vulnerability of the economy to extraneous shocks be reduced. This could be brought about, in part, by a resurgence of productivity growth. Thus, as we grapple with the immediate problem of preventing the food and fuel price increases from spreading throughout the remainder of the economy, we should not lose track of a fundamental long-term malady—slow productivity growth. We must redouble our efforts to revive the growth in productivity.

Senator BENTSEN. I have been speaking for a long time about increasing productivity in this country and addressing the supply side. And this committee helped lead the way with its annual report.

This year, every member of the committee signed the report talking about focusing on the supply side.

We are not going to be able to increase the standard of living as we have in the past unless we increase productivity. Every recession we have gone through we have tried to do something about inflation.

In the last 20 years, it has been one where we have ratcheted up and come out of it finally with a higher level of inflation and a higher level of unemployment.

If you are going to continue to give people a chance in this country for a step up in life, it can only be because we have a growing and expanding economy, and that means being competitive in the world on trade, putting more products on the shelf rather than longer welfare lines, to try to beat down inflation, and rather than longer unemployment lines to try to do it.

And we just have to focus in on that supply side.

Mr. Gramley, looking at your prepared statement, you say the administration firmly believes our best chance for bringing inflation down lies in maintaining a steady course of economic policy.

I don't think we are maintaining a steady course, because I think events have overtaken that. We have got some things that have happened, but I don't know anyone that really anticipated the amount that we would see oil prices go up.

We are looking at a situation today where you have perhaps a \$50 billion drag, fiscal drag on the economy. Our social security tax, people being bumped up into another bracket inflationwise.

Really, false accounting on depreciation because of replacement costs on equipment to business. And then the OPEC increase in price. It is a changing condition from the time you set these economic policies.

I said we were going into a recession 1 or 2 months ago, and it appears to be accelerating. I don't see much downside risk to a tax cut, if you have a tax cut.

And I am not talking about an enormous tax cut, but in relationship with the fiscal drag.

If we are talking about a tax cut of \$20 billion, with one-half of it on the supply side and the other one-half to make people whole, in part.

I agree with you, you are not going to be able to make them whole altogether, for the present, at least. And you may avert a very serious recession.

I don't see where you really can contribute to inflation with a \$20 billion tax cut when you have got a \$50 billion fiscal drag, and I think we went into a really serious recession.

I think—I don't want to overstate it, but I think it would be extremely serious for our country.

Mr. GRAMLEY. Chairman Bentsen, I would agree with your diagnosis, that we are facing a situation now which we had not anticipated in January.

Our economy is weaker than we thought it was going to be. OPEC oil prices have gone up a lot faster than we thought. I think those two events are related to one another.

My judgment is that over the long run, sometime in 1980, 1981, I am not sure when, we will need to lower tax burdens to relieve the fiscal drag you are talking about. But I don't think we have arrived at a position yet where we can afford to jump toward tax reductions at the first sign of economic weakness.

Last month, the unemployment rate was down, not up.

Senator BENTSEN. That really did not look like a true picture.

Mr. GRAMLEY. No, it is probably not more than a technical reaction. But we haven't seen an increase in unemployment as yet.

We are facing conditions which we recognize are highly uncertain. We have lowered our forecast. We recognize the possibility that the economy may be weaker than we anticipated, but we would like to see several more months evidence at least before we decide to move.

We will be watching developments very, very closely over the months ahead. If the economy appears to be weakening more than we have anticipated, if it looks like it is going into a very serious recession, then you could be right. Then we will be back talking to you again.

Senator BENTSEN. I did not say we were going into a very serious recession, although one of the witnesses this morning said that it certainly could not be characterized as mild, from his forecast.

But I am trying to avoid that very serious recession, if we can. And I know how long it takes to get some of these programs into being

and some of these tax cuts passed with all the diverse interests fighting for what they think is their share of trying to get well.

Every recession I can remember in the last 25 years, Congress has been late in passing the tax cut. Certainly that was the 1974-75 situation. By the time we got the tax cut passed, we were coming out of the recession.

I just don't see the downside risk, but I sure see some insurance there. And, you know, the President can propose to the Congress, but they are not going to pass it the next day. It is going to take some time to get it done.

