THE 1980 ECONOMIC REPORT OF THE PRESIDENT

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BEFORE THE

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THE 1980 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, JANUARY 30, 1980

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

The committee met, pursuant to notice, at 10 a.m., in room 318, Russell Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, Javits, Roth, McClure, and Jepsen; and Representatives Bolling, Reuss, Long, Mitchell, Brown, Heckler, and Wylie.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Richard F. Kaufman, assistant director-general counsel; Charles H. Bradford, minority counsel; Kent H. Hughes, George R. Tyler, and Bill Maddox, professional staff members; Stephen J. Entin, minority professional staff member; and Betty Maddox, administrative assistant.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

When I think of energy, and that is something which is concerning all of us these days, I first think of the need to cut the volume of oil imports by increasing our domestic production of energy.

We are striving for energy independence, but have found it a pretty slippery road, even with substantial efforts to conserve energy use. We will still need to import as much as 6 to 8 million barrels daily by the middle of this decade, if we are to return to an economic growth rate of 3½ to 4 percent.

I certainly want to see the growth rate go that high in the next few years; we drastically need that level of growth to meet our employment goals and to provide hope to Americans for a rising standard of living.

Oil imports meet 23 percent of our domestic energy demand. That figure won't change much in the next 5 years.

A third of that comes from the Persian Gulf; worldwide, Saudi Arabia, Kuwait, Iraq, Iran, and the UAE supply about 60 percent of the free world's oil supply.

That supply, a supply the free world must maintain, is jeopardized by the Soviet invasion of Afghanistan and its growing influence in North and South Yemen, as well as by the continued turmoil in Iran and domestic unrest in Saudi Arabia.

The flow of Persian oil is vulnerable to disruption and we don't seem able to respond quickly. For example, Saudi Arabia has a ground force of only 30,000 men, and an air force of about 8,000 to protect their oilfields. American military forces are 8,000 miles away from those oilfields. But Russian occupation troops are only 500 miles away, and Soviet aircraft only minutes away.

In fact, the growing American national security interests in the Persian Gulf make one feel, Mr. Secretary, that we really ought to have, in addition to you, the Secretaries of Defense and State here today.

It's absolutely critical, Mr. Secretary, that we cut imports and that we cut them quickly. We must also quickly put in place an emergency response program designed to ameliorate the impact of an oil embargo, a program to include standby gas rationing, a full strategic petroleum reserve, and emergency steps to conserve oil.

Mr. Secretary, I want to draw your attention to this chart portraying the levels of dependence on Persian Gulf oil by the major industrialized nations. I see that approximately one-third of all U.S. crude oil imports come from the Persian Gulf. Germany receives 38 percent, Canada, 50 percent, Italy, 63 percent, and Japan, 68 percent. And the highest is France with 74 percent of its crude imports coming from the Persian Gulf.

Then I look at a situation like our grain embargo and the Olympic games boycott—our Nation asking these other nations at least to help us send a message to the Soviets. And I notice that the French have already accepted the invitation. Now it seems to me that we have a deep concern about what is happening in the Persian Gulf. And yet, some of our allies have—or should have—an even more serious problem. And yet, we are having a tough time getting them to help us reduce the instability of oil supplies and prevent an interruption in the flow of oil from the Persian Gulf. They are much more dependent than we are, percentage-wise, yet they are being awfully slow to respond to our call.

It is a difficult thing to understand how we have not been able to get the kinds of commitments we should from them, why their self-interest isn't even more apparent than our own, and yet they are acting seemingly against their own national self-interest.

Mr. Secretary, before you answer that, and I very much want to hear your response to that, I would like to defer to the ranking minority member here for any comments he might have. Senator Javits, would you care to comment?

Opening Statement of Senator Javits

Senator Javits. Well, Mr. Chairman, I think the moment of truth has arrived for our allies. And I believe that however any of us may feel about it—and I hope this message is getting across to them—I don't think the American people are going to understand if they don't join with us in securing these oil sources against the danger of Soviet control. And they don't have to do it by having troops occupy the oilfields of the jugular vein of the world, which is in the Persian Gulf.

Then I don't believe that the American people are going to be very sympathetic to a lack of world cooperation. And we may see a situation where the Soviets' dearest dream of victory, which is the shattering of the Western alliance, is made possible by the failure of the Western alliance itself to seek to protect its interests in concert.

And we are certainly willing to lead and to give the most help to preserving our own vital interests.

I think the chairman, speaking as he has and analyzing these figures, has pointed out the key foreign problem of the United States: Will our allies act with us exactly like we do in NATO when our vital interests are even more directly affected than any real threat from Eastern Europe is to Western Europe today?

Senator BENTSEN. Thank you, Senator.

Mr. Secretary, we cannot even get some of our allies to act on the Olympic games boycott, much less on the question of limiting the transfer of technology and technical information that's very valuable to the Soviet military effort. And, their reluctance exists in the face of a much heavier dependence by many of these nations on Persian Gulf oil; they should have an even greater concern about the interruption of that oil flow than the United States.

Mr. Secretary.

STATEMENT OF HON. CHARLES W. DUNCAN, SECRETARY, DEPARTMENT OF ENERGY, ACCOMPANIED BY WILLIAM W. LEWIS, ASSISTANT SECRETARY FOR POLICY AND EVALUATION

Secretary DUNCAN. I've got a short oral statement and have submitted a prepared statement for the record. I thought I'd forgo reading that. But, if you prefer, I'll defer even this, and just answer some questions.

I thought first that I might introduce the gentleman on my right, Mr. Bill Lewis. He's the Assistant Secretary of Energy for Policy and Evaluation.

I'll be guided by your judgment, Mr. Chairman. I'll give a short statement, if you wish, or I'll just try to respond to the questions.

Senator BENTSEN. Why don't you just give us a summation of your prepared statement, if you can, Mr. Secretary.

Secretary DUNCAN. All right.

We enter the decade of the 1980's, as you suggest, overly dependent on foreign oil. That's not just the problem of the United States, as your chart reflects; that's a problem of the industrialized world, and you might say the world at large.

There are obvious economic ramifications from that overdependence. You don't have to think very long before you think about the national security implications of that overdependence.

It's an empirical fact that the world is running out of oil, that we are going to be forced to make a transition from an oil-dependent economy to an energy-diversified economy.

The issue is: Are we going to manage that transition in the right sort of way, or are we going to let a continuing series of crises develop, the most grotesque example of which is the current situation in Iran, which will tend to manage us.

We have got to manage this transition and we have got to manage it in concert with our allies.

If you look at the last 13 months and what the cost of imported oil has grown to, you get a very bleak picture. In December of 1978, the average cost of oil was about $13.50 per barrel. That, as of last week, had grown to an average of about $27 per barrel, and, of course, there have been some actions taken by certain of the producing countries this week. The point is that the level of production and the prices charged for that production are beyond our control.

It's my judgment that Americans are accepting the reality of the situation to an increasing extent, to a greater extent than even a few months ago. They are not trying to point at a villain. They are not trying to point at any one group of people or any one country and say that that causes the problem.

I think there's an increasing understanding of the fact that we are in a transition away from overdependence on oil into an energy-diversified economy.

We are fortunately an energy-rich country; we're not an energy-poor country.

The bill that we'll be paying for oil in the next year, if you consider the actions taken by the OPEC countries at Caracas and only those actions, because we cannot project accurately or with certainty what the situation might be for the total year with respect to prices, or the total year respecting supply, the numbers indicate that we'll be paying an oil bill in excess of $83 billion, just given today's information.

Now the impact of that on the inflation rate, the impact of that on the CPI, the impact of that on the value of the dollar, the impact of that on our industrial growth are just obvious.

We don't need to belabor the points.

For the next 5 years, we're going to continue to be heavily dependent on oil. We have no option. We've got to emphasize conservation. The world at large will be dependent on oil for about 60 percent of its energy requirements.

That means that we've got to emphasize conservation. The thing that's most available to us in reducing the need for imported oil is conservation. This will be particularly important in a 5-year time frame.

If you're looking at a 20-year transition, and I think we are, I think we've got to constantly remind ourselves of the fact that this is a long-term transition, this is a long-term management problem, this is a long-term foreign relations problem.

It's not something of a year or two duration.

When you look at the time frame between 1985 and the year 2000, I think you'll see a move away from an economic system that's so dependent on oil to one that relies more on coal, more on coal-derived synthetics, on solar technologies, oil shale, unconventional gas, nuclear power, and so forth.

Beyond the year 2000, I think we'll move further in the direction of renewable energy resources, sophisticated photovoltaics, advanced nuclear technology, fusion, and the like.

But I reemphasize that it's very important that we think of this in terms of a 20-year transition, not as a short-term matter.

It's my own judgment that market forces have got to be a major factor in bringing about this transition successfully. We've got to depend heavily on new energy technologies, and that's largely the responsibility of private enterprise.

But the Federal Government has a very important and a very substantial role to play. We have got to provide a stable commercial and regulatory climate. We must not overregulate industry.

In fact, we have a careful review underway right now to see what regulations we can eliminate, to see which regulations might have outgrown their usefulness.

In my judgment, it is important, Mr. Chairman, as you said in your opening comments, that we proceed with the filling of the strategic petroleum reserve. I think that's very important.

We have to encourage imports of conventional energy, particularly oil and natural gas, from Mexico and from Canada.

I think the congressional initiatives that are now emerging from the Congress, the Energy Mobilization Board and the Energy Security Corporation, are very appropriate and very necessary, and I'm very encouraged by the progress of that legislation.

In conclusion, I'd like to stress once again, perhaps at the risk of being overly repetitive, that this transition from an oil-dependent economy to an energy-diversified economy is a long-term proposition.

We're looking at a 20-year pull on this. It's going to represent a joining of national resources and resolution on a scale that we have never attempted in peacetime.

There are no shortcuts. There are no technological miracles. There's no quick fix, no quick solution that's going to make this transition easier or shorter or less demanding.

It requires the closest possible cooperation between the private sector and the public sector, and it's an issue where we're going to have to emphasize both supply and conservation.

We've got to do what we can to increase supply, in the conventional sense, and also in the unconventional sense. We've got to emphasize and stress continually the importance of conservation.

This is not an issue where you choose one or the other. We've got to have both, in my judgment. We've got to take all appropriate initiatives to enlarge supply and we've got to do everything we can to conserve to lessen our dependence on foreign oil because the national security consequences and the economic consequences are simply too serious not to follow that path. Thank you, Mr. Chairman.

[The prepared statement of Secretary Duncan follows:]

Prepared Statement of Hon. Charles W. Duncan

Mr. Chairman, I appreciate this opportunity to appear before you today to discuss a broad range of energy and economic issues.