I would certainly encourage the administration to be moving in that direction.

The statement was made by one of the preceding witnesses—now, you say that you can't stress too strongly the correlation between the increase in energy costs and inflation, or words to that effect.

Secretary Blumenthal was testifying to that a few days ago. One of the preceding witnesses—I think Mr. McCracken—said that it would be a very pleasant thing to put all of our problems on that, but then he points out the point that Japan and Germany import a much higher percentage of their oil than we import, and said they are not having the same kinds of problems to the degree we are, at least.

How would you respond to that?

Mr. GRAMLEY. Well, I would make two comments, Senator Bentsen.

First, the state of the cyclical process in countries like Japan and West Germany is different than ours. They had a slowdown in economic growth in 1977, and then emerged from it with a much more strongly growing economy.

When the basic forces of expansion are as strong as they are in countries like West Germany and Japan, the effect on the economy tends to be less. But they are suffering, too. They are in the process of revising downward their economic growth rates for 1979 and 1980.

So far as the inflation effect is concerned, both West Germany and Japan are experiencing sharp increases in their prices, much sharper than they were. I think they are experiencing roughly the same kinds of effects as we are.

But we have had our energy price problem compounded by the fact that the cutback in Iranian production has reduced supplies of oil in the United States so much that our markets have been very tight.

As a consequence, we find refined product prices going up much faster since last September than prices of crude oil. That has complicated the inflation problem. It has also made the economy weaker.

Senator BENTSEN. Let me ask you this: Hasn't the overrunning of events here, hasn't it really meant that your fiscal policy has tightened; isn't that the end result?

Mr. GRAMLEY. Certainly, the end result of higher OPEC oil prices is a great deal more fiscal drag than we had anticipated. We are going to have to face that situation.

We think it is premature to move on economic policy now, because as yet we face a situation which we regard as highly uncertain. We see no increase in unemployment yet, and we are facing a very, very serious inflation problem.

We want to give a signal to the American public that fighting inflation is still our top priority. We will move on the fiscal front when it appears to be necessary. We are going to be watching developments very carefully over the months. I think it would be premature to reduce taxes now.

Senator BENTSEN. Mr. Bosworth, you are talking about how labor and industry has done a pretty good job of observing the guidelines. But I think you were posing the difficulty of making them continue to do it.

Do you think we should continue the wage and price guidelines?

Mr. BOSWORTH. I think we should continue the wage and price guidelines. However, we need to do more than just continue them in their present form; we need some additional incentives to try to get people to go along. I think we will find that the support for the standards will erode unless the public is convinced there is some end to this period of restraint, that somewhere down the road things are going to get better.

I don't believe that we can maintain that type of—what might appear to be—endless restraint in declines in real income. I think people will accept restraint on real income, or rather, nominal wage increases and real income only as long as they feel it is temporary.

And I think as part of the comprehensive programs to get the country out of its economic difficulties, that means addressing problems in areas other than the wage price standards. Perhaps we will need to consider various types of means to stimulate compliance with those standards.

Earlier, for example, we were mentioning things like tax cuts. There will be disagreement within the administration over when, but I think whenever those tax cuts come, that it is vitally important that tax cut money, which is limited, be used in a way that will contribute to the maximum extent possible to reducing inflation at the same time.

And that suggests a type of tax cut that either addresses the supply problem or a tax cut that encourages incentives to exercise restraint, or where it has a direct impact on prices.

I don't think, for example, we can just afford to have a general income tax reduction.

Senator BENTSEN. Nor do I, Mr. Bosworth, and I think the American people will tighten their belts and make some sacrifices as long as they can see somewhere down the line that we are going to be able to not have a lower standard of living, but we are going to be able to continue to improve the standard of living of the American people.

Don't you think that one of the things that we are going to have to have is a tax cut that focuses in on some long-term increases in productivity.

Mr. BOSWORTH. Yes. I think the issue is going to be in the timing of it: whether we should do it now or whether we should wait until the situation clarifies itself a little bit more.

For example, in the current situation, given the supply side difficulties and the need to stimulate capital formation, I think we should avoid the type of response we have had in the past recessions and booms which is during the upside, the economy is very strong.

It is always monetary policy that moves toward restraint, and then the moment the economy weakens, we jump in with a tax cut. And we end up inheriting a long and large deficit.

Given that the immediate need is to stimulate capital formation, I would prefer that in this period of beginning to stimulate the economy we try to avoid a severe recession. The first jump should come from monetary policy and not from fiscal policy.

I think the first move in the economy should be a loosening up of macroeconomic policy in the area of an easier monetary policy.

The problem that the monetary authorities, in my view, face right now with trying to do that is they are concerned about the balance of payments situation.

Earlier you asked, for example, why Germany and Japan have not had quite the same worsening of their inflation with respect to oil as we have had. And one of the major reasons has been that oil prices have been denominated in dollars and the dollar has been devaluing with respect to German and Japanese currencies.

Therefore, if there were a way to address the balance of payments problem in this country and get us back onto a sound footing with respect to the competitiveness of the dollar in the international markets, it would relieve the monetary authorities from the need to have high interest rates to maintain capital flows in this country. Then they could address the domestic problem.

I think the crucial issue, the point the President is trying to make, is that we are not going to cure our balance of payments difficulties by trying to ratchet up interest rates another percentage point or so, especially not in view of the huge size of the Eurodollar markets. You cannot settle our balance of payments problems with interest rate adjustments anymore.

What we have to do is address the fundamental trade problems we face, which are overwhelmingly in the area of oil. This country just cannot afford to import oil the way it is.

So that if we could get an oil policy in this country—and maybe one of the worst things that is happening to us is the gaslines have gone away, because it is likely to lull us back into a sense of false complacency.

If we could get an oil policy in this country where we really appear in the eyes of foreigners to be reducing our dependence on foreign oil and cutting our import bill, we would find that the American dollar would be strengthened in the world markets.

It would offer the opportunity for an easing of monetary policy in order to address the problem of capital formation in this country.

Therefore, I would like to avoid jumping into an income tax cut or any other type of tax cut, if first we could possibly work out a means by which monetary policy easing was the first step to bringing this country of an economic slowdown.

Senator BENTSEN. I'm not sure how you do that, but I would like to do it, too.

Congressman Wylie.

Representative WYLIE. Thank you very much, Mr. Chairman. I think I would like to get into that a little more. We all want to do the right thing. Unfortunately there is no real consensus among economists

as to what the right thing is. I'm not necessarily against a tax cut, although I'm inclined to agree with you that it may be premature. I think, rather, that we need to balance the budget first.

Mr. Gramley, you said that the administration was going to present to Congress a balanced budget by 1981. On what basis can the administration predict that it will send to Congress a balanced budget in 1981, in the face of the recession this year and next?

Mr. GRAMLEY. Congressman Wylie, I'm not sure we will be able to. It is still our objective to achieve a balanced budget in 1981 if that's possible. What the President is trying to do now, is to keep his options open so that we can balance the budget if possible. If he can balance the budget in 1981, he will.

However, our commitment has always been to move as rapidly as possible to a balanced budget, recognizing the condition of the economy. The slowdown in our economy has made it much more difficult. If we were to go to a large tax cut immediately, then certainly we would not get there.

Representative WYLIE. What was that?

Mr. GRAMLEY. If we go to a large tax cut immediately, all hopes for a balanced budget in 1981 would be lost. But we're going to have to weigh the facts as they come in, and watch the performance of the economy over the months ahead, and decide whether it is possible to get to a balanced budget in 1981, and decide whether it is desirable to do so.

Representative WYLIE. Why don't we just say we're going to do it, if everybody agrees that it is desirable to come to a balanced budget, and begin at square one. Then, if we have to modify that course a little later on, then say that we have to go the deficit route. But we can't make deficits a way of life, and say we're trying to search for a balanced budget some time in the future. Why don't we just start with a balanced budget and say we will modify it later on if we have to.

Mr. GRAMLEY. I think the answer to that, Congressman Wylie, is that we can't just balance the budget without being concerned about the consequences of that action on the economy.