IMPACT OF 1979

The past year has been dominated by turmoil in the world oil market. First the Iranian revolution curtailed one-fifth of OPEC's production capacity, and dramatically tightened the world oil market overnight. During the summer months we faced gasoline lines, as the full effects of the Iranian oil cutoff reached this country. While the lines receded in August, the oil market remained tight through the fall as importing nations stocked up on supplies. By the end of the year, world oil prices were about 50 percent higher compared to summer prices. U.S. refiners have been paying almost $30 per barrel for imported oil, double the price paid the same time last year and about ten times the price paid in 1970. Spot prices of about $38 per barrel are even higher.

As in 1973, the impact of the energy events of 1979 will be felt for many years to come. High prices and limited supplies will permanently change the way we utilize energy. I would like to outline for you today the legacy of 1979—the impacts of the past year on our energy future.

Before the Iranian revolution, the Department of Energy believed that forces were at work to cause sharp price increases and perhaps even shortages by the mid to late 1980's. Supply was expected to peak sometime in this decade, whereas world demand for oil would continue to rise. The Iranian revolution has accelerated these trends. Continued large price increases, as well as shortages, are a distinct possibility for the next several years. It is quite possible that the political impact of the Iranian revolution on other Middle East countries will be in the form of reduced investment in new oil production capacity.

Free world oil consumption is expected to drop by about 1 million barrels per day (MMBD) in 1980 because of higher prices, the effects of conservation, and the expected economic slowdown in the United States and other Organization for Economic Cooperation and Development (OECD) countries. However, considerable uncertainties on the supply side could make for a tight market. In part the uncertainties themselves, by raising the demand for inventories, have enabled higher prices to prevail. In addition OPEC production is likely to fall by 1-2 MMBD while non-OPEC production should increase by about 1 MMBD. If the OPEC cutbacks are limited, supplies should be adequate, though possibly at higher prices. If OPEC production falls by several MMBD, shortages could return in 1980, and would undoubtedly be accompanied by further major price increases.

For the longer term, we now anticipate that even by 1985 OPEC oil production will not exceed significantly the current production level of about 31 MMBD. Since OPEC's internal consumption is expected to rise by about 1 MMBD during this period, less oil will be available for export. Other non-OPEC producers are in the aggregate expected at best to make up this loss. However, increased competition for scarce oil may come from the Soviet Union and Eastern Europe, which might cease oil exports and become a net importer by the middle of the decade. Thus, the United States will have to be prepared to import no more and likely much less, oil during this period.

The impacts on the U.S. economy from the oil price shocks of 1979 have been and will be considerable. Consumer prices for energy will continue to rise much faster than the overall Consumer Price Index although by somewhat less than in 1979. Real GNP is projected to be as 2 percent lower in 1980 than would have occurred otherwise with a correspondingly higher unemployment rate of between 0.5 and 1 percentage points. The U.S. oil import bill will increase to about 80 billion dollars, about 22 billion dollars of which is attributable to price increases associated with the Caracas OPEC meeting.

Two additional points regarding the 1979 world oil price increases are worth noting. First only a negligible amount of the projected 1980 and 1981 increases in the Consumer Price Index is attributable to the Administration's phased decontrol program. Secondly, though painful, especially for low income households, higher prices have had, and will continue to have, the beneficial effect of reducing demand for these fuels, and thus lessening our dependence on insecure imports.

ENERGY STRATEGY

The administration's strategy for dealing with these problems is conditioned by the nature of the transition from an oil-dependent economy to an energy-diversified economy. For the next 5 years—the short term—the world will continue to rely heavily on oil, which supplied 60 percent of the world's energy in 1979. The most readily available and economical source of energy for this period is conservation. In the mid term—between 1985 and 2000—the world will move away from an energy system dependent on oil towards one relying on coal and coal-derived synthetics, solar technologies, oil shale, unconventional gas supplies and nuclear power. Beyond the year 2000—the long term—the world will move further in the direction of renewable energy sources and advanced nuclear technologies.

We intend to rely as much as possible on market forces to bring about this transition. Large-scale commercial utilization of new energy technologies will and should be largely the responsibility of private enterprise. Accordingly, a critical component of this Administration's energy policy is to provide a stable commercial and regulatory climate to enable it to accomplish this mission at minimum cost to the economy. We have underway a careful review of the Department's existing regulations to eliminate those that have outgrown their usefulness. We expect to publish shortly a list of regulations that we intend to eliminate. We are also going to publish a schedule for deregulation so that the September 1981 expiration of existing regulatory authority will be met smoothly and on schedule.

Markets alone cannot reduce our dependence on foreign sources of oil quickly enough. There are public benefits to import reductions such as restraint on increases in oil prices that result from lower U.S. demand and reduced vulnerability to supply disruptions. Therefore, the government must act to reduce the quantities imported below what market forces are likely to accomplish. The Department seeks to rely on regulation only as a last resort and as required by current statutes. There are a number of ways to stimulate conservation and increased domestic energy supply without imposing additional regulatory burdens on the economy. Voluntary initiatives, buttressed by appropriate economic incentives and information, are preferred methods for reducing oil imports and changing our energy balance. In order to ensure that regulations issued by the Department are soundly conceived and consistent with this policy, approval must be granted by the Deputy Secretary or me before any significant regulation is developed.

Our highest priority programs are aimed at cutting energy demand during the next several years. The policy of oil decontrol is introducing more realistic prices into the marketplace, and is thus making an important contribution to reducing demand. At the same time the Administration's proposed Windfall Profits Tax is designed to ameliorate certain hardships related to increasing prices.

The Department's contingency planning efforts include setting gasoline consumption targets for each State. We are also developing a nationwide gasoline rationing plan to enforce compliance with the targets, to be used in the event of a severe supply disruption. The President has stated that U.S. imports will never exceed 8.5 MMBD in any year. In his State of the Union address for 1980, the President announced that the U.S. import ceiling for 1980 would again be set at 8.2 MMBD. While we currently expect to achieve even lower levels of imports, the President has made clear his intention to enforce this ceiling through the use of an import fee if imports threaten to exceed the 8.2 MMBD level.

These efforts are only one part of the spectrum of Departmental programs intended to reduce demand. The Administration requests almost 1 billion dollars in budget authority in fiscal year 1981 to encourage as well as provide the mean for more efficient use of energy. Some of these funds will be spent on research and development. However, the bulk of Federal expenditures will be used for retrofits of schools and hospitals, weatherization assistance for low-income, elderly, and handicapped persons who live in old, less energy-efficient housing, and grants for other State and local conservation activities. Private households and businesses will continue to benefit from tax credits designed to encourage investments in conservation and renewable resource use. Low- and moderate-income persons will have access to subsidized loans for this purpose through the Conservation and Solar Bank to be created through pending legislation proposed by the President.

One other important part of the Administration's plans to reduce vulnerability to imports is the Strategic Petroleum Reserve. Funds are available in the budget for resumption of oil acquisition in 1980. The budget plan calls for about 250 million barrels in storage by 1983; up to 750 million barrels are planned by 1989. An additional 250 million barrels of storage may be established later. A billion barrel reserve would provide adequate protection against lost imports.

Since we will still, in spite of these efforts, be quite vulnerable to supply disruptions during the next decade, we intend to encourage as much as possible imports of both oil and natural gas from a number of countries, in particular Canada and Mexico. Net future oil imports from Canada are expected to decline from their current small level of about 100,000 barrels per day. U.S. oil imports from Mexico, however, are projected to increase to around 1 MMBD compared with the current level of over 600,000 barrels per day. Canadian exports of natural gas are currently about one trillion cubic feet. Imports around this level are expected to be maintained until Canadian domestic demand reaches its production capacity level in the mid 1990's. Mexico has just commenced exporting gas, at a level of around 100 billion cubic feet this year. There is potential for increased exports, but no precise figures are currently available.

The suddenness of the rise in energy prices has caused substantial hardships for many low-income families. It will also, now that oil is being decontrolled, provide substantial windfalls to a small group of individuals and companies. This situation must be remedied via the Windfall Profits Tax. This tax will, among other things, provide $2.4 billion annually to assist the poor in paying higher energy bills. For the current winter, the Administration has already acted quickly to ensure that low-income persons were and are given relief. This means of aiding the poor, which does not offset the stimulus of higher prices to conserve, is far superior to controlling prices, which not only yields benefits to rich and poor alike, but also impedes energy conservation efforts.

The bulk of the funds from this tax will assist our mid term and long term policy of increasing the supply of domestic substitutes for oil which are economically and environmentally acceptable. Conservation programs must and will be pursued vigorously, but are not by themselves sufficient; new domestic sources of energy must be developed or expanded. Private enterprises are working to move new energy technologies to the stage at which they are ready for large-scale commercial use. However, alternative technologies are in various stages of development and incentives are necessary to expediate this process for the public benefit. Therefore, the Department supports research, development, demonstration, and commercialization activities in many areas of energy technology.

PROJECTED SUPPLIES

Total U.S. production of oil, including natural gas liquids, is expected at best to remain near current levels of 10 MMBD through 1985. Even with decontrol and high world oil prices, production in the lower forty-eight States is expected to decline during the decade, offset somewhat by increased production from new sources of oil such as Alaska, offshore oil, and enhanced oil recovery. U.S. net demand for oil is forecast at 16–18 MMBD in 1985, slightly below the 1979 level of 18.4 MMBD.

U.S. natural gas consumption in 1979 remained about the same as in recent years at around 19 trillion cubic feet. By 1985, natural gas consumption should increase slightly to 20–21 trillion cubic feet, despite continued declines in conventional lower-48 production. Most of the increase will be due to increased use of gas imports, Alaskan production and some gas from unconventional sources. The substantial rise in drilling activities already apparent due to recent natural gas legislation will increase reserves in the next few years, forestalling somewhat the projected decline in gas reserves and production.

Total consumption of electricity increased by about 3 percent in 1979 to about 2.1 billion kilowatt-hours. Nuclear power supplied a little less than 12 percent of this total. At the end of 1979, there were 71 nuclear reactors with a combined capacity of 52 gigawatts (GWe) in operation. Our estimate for the future growth in the nuclear-generated share of electricity has been reduced in the aftermath of the accident at Three Mile Island. The erosion of nuclear growth forecasts has numerous causes.

Along with the rapidly growing financial burden of building and operating nuclear plants, two major factors are heightened concerns about reactor safety and radioactive waste management. The Department, at the direction of the President, is increasing its efforts with regard to both of these concerns. Nuclear capacity in the United States now appears likely to increase to 150–200 GWe by 2000. The range of future nuclear capacity depends on completion of the 100 GWe of capacity currently under construction or with their construction permit granted, and on the outcome of management and regulatory decision on another 50 GWe awaiting construction authorization or in the planning stages.