If the economy were very strong now, if it were projected to be very strong continuing on into 1980 and 1981, then balancing the budget in fiscal 1981 would be relatively easy. But we're looking at a situation now in which the outlook for the economic growth has been much affected by what has happened to prices and particularly energy prices, and we have to take that into account, too, in our fiscal planning.

Representative WYLIE. Well, I also agree with something else you said, and that is you feel the American people—and Senator Bentsen said this—are prepared to do whatever is necessary, if they can sense what is necessary.

I think one of the problems has been that the public is confused over the vacillation of administration policy vis-a-vis the economy and the energy policy. Is that a fair analysis?

Mr. GRAMLEY. I think the American people are uncertain about what the course of economic policy has been and should be; they are uncertain about the events that are facing them in terms of rising prices and the weakening economy.

What I have tried to say in my testimony today is that I do think we need a steady course of economic policy. We may need to do something to prevent a very serious recession, but we're not there yet.

Representative WYLIE. Mr. Bosworth, I thought your chart No. 2, in your prepared statement, was very interesting, and indeed, fascinating. You've said that there is a direct relationship between real hourly compensation and productivity. And it would seem that that might be the case. What does that mean? Are workers unhappy with their wages and they won't work? Is that why they are not producing? How do you interpret that?

Mr. BOSWORTH. No. When we say we should do something about improving productivity growth, it is very difficult even for most economists, who spend a lot of time trying to study it, to offer a solution. If they were to be honest, they don't really know why productivity growth in this country has declined to the extent it has, and there is a great deal of uncertainty even about the impacts of different policies and what they would do to it.

But the notion that American workers don't want to work anymore, for example, is one that you commonly have. People cite surveys saying they don't like their jobs. There have been efforts to try to do that in the past, with surveys back around 1900. If you asked people if they didn't like their jobs, and asked them in the 1940's and they didn't like the jobs, and you ask them today and they don't like their jobs. Most people would rather not work if they didn't have to.

Representative WYLIE. I'm not sure that's right.

Mr. BOSWORTH. I don't think there's been much change in worker attitudes toward job performance. Most of the decline—

Representative WYLIE. Do you really think most people in the United States would prefer to work if they didn't have to?

Mr. BOSWORTH. Basically, at the type of jobs they're now doing, yes. That is why they get paid for them. If we thought everybody liked working, we could do away with wages. But I would say a lot of people like working, given the wage rate they earn. But the point is that most of the studies did not indicate a change in workers' attitudes. That would seem to be an important contributor to the slowdown in productivity growth. In the 1970's there has been a big decline in capital formation in this country. Part of the decline in productivity is actually just a measurement problem.

We had rapid growth of productivity in the fifties and sixties in part because we were improving measured productivity performance by destroying some elements of the environment. We were not paying for the pollution that we were putting out.

Today, we are trying to reduce pollution. We pay for more of reducing pollution, and that does have the effect of slowing the rate of growth of productivity. There have been demographic changes in the labor force. Then there is just this big remaining component—when somebody asks you, why does Germany have a faster rate of growth in productivity than the United States, nobody is too certain, fully, what the reasons for that are.

Representative WYLIE. What are your projections for the cost of heating oil for this winter? I am being asked that more and more. Will there be an adequate supply? Have you really had to make a prognosis on that?

Mr. BOSWORTH. I would guess that when you look at the aggregate supply and demand, I don't think the problems for home heating oil this winter will in fact be shortages in quantities.

The problem for home heating oil which very few people seem to have fully realized yet, but will realize when cold weather comes, is what they're going to pay for it. There has been an enormous increase in home heating oil prices. The percentage increase is going to be far larger than the increase in gasoline prices, and it is going to have a remarkable impact on some people's budgets this winter.

I think the problem this winter will not be shortages. The problem this winter is going to be price, and what people are going to have to pay for it. A lot will depend upon the Department of Energy regulations because I think increasingly both in the area of home heating oil and in the area of gasoline, it is becoming more and more clear that the fundamental problem with these shortages that we've been experiencing is our own regulatory practices, rather than anything inherent in the nature of the oil industry.

Representative WYLIE. Well, why don't we do something about it, and if it is our own regulatory practice, why don't we repeal some regulations?