Coal consumption grew in 1979 by more than 50 million tons, to a level of about 700 million tons. Coal consumption will increase to about 900 million tons by 1985. A substantial portion of this increase can be achieved through effective coal conversion efforts. Of this projected total, about 25 percent will be consumed in the industrial sector, and the rest by utilities to produce electricity.

Solar and renewable energy sources contributed about 5 quads to our energy supply in 1979, about the same as in 1978. Renewable supplies in the United States are projected to increase by 20 percent by 1985. One area which shows promise in the near term is alcohol fuels. On January 11, 1980, the President announced a national target for alcohol production capacity of 500 million gallons per year in 1981, more than 6 times the 80 million gallons produced in 1979.

The proposed Energy Security Corporation will help the private sector make investments in the production of synthetic fuels from coal, biomass, peat, oil shale, and tar sands. In December the Joint House-Senate conference on the Energy Security Bill, S. 932, adopted a goal of 2 MMBD of synfuels production by 1992. These efforts will be assisted by the proposed Energy Mobilization Board. The Board will be authorized to designate certain non-nuclear facilities as critical to achieving the nation's import reduction goals and to establish binding schedules for Federal, State, and local decision-making with respect to these projects.

CONCLUSION

In conclusion I would like to stress that the transition from an oil-dependent to an energy-diversified economy represents a joining of national resources and resolution on a scale never before attempted in peacetime. It is, however, no more insurmountable a challenge than many we have faced successfully in the past. But it requires a close partnership between the public and private sectors.

It requires the long-term integration of different energy approaches in the face of factors sometimes beyond our control. And it requires a recognition that there are no short cuts, no technological miracles, and no quick solutions dictated in Washington that by themselves will make this necessary transition significantly shorter or less demanding.

Mr. Chairman, I would be pleased to answer any questions you and the committee might have.

Senator BENTSEN. Mr. Secretary, that is as blunt and as candid a statement as I've heard from a Secretary of Energy in a long time. And it's a pretty bleak and a pretty tough picture, as well.

Now, we have a situation where the President has talked about limiting imports to 8.2 million barrels a day, the approximate level that we imported, as I recall, in 1978 and 1979. Because of bloated domestic stocks, and the impact of energy conservation, our import level is running less than that now. But let's say as this Nation continues to grow, suppose we find ourselves in a situation where we're bumping up against that to reinforce his import ceiling target?

What kind of a tariff level is the President ready to impose?

Secretary DUNCAN. Let me make a couple of comments on that, Mr. Chairman.

The level of imports that he mentioned in his state of the Union message was a target of 8.2 million barrels a day of foreign imports.

He said at the same time that he was prepared to reduce those targets in concert with our allies.

We had a meeting in Paris in September of the energy ministers of the Tokyo Summit Conference. We talked at that time about the importance of national goals to constrain imports.

This was followed up by a meeting in December, also in Paris, of the energy ministers of the International Energy Agency, where we were successful in getting the OECD countries, the member countries of the IEA, as well as the European Community, to all agree to national import targets, meaningful targets, hopefully backed up by conservation measures.

Senator BENTSEN. Well, let me interrupt please.

You say you got them to agree to it. But as I recall, when you had the Iranian embargo a year ago, they rushed like beggars to try to fill their own particular supply tanks. And then in December, again, we saw an identical situation, led in that case by the Japanese and the West Germans trying to take care of their own interests first.

The administration has failed to obtain agreement for the imposition of meaningful economic sanctions on those countries which fail or refuse to comply with reduced oil import targets.

Secretary DUNCAN. Well, what was done was this. With all due respect, Mr. Chairman, that's a bit of a different issue. What I was discussing——

Senator BENTSEN. But it's a question of cooperation of these countries to keep oil prices and oil imports down.

Secretary DUNCAN. Right.

Senator BENTSEN. And I'm concerned that we are making no progress in that direction.

Secretary DUNCAN. Well, I am, too. I think the points you made in your opening statement are very appropriate points.

I'll try to do this very briefly.

The thing that the U.S. Government is trying to do, and I personally have given a lot of time to, is to try to inculcate in the minds of our industrialized partners the urgent necessity of reducing collectively their imports of oil.

To do that unilaterally is one thing; to do it successfully on a multilateral basis is far more important.

Now I think it was a rather significant achievement that the European community agreed at their meeting in Dublin that they would constrain their imports in 1985 and they allocated that by country to 472 million tons of oil.

They express it in millions of tons. That would equate to about 9.5 million barrels.

They're also setting 1980 targets, and if we can get a mechanism through which we can collectively constrain our imports to what we project available supply to be, I think that's a very positive thing to have happen because to the extent that that happens, you'll take bidding between countries out of the market. You'll tend to avoid the kind of situation that you just mentioned—people jumping in and buying that oil.

And I think that's a very destructive thing to have happen, Mr. Chairman.

Senator BENTSEN. Well, Mr. Secretary, I hope that your optimism and expectations are fulfilled there. I am doubtful, based on what I have seen here, for example, just on the Olympic boycott. Despite the great dependence of France and Japan on Persian Gulf oil, I do not see the kind of forthcoming action to help back us up in limiting technological transfers or information to the Soviets. On something as basic as the Olympic boycott, the lack of cooperation there is of great concern to me.

Now, do you see anything in the offing by the administration for gasoline rationing or a Federal excise tax on gasoline?

Secretary DUNCAN. As the newspapers reported last fall, we talked in terms of an excise tax on gasoline on the order of magnitude of 50 cents a gallon. That preceded the OPEC action in Caracas where they took price actions which you've heard about. It went from a range of approximately $18 to $24 per barrel to a range of approximately $34.50 per barrel. It now seems to be elevated to $26 on the minimum side.

So I can't tell you exactly what level an excise tax should be. I can't really predict to you accurately today whether or not we should have gasoline rationing today. I think much more important than to say we're going to have rationing today, or we're going to have a tax of x cents per gallon on imports today, or that we're going to impose a fee on imported oil of so much per barrel; I think it's much more important to set an objective and to say to yourself that we're going to exercise whatever demand constraint measures we need to achieve that objective. That's what I would say about gasoline rationing.

I think it's very important that in our emergency planning that we have a standby rationing plan. You made reference to that in your opening statement. We are going to have that plan, I hope, by the 19th of February. We're going to have that plan very quickly. We need to have some streamlined plans that we can implement even more quickly. We need to think in terms of an imposition of an excise tax on gasoline. We need to think about the imposition of a fee on imports in order to constrain imports, if we have to.

But we need also to orchestrate effective conservation measures. The American driver is driving much less today than the same period a year ago, and that's very constructive.

To impose arbitrarily something like a 50-cent tax or some other bureaucratic mechanism which could be even more costly than the tax, such as gasoline rationing, with the enormous bureaucracy that would be required to implement it, to impose that on our economic system, in addition to the alreadying increase in the price of gasoline, would impose enormous strains on the economy, in my judgment.

Senator BENTSEN. Mr. Secretary, my time has expired. But I do note that you and your associate are practicing conservation this morning. I note that each of you are wearing sweaters.

Secretary DUNCAN. That's not premeditated, Mr. Chairman. [Laughter.]

Senator BENTSEN. I defer to Senator Roth for any comment he might have.

Senator ROTH. Mr. Secretary, first of all, I want to say that I think we're very fortunate to have you in this hot spot. I've admired your work in the past and am pleased to see you assume this responsibility. I'd like to emphasize again that I look upon the Persian Gulf as potentially our Pearl Harbor. I don't think we can overemphasize the vulnerability of this country and the free world to the need for oil from the Persian Gulf.

What bothers me is that the Russian army is less than 300 miles from the Strait of Hormuz. Two-thirds of the free world's supply of oil comes through those straits. What bothers me in particularly is that I'm told by the military that ships can mine that strait in a matter of 4 or 5 hours, or an airplane in 5 or 10 minutes. So you're not only talking about possible action on the part of the Soviet Union; you're talking about some terrorists or some similar group, radical group, taking action.

Now, my concern is that we get, I think, something like 2 million barrels a day from the Persian Gulf and, if that were shut off it would place a tremendous blow not only to the United States but to the free world. I asked the Library of Congress to make a study as to what this would mean, and I think it's important to show our vulnerability. If that 2 million barrels of oil is shut off over a period of time, it could mean a loss of 1.6 million jobs. This would increase inflation roughly 5.4 percent. Gas prices would increase $1.48 a gallon. There would be a GNP loss in 3 years of 7.3 percent. And of course, in many ways worst of all, heating oil would be something like $3.01 a gallon.

This, incidentally, is based upon a study made for me by the Library of Congress. In my opinion the findings are shocking. To me, as our chairman and ranking member have pointed out very frankly, this study sounds the alarm for positive action by the free world.

And I couldn't agree more strongly, Mr. Secretary, and I wish we had the Secretary of State here. Somehow we have to get a common policy, some common guidelines with respect to the Persian Gulf with the free nations, including Japan. We talked about that over there. The same thing is true in the free world.

One question I'd like to ask you, Mr. Secretary, and there's no easy answer, and I understand that. What is the administration doing with respect to this vulnerability? This could happen tomorrow. We don't think it will, but neither did we think Pearl Harbor would happen. And where would we be? What could we do to minimize this impact? What other sources do we have? How can we expand them, as supply lines are concerned? What are we doing, for example, with respect to our reserves? Should we not be perhaps building them up faster?

I guess what I'm trying to say is, time is not on our side. I don't think we really have time to be thinking. The time is for action. If this happened tomorrow, where would we be and what would we do?

Secretary DUNCAN. Well, if it happened tomorrow we'd be in very bad shape. If you take 2 million barrels per day out of our economy now, given our dependence on oil, given the fact that so much of our industrial system, so much of our capital infrastructure in this country, can use liquid petroluem or forms of liquids only, as opposed to coal, as opposed to gas, as opposed to other things, it means that we'd be in very bad shape.

That in a sense is the chart that evidences and documents what I said earlier. It shows the cost of our dependence on foreign oil, a cost that I always say far exceeds the price that you pay foreign producers, given the social and economic dislocations that are caused by that overdependence, not to speak of the national security considerations.

With respect to the national security aspects of that overdependence—of course I'm no longer involved in national security, but I was formerly the Deputy Secretary of Defense—I understand the points you've just made. We have a very substantial naval presence in the Indian Ocean today. We have airplanes that are very close to that particular strait right now. Of course, they're not there for nothing, and of course other countries in the world are getting the benefit by their being there.

I think longer range, these things indicate that we've got to do a lot of thinking about ways to incorporate the interests of the industrialized world in our collective dependence over the near term, defined as the next decade, on oil from the Persian Gulf.

If you ask what we are doing in a military way, look at Harold Brown's testimony yesterday and what he's asking the Congress for, to give our military greater capability. We have today an intensified military presence in the Persian Gulf. Over the last year look at our naval presence, look at what we have done in certain countries in the Middle East, for example, Yemen, look at what we are now doing with Pakistan, the Turkish embargo, et cetera—just look at a few facts, and I think that you'll see from that, that we do have an intensified presence in that area.

In the longer term sense, the end result will be to lessen our dependence on oil, and it's important that we do that, not unilaterally, but that the industrialized world do it multilaterally. The current report which we have just completed, the Secretary's Annual Report to the Congress talks about not only historical initiatives, but prospective initiatives which, over time, are going to lessen our dependence on foreign oil.

The unfortunate fact is that it does take time, that it will take 10, 15, or 20 years, to really make substantial inroads on our dependence on foreign oil.

The chairman made a very important point earlier when he said one important thing we have to do is to delink our economic growth from our growth in energy consumption. We've got to maintain a viable increase in gross national product, and that's one key aspect of perpetuating world leadership in an economic sense and in other senses as well and unlink it from energy growth. That's very important.

We're making very good strides in that area, as you know. The relationship of energy consumption to the increase in gross national product is a trend that's improving now.

Senator ROTH. Mr. Secretary, my time is up. But I would just like to make, if I could, two recommendations to you.

Secretary DUNCAN. Yes, sir.

Senator ROTH. I feel that this is such a critical vulnerability, that this, as I said, is a potential Pearl Harbor. We should not wake up tomorrow or the following day or a week from then and have it happen and say, what are we going to do.

I would urge you and your colleagues to meet today, tomorrow, and plan exactly what we would do in the event of this crisis. I don't want us to be found in the spot that we have no plan of action, immediate plan of action, in the event that somehow these 2 million or 3 million barrels are turned off.

I would also urge, although I realize this is not your primary responsibility, that our diplomats at the highest level, together with Western Europe and Japan, ought to be meeting to try to decide exactly this same thing, because we don't want to wake up some December 8 morning and find this crisis upon us.

Thank you, Mr. Secretary.

Secretary DUNCAN. Thank you. Your advice is very sage.

Senator ROTH. Thank you.

Senator BENTSEN. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Secretary Duncan, if we did impose a well-administered gasoline rationing system tomorrow, which guaranteed to all industrial and agricultural uses what they needed, and enough so that people could get to and from work, but cut out all non-essential pleasure purposes, what percentage of our gasoline consumption would be saved?

Secretary DUNCAN. Right. I think you could set your consumption target at various levels, and then you would control the distribution of ration rights to accommodate any particular consumption target that you set. In other words, I would see that as something that would have to have flexibility and that you would, in a management sense, be able to vary some dependent upon your projections of supply.

Representative REUSS. Let me ask that question another way. What do you see as the rock bottom essential portion of our gasoline consumption which has to be maintained in order to keep our industry and agriculture and other essential things going, as opposed to that which is not essential?

Secretary DUNCAN. Forty percent of gasoline consumption is considered to be discretionary consumption. We're now consuming gasoline at a rate of approximately—in 1979 it was 7.05 million barrels per day, on the average. So assuming that number, about 2.8 million barrels per day of gasoline was in the form of discretionary consumption. That would be a difficult number to get precisely accurate.

Representative REUSS. That's good enough.

Secretary DUNCAN. If you were to take that amount of consumption out of the market, I think the American people would be paying a very substantial price.

Representative REUSS. You say in your statement: "We are developing a nationwide gasoline rationing plan to be used in the event of a severe supply disruption." The facts are plain, and they're quite brutal. You testified this morning that our oil import bill this year, in 1980, will be $83 billion. That's up from $40 billion in 1978 and $56 billion in 1979. That's a staggering figure, quite apart from energy shortages.

I put it to you that, since it is our oil import deficit which creates our whole trade deficit, and since that dollar deficit is actually increasing rather than getting better, and since the perpetual weakness and decrepit quality of the international dollar is a leading contributor to inflation, we ought to take meaningful steps to fight inflation now. And that means, in my view, rationing gasoline so that we make the very considerable savings in consumption which obviously can be made.

We're squandering gasoline as no European or Asian country does, and earning a bad reputation for it. Why don't we do something meaningful about decreasing consumption?

Secretary DUNCAN. If you look at our total energy consumption as a nation expressed as a percentage of gross national product, you see the amount of energy we consume. I often hear from my colleagues in Europe that our per capita energy consumption is much higher than others. But there are different ways to look at energy consumption. That's a function of your standard of living. That's a function of economic development. That's a function of suburbia, the way that your cities have been built.

Now, I'm not suggesting, please understand, that we should not do a lot more. But I'm saying it's a more complicated thing than that particu'ar ratio. For example, if you look at the ratio of energy consumption compared to gross national product among the members of the IEA, we're No. 4 on the list, not No. 1, because that takes into consideration things like economic growth, standard of liv ng, and degree of industrial development.

We have the kind of society that has consumed energy.

Now, back to the gasoline rationing question. If you have a demand constraint requirement because of some serious supply interruption which exceeds the conservation achievements that the American people are now attaining, it may not be that you would want to use gas rationing. The cost of a gas rationing plan we have estimated to be approximately $2 billion annually.

One way to look at the cost of gas rationing is to look back at that chart and to see what would happen if you had a shortfall of two million barrels, and assuming that number, it means the price of gasoline would be up $1.48 per gallon. What I suggest is that the cost of a rationing plan is very, very significant on the American consumer, going way beyond the $2 billion of administrative bureaucratic costs that would be involved.

It's a very complicated economic question. If you take that much gasoline out of the system and compute what that does to industry, all kinds of industry, what that does to the industrial sector, what that does to jobs, I think you'll find this very, very significant. It's not clear in my mind that you could implement a gasoline rationing plan as a demand constraint measure and do it more cheaply, more inexpensively, more economically, than you could, say, an excise tax on gasoline or some other form of mandatory demand constraint.

It's very much an open issue. It's not a clear case that gasoline rationing is the best method to use in the event of a severe supply restriction. I've heard many people argue strongly, people I have respect for, that the opposite is true, and the administration of a gasoline rationing plan with equity, with bureaucratic equity, is a phenomenally difficult undertaking.

I've talked with many people recently who were involved in it in World War II and they have said to me; Charles, let me tell you that this is a bureaucratic nightmare, it's absolutely a bureaucratic nightmare. So I am not abandoning—I'm not saying that I would not recommend some day a gasoline rationing plan in the event of a severe supply shortfall. What I am saying is that the cost of a rationing plan is far in excess of the bureaucratic administrative costs. But even that we are projecting as $2 billion annually.

Representative REUSS. My time is up. I would just say that in my judgment, either the administration should go with John Anderson and impose a heroic gasoline excise tax, or with Ted Kennedy and impose rationing, or we will be sunk by inflation.

That's all.

Senator BENTSEN. These are pretty strong alternatives.

Congressman Wylie.

Representative WYLIE. Thank you, Mr. Chairman.

We're all looking for new, quick sources of energy. I think that's a truism. The Ohio Farm Bureau Federation has convinced me that we should be doing, and could be doing more on gasohol. I might say I have a bill in to provide gas incentives to build alcohol-producing plants and to provide a tax credit for alcohol-fueled automobile engines.

I talked to Secretary Schlesinger about this from my home on Saturday morning about a year and a half ago. He said that the basic problem was securing stock. But now we have plenty of stock and we'll have plenty more, apparently, from grain bins all over the country.

I think, in this regard, there may be a blessing in disguise in the Soviet invasion of Afghanistan. It may force us to alleviate our dependence on Persian Gulf oil and foreign oil and to concentrate on other sources of energy.

But as you know, Mr. Secretary, methanol and ethanol are fuels which can be produced from our Nation's farms and from biomass. In addition, Brazil is running a substantial percentage of their automobiles on methanol at the present time and the cars in the Indianapolis 500 run on alcohol.

Can we do more in this area?

Secretary DUNCAN. We are doing substantially more. This is an initiative that we have had underway in the Department of Energy since about September. We have been moving on gasohol very, very aggressively. There are some who argue about the energy efficiency of gasohol. But I think, using coal or using cogeneration, it is very energy efficient. We produced about 80 million gallons of ethanol for blending into gasoline to make gasohol in 1979.

I've talked to the chairman of Archer, Daniel, Midland very recently. I've been to the Archer, Daniel, Midland plant. I've been through the facility. I've talked to their board, their executives.

They're making substantial additions to that plant. They announced a plan about 10 days ago in Des Moines to substantially expand their capacity.

I think the target that we have set of producing 10 percent of unleaded gasoline as gasohol sometime in 1981 is a realistic target, given what is in progress today, what is under construction today.

We have assembled a list of some 20 private concerns, large concerns that are moving into gasohol, moving into the manufacture of ethanol for gasohol and who have actually placed orders for equipment. They actually have made commitments.

Of course, this says nothing about what farmers may be doing as individuals and it says nothing about the results of the Presidential initiatives which were just announced very recently in his recommendation that we have $3 billion over the period of the next 10 years to facilitate the production of ethanol.

Representative WYLIE. You may answer this one for the record, but is there anything more we can do to provide incentives? In this regard, I'd like to send you a copy of my bill, which I've given a considerable amount of thought to.

Secretary DUNCAN. I will furnish that for the record.

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

GASOHOL INCENTIVES

The most important thing the Congress can do for gasohol is to pass, through the Windfall Profits Tax Bill, an extension of the 4 cents per gallon Federal excise tax exemption on gasoline. This exemption must be extended. We are recommending a permanent exemption.

The next most important thing is rapid passage of President's proposal for an Energy Security Corporation, with the loan guarantee funds included for alcohol production.

Representative WYLIE. What are we doing on coal liquefaction at the present time? The technology is here.

Secretary DUNCAN. We're working very hard on coal liquefaction. If I can expand the question to gasification as well, which I think is very important, there's a plant—American Natural Resources—that will begin construction this summer in North Dakota, which is really the first synthetic fuels plant in America. That plant is moving. We are going to begin to get some activity in the manufacture of synthetic fuels, which is extremely necessary.

If I could just digress one more second.

If we move into the next century not having learned what we can do as Americans with American resources, particularly with oil shale and with coal, we will have done a great disservice to future generations. We are enormously rich in energy resources and we've got to move on these things. I'm delighted that this first plant is getting underway.