Mr. BOSWORTH. That is a good question. One problem is just trying to figure out what the effect is of the current regulations—which most people, including myself, can't understand when they read them. Therefore, what change to make to get a different effect is not clear.

We're in the business of trying to regulate something where the regulations have grown to the point that they're not understandable by any single person any more. We don't know what the effects of them are, and there are wide divergencies of opinion over what to do about them.

Representative WYLIE. Well, except that Secretary Blumenthal said almost the same thing you did when he was here Tuesday. We need to get rid of some of our regulations, or modify them.

I would suppose that there are at least two people in the administration who feel that way. Maybe we could find some more. Maybe we could get a consensus. I have asked a question here a little earlier of Mr. Evans and Mr. McCracken, which I would like to put to both of you, about the Congressional Budget Office's economic outlook—I think this is important—which assumes that the price of imported oil will increase to \$20 per barrel in July of 1979 and rise thereafter at a rate that is 3-percent higher than the rate of inflation.

Now, this rate is lower than the rate of increase in the price of imported oil during the past 5 or 6 years, and it is much lower than the rate of increase during 1979. What would be the economic outlook for the four calendar quarters of 1980 if we had an oil price increase of 50 percent in the autumn of 1979, which increased the price of imported oil to \$30 a barrel? I realize that you may not be able to generate an accurate quantitative answer to that, but I would like your opinion because I think a price increase is a real possibility in view of what has been happening in the recent past.

Mr. GRAMLEY. I can't give you any numbers, Congressman Wylie, on what an increase of that magnitude will do, but I certainly would say that the outlook for the economy would be dismal, both from the standpoint of real growth and from the standpoint of inflation.

I doubt seriously whether the OPEC countries could get away with that large an increase because it would mean such a severe blow to the Western economies as a whole; I doubt that the markets would clear at those prices. So I think they are going to be restrained in their actions in the future by the magnitudes of increase that are already in place.

Those increases are generating reductions in demand for gasoline and other products as consumers try to rearrange their budgets and live within their means. It is slowing growth here and abroad. It is a painful process, but that is the way the markets for oil work.

What we need to do to reduce these effects on our economy in the long run is to increase our energy independence, and I think the President's statement this weekend will address that issue.

Representative WYLIE. I could not agree with you more. That is the bottom line. We need to increase our energy independence. So far the OPEC nations haven't indicated a desire to take into account the economic situations in the rest of the world. Thank you.

Senator BENTSEN. Thank you very much, Congressman Wylie. Senator Sarbanes?

economy goes soft, really soft, wouldn't that contribute more than any other single factor to a sharp increase in the size of the deficit?

Mr. GRAMLEY. Yes; it would. A substantial weakening in the economy would raise expenditures for unemployment benefits and social security benefits, as well as reducing revenues; it would have a very substantial effect on the deficit.

Senator SARBANES. So to refrain from taking measures of fiscal stimulus designed to keep the economy from going soft on the grounds that you want to get it to move—that you want to move to a balanced budget first—might, in fact, in practice, produce far larger deficits than would otherwise be incurred by following the fiscal stimulus approach. Isn't that correct?

Mr. GRAMLEY. I don't believe it is, Senator. I don't know of any way you can reduce taxes or increase expenditures and get so much economic growth as to avoid having any increase in the deficit.

Senator SARBANES. I did not say any increase. I'm contrasting that increase in the deficit with the increase caused by the economy going soft.

Mr. GRAMLEY. Well, the economy going soft will clearly increase the deficit. If you at the same time add tax reduction you would expect the deficit to be still larger. Not a lot larger, but somewhat larger.

I think the appropriate course of action is to wait and see how developments emerge over the next several months to see if we really face that kind of economic softening. If we do, then we may be forced to take action to try to prevent a deep decline in economic activity, but we are not there yet.

Senator SARBANES. Well, what about holding a course and getting a balanced budget and not taking any action? Where would that lead you?

Mr. GRAMLEY. It depends very much on where the economy goes.

Senator SARBANES. Well, that's right. If the economy is going soft, where would that lead you?

Mr. GRAMLEY. Well, if the economy is softer than our projection indicates, if we have more economic weakness, that in itself would lead to a larger deficit.