With regard to coal liquefaction, we are beginning to construct the SRC-1 plant and the SRC-2 plant—that's solvent refined coal. We also have the H-coal plant and the Exxon donor solvent plant.

We have many initiatives within the Department in this area.

With the advent of the Energy Security Corporation, commercial ventures which have not been attractive up until now–no synthetic fuel plants have been built up until now—will be able to be given a financial catalyst, an investment banker type catalyst to facilitate private industry undertaking those investments.

That's very much in the national interest—coal, coal gasification, coal liquefaction, and oil shale offer tremendous opportunities for this country to become independent of foreign oil.

Representative WYLIE. I think so too, Mr. Secretary, and I regret that my time has expired.

Senator BENTSEN. Congressman Mitchell.

Representative MITCHELL. I have two questions and I will put them as succinctly as I can.

As you know, Mexico is suddenly very popluar, being wooed by Japan, Finland, and Great Britain because of the possibility that its oil production will be raised to 4 billion barrels a day, if President Portillo so elects.

Have we begun to fashion some kind of long-term agreement with Mexico with reference to acquiring that new oil?

That's question No. 1.

Question No. 2: You spoke rather optimistically about conservation successes and I must confess that I was not aware of them.

People are now driving at 55 miles per hour and that kind of thing. But I'm not at all sure that we are really doing as much as we can.

My specific question is: What are the things being done in industry? What are the conservation techniques being employed by industry?

Secretary DUNCAN. Well, in the case of Mexican oil and gas, as you know, we have begun to import gas from Mexico at the rate of 300,000 cubic feet per day.

Representative MITCHELL. Long term?

Secretary DUNCAN. It might be subject to short-term cancellation. But I think the expectation on the part of both parties is that it's a long-term proposition.

We actually began receiving that gas, I believe, on January 15 just a few days ago. That gas, I think, is very important to this country. I would hope over time that the quantity of gas will increase.

It seems like given the capacities of pipeline and other constraining aspects of the volume of gas we take, I do think we have an opportunity or potential to get substantially more gas.

We are presently by far the biggest recipient of Mexican oil. If they do export more oil, I would hope that American oil companies, who are very aggressive in trying to obtain crude oil supplies from anywhere in the world, not just OPEC, will be able to obtain a significant share of that.

I have every confidence that they will.

We have not, to my knowledge, directly intervened with respect to that, but I do think that we will have a substantial opportunity for increased oil receipts, as well as gas receipts, which have already commenced.

In the case of Canada, I might interject very quickly, we're importing very substantial amounts of gas from Canada. That has recently been increased somewhat in order to accommodate the prebuild requirements of the Alaska natural gas pipeline.

As I indicated in my formal remarks in my opening comments, it's very important that we do what we can respecting oil and gas from both Mexico and Canada.

Going back to conservation, I think industry has made very significant progress. If you compared increases in our gross national product with increases in consumption, there used to be a 1-to-1 correlation. That correlation today is down just under 0.5 to 1, meaning that we can get an increase in gross national product using only one-half of the energy increase formerly required. That used to be a straight line relationship. It's no longer a straight line relationship.

The rising price of energy, which is unfortunate in so many ways, has done one thing—it has caused industry to look very hard at its energy usage. American Telephone & Telegraph, as an example, has not increased its energy usage over the past 5 years and has announced that it will not increase it over the next 5 years.

Energy is doing very well. Where we need to do a lot better is with consumers: in the weatherization of our homes, in the discretionary driving, consuming gasoline, in increased use of renewables, and the like.

Looking at gasoline consumption, you'll see that compared to the same periods last year, we're now driving about 10 percent less, the American public is, compared to the same periods of time 1 year ago.

So we are making improvements in gasoline consumption I'm convinced that we're making very rapid improvements.

We're now weatherizing homes at a rate in excess of 15,000 a month. We've had very dramatic increases in the weatherization of houses.

We have established within the Department of Energy what we call conservation initiatives expressed in terms of output, such as how much are we going to be able to do by quarter during the current year?

You're familiar with Pittsfield, Mass., and what happened there. We're now expanding that program to 18 different cities.

So there's a lot going on. I think we need to be more communicative about what we have done, and a lot more needs to happen. We aren't satisfied that sufficient progress has occurred yet.

Representative MITCHELL. Thank you.

Senator BENTSEN. Thank you. Senator Jepsen.

Senator JEPSEN. Thank you, Mr. Chairman.

Mr. Secretary, in President Carter's statement on gasohol, when he imposed the embargo, he said, and I quote: "We will have a massive increase of the use of grain for gasohol production here at home."

We are very pleased in Iowa to hear that. We have been producing gasohol for some years now.

As of last year, we rose to a point of about 8 million gallons per month of gasohol being sold through over 700 retail outlets in the State. As you indicated, we are expanding production. We are building a new plant in Cedar Rapids and in the Sioux City area, in addition to one that will soon be announced elsewhere.

My question is: In keeping with the spirit of the times and the interest to provide new sources of fuel in addition to conservation and all the other things which we must do, there seems to be the normal disjointed bureaucratic response to information requests by concerned and capable citizens who have rolled up their sleeves and are ready to take action by asking for information.

The President has emphasized it. There are a number of departments that have emphasized it. The Department of Energy has emphasized it.

But when they ask for information, what they really want, Mr. Secretary, is informa ion on gasohol covering the entire spectrum of its production, its financing, its loans, its licensing permits, technical information on the alcohol fuels process the construction of alcohol fuels plants, the Bureau of Alcohol, Tobacco, and Firearms standing on their licensing, and many others.

With your good business experience and background, and by the way you've been very helpful to us every time and I thank you for that, do you think that you could pull all these things together soon so we can really get about the business of taking advantage of all these good proposals from Washington?

Secretary DUNCAN. Well, I can certainly try. There is a DOE hotline, for the purpose of gasohol information.

Senator JEPSEN. May I interrupt there? You know what we're getting when we call that hotline? We're getting hotline telephone numbers located at universities around the country.

Secretary DUNCAN. We've given grants to one group of 40 colleges, and we are working on plans for a second group of 60 colleges, to get at least a college in every State that can be a repository of information respecting the manufacture of ethanol for blending into gasohol. We were hopeful that that would help. I've talked with Secretary Bergland as recently as this morning about the Department of Agriculture and the fact that they have ways to get information out. He and I are thinking generally about the Department of Energy handling the significant projects and the Department of Agriculture, which has an agent in every county in America and is in a much better position to disseminate information, to handle on-farm projects.

I'll look into that, and Secretary Bergland may even be here.

Senator BENTSEN. He'll be testifying next.

Secretary DUNCAN. We have a 17-page manual that we've just produced on it. I'm not suggesting to you that we're doing well or that we have communicated our capability to give information adequately. We'll look into it and try to meet what's a clear need.

Senator JEPSEN. Thank you, Mr. Secretary.

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

ALCOHOL FUELS INFORMATION

In July, 1979, the Department of Energy began a program to provide information on alcohol fuels to the public through Nicholls State University in Louisiana and Southwest State University in Minnesota. These universities answered inquiries and in turn referred some calls to 40 other colleges with expertise in this area.

The two universities have responded to more than 10,000 requests. In addition, DOE headquarters personnel have been responding to some 550 inquiries a week. Due to the volume of requests, some problems have developed. Some persons have not received information as promptly or efficiently as we might wish. A valuable publication, "Fuel from Farms—A Guide to Small Scale Ethanol Production" has been in short supply at certain times.

We are gratified by the intense interest from potential ethanol producers, and we will continue to explore all avenues, with the Department of Agriculture and other agencies, to improve the flow of information of this subject.

Since the hearing, DOE opened an information center at the Solar Energy Research Institute (SERI). Called the National Alcohol Fuels Information Center, it has a toll free number (1-800-525-5555). DOE's information program at universities will end in June.

In mid-February, I outlined certain new plans for the Office of Alcohol Fuels in order to meet the President's goals, and I have assigned E. Stevens Potts as Acting Director of the office reporting to the Assistant Secretary of Conservation and Solar Energy through the Deputy Assistant Secretary (Solar Programs). I have directed this office to respond to inquiries from the public promptly and effectively.

Senator BENTSEN. Congressman Long.

Representative LONG. Thank you, Mr. Chairman.

Mr. Secretary, the strategic reserve program that the Department instituted some few years ago here has been less than successful, as you well know.

My own State of Louisiana has experienced a great many problems with the program—problems ranging from inefficiency to ineptness even perhaps to some charges of fraud.

Is this still a viable program?

Secretary DUNCAN. Yes; it is and it's one, I think, that needs emphasis.

The chairman indicated in his opening remarks that he felt we ought to move to fill that reserve. And I think that reserve is very important, not only in a national security sense, but also in an economic sense.

Representative LONG. What about the objectives we have heard, from at least one of the Arab countries, about the use of its petroleum in the reserve program?

Is that going to have any effect on it?

Secretary DUNCAN. I don't think that we ought to begin building the reserve until we've had appropriate consultations with our partners, both consuming partners and producing partners.

In fact, we committed that we would not do that at the Tokyo summit meeting. But having said that, and I do think it's important that we go ahead with the consultations before we do anything—but I do think it's important that we go ahead with the building of that reserve.

I think we've made major improvements in the management of that activity. We can get the oil out of the ground now at 1 million barrels per day, as you know. We have 92 million barrels in storage and we have got capacity—we have appropriations to build capacity for 528 million barrels.

We are contemplating in the budget that we have just sent to the Congress for 1981 that we begin to fill that reserve at the rate of 100,000 barrels a day for the next 2 years, then 250,000 barrels per day beyond that. I would hope that we can do that.

There is a possibility that there will be some softness—I use the word "softness" carefully—in the crude oil market, that there may be a period of time here when the availability of oil exceeds the demand of oil. And I hope that that does not cause a sense of complacency on the part of the American public because the problem is real and long term, as I said earlier.

Any aberration is going to be of a short-term duration. But if we do have an opportunity to acquire some oil from that reserve after consultation with appropriate partners, both producing and consuming partners, I would like to see us move to begin to fill that reserve. And as I say, we have put that in the budget.

Representative LONG. You feel, then that the technical and operational problems are sufficiently in hand to enable you to proceed with the program in the event that the oil does become available.

Secretary DUNCAN. I do. I have gone to New Orleans, I have gone to the office of the strategic petroleum reserve, I have talked to Mr. Jones as recently as this week, who is the new head of the SPR, and I am involved. It is a program that has not been without its problems, as you suggest, but I do think that we have made some rather substantial progress in the last few months.

Representative LONG. Thank you, Mr. Chairman.

Senator BENTSEN. Mr. Secretary, I know it's 11 a.m. and I told you I would let you out of here by 11. But I have some members of this committee who have waited very patiently. If they would limit their questions to one apiece. I would like to let them ask, if they will.

Congressman Brown.

Representative BROWN. Mr. Chairman, I thank you for that courtesy, and I want to, before my question, just compliment the Secretary on his independence and his candor.

Mr. Secretary, you mentioned the possibility, or it has been mentioned this morning, of gas rationing. You mentioned the possibility of import fees, which would be a tax imposable by the President of the United States on all oil products in the nature of a tax on gasoline. It has also been proposed, as noted by some of the Presidential candidates, that we have a tax on gasoline to raise the price.

All of that is predicated, I assume, on the idea that conservation does come from a higher price. And, in fact, that's true, because last December versus December of a year ago, we've cut down 10 percent in our gasoline consumption because the prices have gone up.

My question is a direct economic question, I think, appropriate to this committee. And that is that we still are subsidizing the import of foreign oil by price controls on both gasoline and domestic oil production. The price controls on oil production will not go off until the fall of 1981. Has there been any thought in the mind of the President or anyone else that perhaps the American people would rather see the price go up more sharply so that we could get off our dependence rather than the possibility of imposing a new draft and taking military action to assure that supply? Conservation may be the way out of that dependence.

Secretary DUNCAN. I don't know exactly what the President has been thinking about or not been thinking about, but this is the kind of thing that we think about and talk about within the Department of Energy all the time. You know, there are people who often make a comparison between the price of gasoline in the United States and the price of gasoline in other industrialized countries of the world, and they always point out the discrepancy. But the fact is that in the United States the price of gasoline has gone up at the sharpest rate of any country in the world now.

Representative BROWN. But still controlled and still subsidized. Correct?

Secretary DUNCAN. It is still controlled to the extent we are paying more for foreign imports than we pay for domestic production. You're subsidizing foreign imports.

Representative BROWN. Exactly.

Secretary DUNCAN. So that is an accurate statement.

I think you have to ask yourself though, when you think about accelerating the rate of oil decontrol, what strains would you be imposing on the economy. The fact is that the capital infrasturucture has a precipitous impact on the economy. That would have a precipitous impact on the economy. That would have a precipitous impact on industry. You can think in terms of economic recession. You can think in terms of unemployment. You can think in terms of all of these things.

To move through decontrol in a phased way with a deliberate program in which you manage this change is a much better way to do it than to move with some sort of dramatic action. This is a time for careful management, for careful consideration, but for steady movement toward the process of deregulation, decontrol. I favor that. At the same time, I don't think you should do it in such a precipitous way that you have enormously adverse impacts on lower income people or on the capital structure of this Nation.

Senator BENTSEN. I would like to next call on the distinguished former chairman of this committee, Congressman Bolling.

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

I am going to make matters simple. I am not going to have a question. I am going to make a very brief statement, that is perhaps more socio than economic in nature. It has to do with putting this whole matter in perspective.

I am one Member of Congress who thinks that the major responsibility for the situation in which we find ourselves falls on Congress. I think the President has been far ahead of the Congress in the proposals he has made. I am almost prepared to say that several Presidents have been ahead of the Congress. I think it's terribly important to get it on the table that at least one Member of Congress thinks that that is a fact.

And I think it's a fact because the people on the outside and the people on the inside of this excess oil consumption question—essentially, the producers versus the consumers—have been so rigid in their viewpoints that the House and the Senate have been unable to come up with compromises that are acceptable. Both sides have been so rigid in their insistence that they get all their way that they have come very close, in my opinion, to putting the country on the edge of destruction.

We have had example after example of this. The House passed a standby rationing plan. What happened—to the 1977 bill that the House special committee and the House passed—in the Senate? Nothing. Present difficulty over windfall profits are another classic illustration of the American way not working in Congress. Now, part of the reason is the fault of the American people for their failure to understand the serious nature of our situation. But, a great deal of the reason is the way in which our institutions are organized.

I had the misfortune over the years, before we had an ad hoc Energy Committee in 1977 and 1978, to preside over the House during the consideration of most of the major energy bills. I watched the country fall apart before my eyes, as the interest groups dominated the battle. And unless we find in this Congress the capacity to come together in the interest of the country and to subordinate special interests, each side is going to regret the future, because the future is the kind of disaster that has been brought out by your very able statement and by the questions and your answers to them.

The Congress, along with the people, is more at fault than any other group.

Senator BENTSEN. Thank you very much, Congressman.

Senator McClure.

Senator MCCLURE. Thank you, Mr. Chairman. I will be very brief.

Mr. Secretary, following up on what Congressman Bolling has said, I am concerned that we're not really addressing the question in its broad parameters. I look at the President's budget proposals where I try to match fact with fantasy, where I try to look at hard policy choices with the dollars that must implement those choices.

And it seems to me, rather than attacking the problem on a broad front, the total budget tries to assure the American people that they can mak› whatever economic adjustments has to be made with no pain at all in the public sector, in the public-spending sector; that the only sacrifices that are going to be required of them are to be in the private sector. There are people who are being assured that we can have all of the programs of Government but that we will somehow make all of the adjustments necessary in energy outside of restraint by Government.

I can't buy the idea that we can conserve our way out of this any more than we could ignore conservation and simply produce our way out of this problem. It will require a combination of both. And yet, I look at the President's budget request to us, and all I see is further restrictions on private initiative, further expansion of Government programs, and further requirement on the part of individual citizens to lower their standard of living in every sector of their life except that which is directly related to Government expenditures, where we in the Congress are going to assure them that nobody has to bear any pain.

I appreciated your statement a moment ago that just looking at energy consumption as a function of per capita income in this country is false. And I agree with you. I think one of the things we have to look at is that the United States still provides 84 percent of the world's humanitarian food relief. Secretary Bergland, sitting behind you, will corroborate that fact.

One of the geniuses of America has been our ability to produce, and there has been no one who expanded production more rapidly than our Nation's farmers. And that's why we're able to give humanitarian food relief around the world. Where did they turn when the Cambodians were starving? They turned to the United States for food. But our farmers were able to do that because they bought bigger equipment; they bought larger tractors; they consumed more energy; they produced more food. And now, it seems to me, we're saying, "Everybody in society that depends on Government, whatever the Government expenditure may be, will be guaranteed, that there will be no cut in that, except in energy programs."

I am very deeply disturbed that the President keeps saying he's in favor of energy production, but every action of Government that I have been able to see constrains domestic production of energy, except in the public sector.

Secretary DUNCAN. Well, if I could just make a couple of comments on that.

The President has proposed a very tight budget—$616 billion. He's proposed a budget that has a budget deficit of just under $16 billion. In doing that, he's maintained social programs that he thinks are necessary. And he's increased the defense budget substantially, which I personally think is very necessary.

Senator MCCLURE. Mr. Secretary, I don't mean to interrupt, but the expansion of the defense budget is because of the failure, in large part, of energy policy in this country. Some of us over the last several years, were trying to warn people that the lack of an energy policy in this country would drive us to a world war. And we're perilously close to that today.

Secretary DUNCAN. I would like to discuss that one with you further, that particular point, because I wouldn't want to, carte blanche, accept the point without some further discussion.

Senator MCCLURE. I understand.

Secretary DUNCAN. But let's talk about energy, because my particular responsibility is energy. If you look at what the President has done, and when you say that nothing has happened to increase supply, you have to consider a few facts. The fact is the President has recommended to the Congress and the Congress is now successfully acting on legislation creating the Energy Security Corporation and the Energy Mobilization Board, which I think can have a dramatic and positive impact on increasing energy supply and lessening our dependence on foreign oil.

The President took a decision in April to decontrol the price of crude oil on a phased basis. As a consequence of that action, there are 2,600 drilling rigs in action today, more than at any time that we've had since the middle 1950's. We are doing more to develop domestic oil and gas today than we have done in probably 25 years, if you look at the number of rigs, the number of holes that are being put in the ground.

We are giving incentives in the windfall profit tax to enhance oil recovery, to heavy oil, incremental tertiary recovery, to those things that enable you to get more out of your existing oil and gas reserves. So, I just can't accept the statement that we haven't promulgated programs that are going to have a very desirable and positive impact. Why they didn't happen a few years ago, I can't say, but what you see today are dramatic efforts to lessen our dependence on foreign oil. You're seeing a dramatic increase in the number of wells being drilled in this country. You're seeing dramtic emphasis on coal conversion, coal gasification, coal liquefaction, and oil shale. Why it didn't begin in 1973, I can't answer, but it is beginning now.

Senator MCCLURE. You indicated you would like to have the opportunity to discuss some of those items a little further; well so would I. And I will not burden this committee this morning.

Senator BENTSEN. We will allocate you two gentlemen time for that at another time, if we may.

Senator MCCLURE. Thank you.

Senator BENTSEN. Congresswoman Heckler, would you care to comment?

Representative HECKLER. Thank you, Mr. Chairman.

Mr. Secretary, perhaps the aspect of the energy policy, the impact of energy prices that is most difficult for New England, is the price of heating oil. In the last month it has increased by 11 cents a gallon. I am wondering whether or not you feel that there is anything of a competitive environment in terms of supply and of providing alternatives for the consumer.

The retailers seem to be afraid to go to an alternative supply because if they do they will lose their allocation from DOE or from the supplier. The fact is that if they are not able to move competitively and to find opportunities, then is there really a competitive environment at all? And what can DOE do about this? Is there anything that you are looking at that can increase competition to somehow provide for some relief for the consumer?

Secretary DUNCAN. The thing that we have tried to do with heating oil, all year since the early spring, when we first announced the targets for inventories in the Northeast, and what I have said very often to congressional delegations that are interested in the price and the availability of heating oil, is that the thing that I think will have the most positive impact will be to keep large supply in the market.

We have had many discussions with the oil companies and have successfully encouraged them to meet that 240 million barrel target in October, to keep adequate supplies in the market. I am told supplies of heating oil in the Northeast and Midwest are very satisfactory at the moment. Now, that, in my judgment, is the best thing we can do to ameliorate the increases in prices.

The price of gasoline has been controlled throughout this whole period. The price of heating oil has not been controlled, as you know. But if you look at what's happened, expressed in cents per gallon of increase to the price of heating oil and the price of gasoline, you will see that the price of gasoline, which was controlled, went up slightly more than the price of heating oil that was not controlled. So, controls, per se, didn't help that much on the price of gasoline or to keep the price of heating oil down. Heating oil fared a little bit better in terms of cents a gallon of increase. There is an important lesson to be derived from that.

Representative HECKLER. In terms of competition was the question, Mr. Secretary.