We would respond to that, depending on whether or not we thought the economy was slipping into such a severe recession that it needed fiscal help. We fully intend to watch the indicators quite closely over the next few months to see if such action would be warranted.

Senator SARBANES. You really want a balanced budget in the context of a balanced economy, don't you?

Mr. GRAMLEY. That's correct.

Senator SARBANES. And you would not advocate a balanced budget as a first and foremost goal, regardless of whether that was going to take place in the context of a balanced or unbalanced economy, would you?

Mr. GRAMLEY. I would agree that a balanced budget is a means and not an end. What we want is adequate economic performance.

Senator SARBANES. In fact, if you balance the budget, but unbalanced the economy, you will in fact, end up with a severely unbalanced budget; will you not?

Mr. GRAMLEY. That is a possibility, yes.

Senator SARBANES. Now, on the fiscal stimulus question, I understand your position that you don't think it is needed. You think you may be able to stay on course and avoid a major downturn. Is the administration considering as part of a fiscal stimulus—and I'm not advocating this; I know it is heresy even to mention it, but it seems to me you have to consider all options—further spending or investment in certain Government programs? Let me give you some examples. Only the day before yesterday, in testimony before the Foreign Relations Committee with respect to SALT, the Joint Chiefs were very insistent on making the point that we have been grossly deficient in our expenditures on military investments, and the balance vis-a-vis the Soviet Union in very important areas has suffered correspondingly.

Second, there are newspaper reports—and I'm now addressing the arguments that you're making about the energy/food sector contribution to the problem of inflation—that the President is being constrained from doing what perhaps should be done in the energy field because some of the moves advocated by some advisers involve governmental expenditures, and that creates a problem with respect to the budget position you're trying to hold to.

Where food is concerned, I am concerned that curtailed Government approaches, either in terms of investment in storage facilities or the underwriting of storage done through the private sector, or a restraint in terms of what you are prepared to entertain in Government support prices, may be counterproductive.

If you seek to encourage production, and world conditions develop in such a way that you are left with a problem of support, and to avoid that situation you seek an acreage set-aside—to save money in the budget—you may not, in fact, contribute to solving the inflation problem in the food area.

In other words, I'm suggesting that perhaps we should put a little more money into food storage, and take a greater risk on the support side to encourage production, so that when we hit a year like this one,

when it appears there will be a strong grain demand because of conditions abroad, we are in a position to respond to that strong demand without creating inflationary pressures on domestic grain prices. This would also benefit our balance of payments. So the question is, everyone when they talk about fiscal stimulus are too often framed only in terms of tax cuts. Then we get into the argument over what the shape of the tax cut should be. If a fiscal stimulus were to prove necessary, investments of the sort we're talking about might, in fact, be called for by a careful evaluation of our national interest.

Mr. GRAMLEY. Senator Sarbanes, we're a long way from getting to the specifics in terms of means to stimulate the economy. As I've indicated to you, I think our present course of policy must be a steady course of economic policy. As a general principle, I think the history of our efforts to use increases in government spending as the short-run economic stabilizer indicates that that is not the way to go.

In general, what happens when you try to stimulate an economy out of a recession with increasing Government expenditures is that it takes so long to get those expenditures on line, that the weakness you're dealing with is behind you by the time those increases and expenditures begin to take effect upon the economy, so they end up complicating your problems of inflation later on.

I think if we have to go in the direction of fiscal stimulus, a very heavy emphasis ought to be placed on the tax route rather than the expenditure route, and I would agree with Mr. Bosworth that what we need to do, if and when we have to cut taxes, is to consider how we can increase supply and how we can encourage a continuation of restraint on the part of the American worker insofar as his nominal wage increases are concerned.

Senator SABRANES. Of course, with that course of action you are over time continually giving away your tax base, and therefore you don't have the underpinning. I'm not necessarily accepting the arguments being made, but I am trying to probe your thinking on them. The military people are very strong in making the argument that they are now suffering so badly that the balance has shifted.

The argument is being made in the energy area that we're not doing what we ought to do because we're not prepared to have the Government make the necessary expenditures. I've outlined this scenario in the food area, and yet, every time we get a softening in the economy, we go the tax cut route. We give away part of the tax base. Then the base is not sufficient, as we move back toward prosperity, to give us revenues to move forward, because we never move to a sufficiently high level of prosperity. It's a vicious circle.