Secretary DUNCAN. In terms of competition, we will do what we can. There's been a change in structure in the heating oil distribution system. There have been credit problems. Interest rates are high. Inventories have been high. It takes a lot of interest to carry inventories.

The same thing with gasoline dealers—this issue of downward certification with gasoline dealers. These are complicated issues.

When you have a distribution system that's been established on the basis of very adequate supplies at low cost, and then you begin to constrain the amount of supply involuntarily—I mean the fact is that supplies are shrinking—then some structural changes are likely to occur.

We should try to do what we can to ameliorate those. I'll look into this particular question of competition. I have not heard about any problems in competition. I have heard about supply problems at various times and being able to get on the list of one oil company as opposed to the other oil company or what might happen to you if you don't have a historical base with some oil company—those kinds of things. We are moving to try to correct those kinds of things.

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

COMPETITION IN THE HOME HEATING OIL MARKET

Attached are several pages from a report outlining evidence that competition exists in the New England (East–South Central) market for home heating oil. Entitled "Analysis of the Competitive Viability of Independent Middle Distillate Marketers," the report was prepared by the Department of Energy Economic Regulatory Administration in November 1979.

NOVEMBER 1979.

EXCERPTS FROM ANALYSIS OF THE COMPETITIVE VIABILITY OF INDEPENDENT MIDDLE DISTILLATE MARKETERS

SUMMARY

The wholesale segment of the East-South-Central Middle Distillate Market has experienced a 43 percent decline in the number of participants from 1972 to 1976, although the current number of wholesalers remaining is within the competitive range. Access to storage facilities and to prime supplier indicates that the decline is not due to barriers to entry. Although the Robert Morris Associates' Statement Studies are not necessarily representative of the market, they do indicate that profits for wholesalers have declined, which would discourage entry. The structure-conduct-performance indicators applied here are limited, due to the availability of data. They seem to point, nevertheless, to a wholesale middle distillate market that is behaving in no less a competitive manner than prior to price controls, and which would not have a negative impact upon the competitive viability of retailers.

NUMBER OF BULK TERMINALS AND STATIONS, EAST-SOUTH-CENTRAL MARKET

PAD and State	1972	1974	Percent change 1972–74	1976	Percent change 1974–76	Net change 1976–72	Percent change 1976–72
PAD I:							
Connecticut	119	107	10	92	14	27	23
Delaware	40	39	3	26	33	14	35
District of Columbia	7	8	14+	6	29	1	14
Florida	541	483	11	351	27	190	35
Georgia	651	541	17	366	32	285	44
Maine	152	121	20	101	17	51	34
Maryland	171	165	4	129	22	42	25
Massachusetts	141	150	6	119	21	22	16
New Hampshire	63	66	5	48	27	15	24
New Jersey	218	204	6	159	22	59	27
New York	668	619	7	509	18	159	24
North Carolina	756	748	1	605	19	151	20
Pennsylvania	677	645	5	509	21	168	25
Rhode Island	36	27	25	25	7	11	31
South Carolina	374	362	3	270	25	104	28
Vermont	55	56	2	38	32	12	31
Virginia	474	430	9	297	31	177	37
West Virginia	181	185	2	129	30	52	29
PAD II:							
Illinois	1,274	1,110	13	651	41	623	49
Indiana	879	764	13	422	45	457	52
Iowa	1,169	978	16	622	36	547	47
Kansas	651	606	7	356	41	295	45
Kentucky	476	422	11	295	30	181	38
Michigan	1,008	921	9	471	49	537	53
Minnesota	986	867	12	471	46	515	52
Missouri	912	775	15	569	27	343	38
Nebraska	465	435	6	252	42	213	46
North Dakota	541	486	10	238	51	303	56
Ohio	837	625	25	422	32	415	50
Oklahoma	584	485	17	329	32	255	44
South Dakota	483	450	7	217	52	266	55
Tennessee	436	441	1	328	26	108	25
Wisconsin	1,016	951	6	546	43	470	46
PAD III:							
Alabama	505	444	12	315	29	190	38
Arkansas	506	444	12	292	34	214	42
Louisiana	557	513	8	358	30	199	36
Mississippi	415	354	15	246	31	169	41
New Mexico	233	222	4	162	27	71	30
Texas	2,757	1,894	31	1,099	42	1,658	60
Total, east-south-central market	22,014	19,143	13	12,440	35	9,574	43

Sources: County Business Patterns, 1974 and 1976, Bureau of Census, U.S. Department of Commerce, table 2. Census of Wholesale Trade, table 3, 1972, Bureau of Census, U.S. Department of Commerce.

RETAIL LEVEL

The retail sector of the middle distillate market is characterized by large numbers of small companies that service small geographic areas that contain many individual buyers. For the purposes of this report, R. Shriver Associates has defined the relevant market as individual counties within a state. Although RSA believes strongly that no generalization can or should be made about the competitive nature of a national fuel oil retail market, the alternative of examining the workability of competition for each county in the 39-state East-South-Central Market is awesome and probably unneccessary. In fact, the data collection effort would be so formidable, that the analysis would be overwhelming and flawed.

The very fact that many sellers and buyers exist in the retail market makes it difficult for the participants to exert market power. Using the economic framework presented in Chapter One and applied in the refiner and wholesale levels of distribution, basic features of a competitive market can be identified. These features can then be tested for selected areas of the East-South-Central Market to determine whether the competitive viability of the retailer has changed since 1972.

Important structural features that are conducive to a workably competitive market are:

Many sellers and buyers

When many sellers are active in a market, it is difficult for them to coordinate activities in an anti-competitive manner. In addition when many buyers exist, it is difficult for a small group of sellers to capture the fragmented market.

Low concentration of sellers

If the top four firms have less than 50 percent of the market, and the top eight firms have less than 70 percent of the market, market power is difficult to enforce. (These are estimated threshold levels; no specific level has been linked with market power.)

Low barriers to entry

If new sellers can enter the market easily, then the possibility of new entrants acts as a deterrent to anti-competitive behavior by current sellers in the market.

Questions of competition at the retail level arise because of the recent increased costs of home heating oil to the residential sector. The concern about the conduct, i.e., pricing decisions, of retailers must be placed in perspective in order to understand why changes in the market have occurred prior to, during, and since price controls.

The number of sellers and buyers in the retail sector of the home heating oil market is a major characteristic of market structure. Estimates of the number of households using fuel oil are available only by Census Regions. Therefore, the discussion of competition in the retail sector will begin at that aggregate level.

In the Northeast Census Region, which includes the six New England states, plus New York, Pennsylvania and New Jersey, 9.2 million households used fuel oil in 1976 (see Exhibit 2–12). That is, there were 9.2 million buyers in the Northeast Census Region. This compares with 8.4 million households using fuel oil in 1970. If all households are considered part of the relevant market, including those using electricity and natural gas, the number of potential buyers in the Northeast Region in 1976 increases from 9.2 million to 16.5 million. In the long term, all households are part of the market, because users of natural gas and electricity can switch to fuel oil and vice versa. However, in the short term, the consumer must choose among fuel oil dealers, rather than among alternative fuels because he is locked into fuel oil burning furnace equipment.

Briefly, in the short term, demand for fuel oil is relatively inelastic. That is, the consumer, faced with an oil burning furnace, must buy fuel oil. The consumer will choose a fuel oil dealer based upon his sensitivity to price, his perceived need for guaranteed service, and the package benefits available to him from each dealer. For example, one consumer may choose to gamble with a dealer who can offer a lower price but cannot guarantee 24-hour, seven-day-a-week service. Another consumer may choose to pay a higher price which includes repair service to his furnace. Consumers, in general, benefit when a variety of price and service arrangements are available from many dealers. These features are characteristic of a competitive market.

As the price of fuel oil rises, interim steps will be taken by the consumer to reduce the impact upon his fuel bills. Conservation occurs through the lowering of thermostats, addition of insulation, storm windows and storm doors. Supplemental fuel systems, such as wood burning stoves, are also employed.

If the price rises above a certain level, which varies from one consumer to another depending upon the consumer's price sensitivity, a decision will be made to switch to an alternative cheaper fuel system, Each individual consumer has a specific sensitivity point at which he will decide to switch to an alternate fuel system.

The number of buyers, or fuel oil burner owners, is not available on a county basis. In fact, the Federal government collects the data only through the Bureau of Census Survey at a Census Region level. Esitmates of average consumers per county can be made in the six New England states by combining surveys conducted by the New England Fuel Institute (NEFI) with the county delineations. In Connecticut, for example, NFEI estimated that 459,157 oil furnace heating systems were in operation in 1977. Given the eight counties in Connecticut, each county would have an average of 57,395 systems (see Exhibit 2–13). The average number of systems per county in New England ranged from 7,854 in Vermont to 97,851 in Massachusetts. The total number of households in the Northeast

Region combined with the estimated average number of buyers in the relevant county market indicates that buyers are not concentrated in the Northeast Region of the East-South Central Market.

Although the number of fuel oil buyers in the South Region is less than in the Northeast, and the fuel's market share is declining, nearly 3.5 million households used fuel oil in 1976 (see Exhibit 2–12). The number of buyers in the North Central Region of the East-South-Central Market also indicates the presence of a fragmented buyer's market. More than three million households used fuel oil to heat their homes in 1976 (see Exhibit 2–12).

SELLER CONCENTRATION

The number and concentration of sellers of fuel oil are difficult to assess. The Census Bureau surveys establishments whose primary business is the sale of fuel oil direct to end-users. More that 6,000 establishments in the East-South-Central Market consider the retail sales of fuel oil as their primary business. Many other companies, particulary in the Midwest, sell fuel oil as a secondary line of business. In the Northeast, the Census data are roughly equivalent to the total number of retailers, although the definable number is still fewer than actual. The Census data are least accurate in the South and North Central Regions, where many fuel oil dealers do not receive the major portion of their income from the sale of home heating oil. Even in the New England states, where the use of fuel oil is the most pronounced, 70 to 75 percent of the fuel oil retailers have fewer than ten employees (see Exhibit 2–9).

The existence of many small retailers is also confirmed by the Department of Energy's Monthly Market Shares Survey of fuel oil retailers. Of the 555 PAD I companies surveyed in 1978, 255, or 45.9 percent, had monthly sales volumes of fewer than 250,000 gallons, which translates into 3,000,000 gallons a year (see Exhibit 2–14). From Exhibit 2–15, we know that the average consumption per household of fuel oil in the Northeast was 140 million Btu's in 1976. There are 5.825 million Btu's in a barrel of distillate and 42 gallons in a barrel. Therefore, the average household in the Northeast Region consumed 1,009 gallons ($140 \div 5.825 \times 42 = 1{,}009$ gallons). In order to sell one million gallons, a retailer would need to have approximately 3,000 customers.