When we were at 5.8 percent, we were prepared to entertain going to 6.9 percent unemployment, which I find, again, astonishing. We're just putting yourself into the vicious cycle. All I'm suggesting to you is that, in considering the question of fiscal stimulus, you ought to consider the whole range of possibilities including whether we need, to invest in some of the areas I mentioned, some of which might be very productive in meeting inflationary problems that Mr. Bosworth was talking about.

Mr. Chairman, I know my time is up. If the witnesses could respond, I would appreciate it.

Senator BENTSEN. Of course.

Mr. BOSWORTH. I think some of the problems are certainly on the expenditure side. You can point to a lot of supply type expenditures, things that would aid inflation, your agricultural stock reserves, and things like that are part of it. The issue, though, is that they're very unlikely to coincide with wanting to make those expenditures at the same time the economy happens to be going into a recession. The timing would probably be wrong. Like now, it is too late to start talking about building bigger grain reserves. The threat is on us for this next year. We should have done it 2 or 3 years ago.

Those expenditure decisions, in my view, ought to be made, in some respect, not necessarily with the notion of balancing the budget, but in terms of whether they are worthwhile social things to do. Defense spending has to trade off against other Government spending, and the same is true of agriculture. It has to trade off with private spending. The problem with expenditures, once you are in a recession, and say, let's modify them now, is the lag in the time it takes to initiate the new expenditure program.

Usually, it means that the timing of it occurs at the wrong point.

The needs on the expenditure side to stimulate supply seem to me to be long-run needs like agricultural policy, agricultural reserves. Those are continuing expenditures, year after year. They are not the sort of things that can just be turned on and off. Defense spending can't be turned on and off without involving a great deal of waste.

I think the usual reasons for advocating tax cuts are the cyclical phenomena as opposed to the long-run approach—simply that private spending can be adjusted more quickly than Government spending, with less waste involved.

Senator SARBANES. Well, Mr. Chairman, I think there is a lot to that argument, but I think we are causing a vicious cycle here. If we go to tax cuts every time we get a softening that erodes the tax base, when you move back into a period of prosperity, you won't have the resources to meet these needs, given that we have the objective of moving toward balancing the budget.

Therefore, you're constantly caught at a level below what you ought to be doing in terms of meeting some of the important needs, including needs that would impact very positively, or could impact very positively, on dealing with the inflationary question.

Mr. GRAMLEY. May I just follow up with a brief comment, Senator Sarbanes? I have a table before me which shows effective tax burdens, and by that I mean the ratio of individual income and employee payroll taxes as a percentage of personal income.

In fiscal 1979, the figure is estimated to be 14.4 percent. That is the highest for any fiscal year during the period covered by this table, which is from 1955 to the present. If taxes were unchanged between now and 1984, the ratio would go up to 17 percent. Those are historically very, very high tax burdens.

I strongly believe that the way to go, in terms of planning for the longer term, is not to encourage a still larger part of our individual incomes to be drained off into taxes to be spent by the Federal Government. It is to allow the private sector to be the source of economic expansion, and I think we ought to hold a very tight reign on expenditures.

That doesn't mean there isn't room for particular initiatives of the type you're talking about. In the energy area, we have planned presently a very large increase in spending from the energy security trust fund from \$1.4 billion in fiscal 1980 to \$10 billion in 1982.

It may well be that the President will see fit to take further initiatives in the energy area. I don't know what his final decision is going to be. I'm certainly not qualified to determine whether or not we ought to spend any more on defense; that is just not my area. We can't rule out the need for particular expenditures, but as a general matter, it seems to me the way we ought to go in the longer term is to rely on the private sector for growth and to recognize also that we've got a very, very heavy tax burden on the American people right now.

Senator BENTSEN. Thank you very much, Senator Sarbanes and Congressman Wylie.

Thank you, gentlemen, very much for your testimony.

The committee stands adjourned.

[Whereupon, at 11:35 a.m., the committee adjourned, subject to the call of the Chair.]