In 1970, the average consumption per household was 153 million Btu's, which translates into 1,103 gallons. In order to sell 3 million gallons, the dealer needed approximately 300 fewer customers, or 2,719. As consumers employ conservation measures to lower their overall fuel bills, reducing the per-household usage of fuel oil, the fuel oil dealer must acquire new customers in order to maintain his sales volumes.

The inability to add new customers can cause fuel oil dealers to diversify into other businesses or to sell his accounts to other dealers and to leave the market. As diversification and exiting occurs, the number of establishments whose primary business is the retail sale of fuel oil declines, making the market more concentrated. The level of reduction has not yet reached the the stage where competition is threatened.

In addition, if the retail market becomes highly concentrated in a particular geographic area, the ease of entry by new firms would discourage the existing firms from exerting market power. The major investment for a potential entrant is a delivery truck. The low barriers to entry into the retail market will always act as a deterrent to anti-competitive practices. The major potential barrier to entry is the inability to obtain supplies. As pointed out in the discussion of the wholesale market, only Tennessee and Florida have lost more than one supplier since decontrol. All of the other 37 states in the markets have lost one supplier, remained stable, or gained suppliers. Therefore, suppliers are available for potential entrants. The ability of suppliers to obtain supplies relates to the basic question of supply and demand, which will be discussed in Section II.

Conduct of the retail fuel oil dealer focuses upon the prices at which he purchases and sells the product. The major time period about which consumers and economists have been concerned is the period since decontrol.

R. Shriver Associates collected price data in two forms: cents per gallon and dollars per million Btu's. Price changes must be viewed from two perspectives: the increasing cost of fuel oil to consumers as it compares with the dealer's costs, and the increasing costs of fuel oil compared with the costs of substitute fuels.

Exhibits 2–16, 2–17, 2–18, and 2–19 illustrate the monthly residential and wholesale price trends for the Northeast, South and North Central Census Regions for the years 1976 through 1978. The wholesale price is a composite of prices of product sold by refiners to other refiners; by refiners to wholesalers; by wholesalers to retail fuel oil dealers. Therefore, it does not exactly represent the price that a dealer would pay for middle distillate fuel oil. Nevertheless, comparing the composite wholesale price with the residential retail price presents a sketch of the trends in prices and gross margins during the last six months of control and since decontrol.

The gross margin represents the difference between the per-gallon price at which the product is sold and the per-gallon price at which the product is purchased (residential retail price—wholesale price=gross margin). The gross margin is used to pay variable costs, to pay fixed costs and to provide profits to reward investors and to reinvest in new equipment or businesses. Variable costs are those costs that are directly related to the volumes of fuel oil sold. Included would be such items as truck drivers' wages, truck maintenance expenses and interest. Fixed costs are those that are incurred regardless of the volumes of fuel oil sold. Utilities, salaries of officers, rent and depreciation are all fixed costs.

Prices for home heating oil have risen substantially throughout the United States since product price decontrol in July, 1976. In the Northeast Census Region, residential prices have risen from 40.17 cents per gallon in July 1976 (a non-heating month) to 53.40 cents per gallon during December 1978 (see Exhibit 2–16). This increase represents a 33 percent growth rate in the per-gallon price a consumer paid for fuel oil. The wholesale price, however, was also increasing from 31.28 cents per gallon to 40.90 cents per gallon over the same time period. The wholesale price, therefore, increased by 31 percent, allowing the gross margin from 31.28 cents per gallon to 40.90 cents per gallon over the same time period. The wholesale price, therefore, increased by 31 percent, allowing the gross margin to rise from 8.89 cents per gallon to 12.50 cents per gallon. The 3.61 cents per gallon margin increase must be distributed among increased variable and fixed costs and profits.

The pattern of prices for the South Census Region is similar to that of the Northeast (see Exhibit 2–17). From an average base price of 37.83 cents per gallon in July 1976, the residential price of home hearing oil has risen to 51.95 cents per gallon in Decembr 1978. This 37 percent increase compares with a 30 percent increase in the wholesale price, which was 39.45 cents per gallon in December 1978, compared with 30.31 cents per gallon in July 1976. The gross margin, therefore, has grown by 4.98 cents from 7.52 cents per gallon to 12.50 cents per gallon.

In the North Central Census Region, the residential price has increased 33 percent from 37.71 cents per gallon to 50.01 cents per gallon in December 1978 (see Exhibit 2–18). The wholesale price has risen by 30 percent from 30.73 cents per gallon to 39.98 cents per gallon during that same time period. The greater increase in the residential price has resulted in an average 3.05 cents per gallon gain in the dealer's gross margin, which stood at 10.03 cents per gallon in December 1978.

To the extent that available wholesale prices fairly represent the cost of fuel oil to the retail dealer, the increased product costs have been passed on to the residential user. In fact, the gross margin has increased in all three Census Regions that make up the East-South-Central Market. As stated above, an increased per-gallon gross margin does not necessarily translate into additional profits. The gross margin is used to pay for all *non*-product costs, such as rent, depreciation on equipment, wages, interest costs, inventory holding costs, as well as to provide profits.

Cost data are not readily available to detrmine the extent to which non-product costs have risen. However, several performance measures indicate that the additional gross margin has not been translated into higher profits. As Robert Morris Associates indicates in its Annual Statement Studies, annual profits before tax as a percent of sales for retail fuel oil dealers are between 1.1 and 1.5 percent.

	Percent
1976–77 [1]:	
204 companies	1. 1
1977–78 [2]:	
235 companies	1. 5

[1] Financial closing periods: 145 companies from June 30-September 30, 1976; 59 companies from October 1, 1976-March 31, 1977.

[2] Financial closing periods: 170 companies from June 30-September 3t, 1977; 65 companies from October 1, 1977-March 31, 1978.

Source: Robert Morris Associates, Annual Statement Studies, 1976, 1977, 1978.

This performance has not been sufficient to encourage entry into the market by new retailers, as evidenced by the ten percent decline in retailers in the Northeast between 1974 and 1976. In addition, gross margin should not be examined in isolation from volumes sold. As the price of home heating oil rises, consumers can take conservation measures to reduce consumption. If the per-household consumption declines, the fuel oil dealer must acquire new accounts to maintain sales volumes. If he cannot increase sales volumes, then he must increase his

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gross margin in order to cover fixed costs. This complex relationship between per-gallon gross margin, volumes and profits will be explored extensively in Chapter Five, which is related directly to the economic viability of fuel oil dealers.

In the short term, the consumer who has an oil burning furnace must use fuel oil and is the victim of higher fuel prices. As an interim measure, he can reduce consumption or supplement his system with other systems, such as wood burning stoves. In the long term, the consumer can switch to substitute fuels, principally electricity and natural gas, if these fuels are available. Conversions can occur naturally, as a consumer's system needs replacement, or ahead of schedule, in response to rising fuel costs.

The ability of a consumer to substitute natural gas or electricity serves as a natural downward pressure on retail prices. From 1972 to 1977, fuel oil lost market share in terms of consumption in all three Census Regions (See Exhibit 2–15). This information is based upon DOE consumption data. According to the Bureau of Census, which monitors the type of furnace system households use, fuel oil systems maintained their 55 percent market share in the Northeast Census Region from 1970 to 1976, but in the South Region, fuel oil systems lost four percentage points and dropped to only 15 percent of the Market in 1976. Fuel oil systems claimed 14 percent of the North Central Region market in 1976, down six percentage points from 1970. If fuel oil prices rise disproportionately higher than electricity and natural gas prices, then the consumer has the incentive to convert his system, either at the time it needs replacement or earlier.

Exhibit 2–20 compares the price of the three major types of fuel in terms of dollars per million Btu's for 1972 and 1977. Note that in 1977 the price of fuel oil was less than that of natural gas in four states in the Northeast Region—Connecticut, Massachusetts, New Hampshire and Rhode Island. In Vermont, the prices are comparable.

For the remaining four states—Maine, New Jersey, New York and Pennsylvania—the price of distillate fuel oil was higher in 1977 than the price of natural gas. These price data have been compiled by DOE for the years 1960 through 1977. (Data for 1978 are not yet available.)

Exhibit 2–21 illustrates the price trends for the three major fuel types for Connecticut, Massachusetts, New York and Rhode Island from 1960–1977. Each of the four states illustrates the ability of fuel oil to compete, in terms of price, with natural gas since the 1973 oil embargo. Electricity incurred the largest absolute cost increases, beginning in 1970 and rising sharply after 1973. Fuel oil and natural gas follow the same general upward price trends, although natural gas continues to be more expensive in Connecticut and Massachusetts. Rhode Island varies from year to year in terms of the comparable costs. In New York the cost of fuel oil surpassed the cost of natural gas in 1973 and has remained higher.

By 1977, fuel oil's cost was greater than natural gas in all but one of the 16 states of the South Census Region (See Exhibit 2–22). In Florida, distillates cost four cents less than natural gas in terms of dollars per million Btu's. The gap had narrowed drastically from what it had been during the time period of 1960 to 1973 (see Exhibit 2–23). The price of fuel oil increased by more than 160 percent in seven states from 1972 to 1977. This increase probably accounts for the loss in market share that fuel oil systems have incurred.

In the North Central Region, the price of fuel oil had outdistanced the price of natural gas in all 12 states by 1977 (see Exhibit 2–24). Even in 1972, Wisconsin was the only state in which the price of fuel oil in terms of dollars per million Btu's was the same or less than the price of natural gas. The recent availability of natural gas, combined with the surge in fuel oil prices since 1973 account for the six percent market share that fuel oil systems have suffered. Illinois and Michigan are representative of the marked shift in prices since 1973 (see Exhibit 2–25).

As the market for fuel oil shrinks, both in terms of households using the product and consumption per household, dealers, striving to increase volumes to cover fixed costs, must look to current customers of other dealers as the only new business prospects. This cannibalistic process, evidenced in consumption and profit performance data, indicates that the retail market is highly competitive.

The consumer's ability to switch to other fuel types is an important safeguard to competition in the retail market. The degree to which consumers are choosing to switch to substitute fuels is discussed in Section II.

FUEL'S SHARE OF HOUSEHOLD MARKET EAST-SOUTH-CENTRAL MARKET

Fuel type	1976 Number of households (thousands)[1]	1976 Fuel's share of market (percent)	1970 Number of households (thousands)	1970 Fuel's share of market (percent)	Change in number of households (thousands)[2]	Change in market share	Share of change in number of households (percent)
Northeast census region:							
Natural gas	6,140	37	5,741	37	399	0	37
LPG	125	(3)	168	(3)	(43)	(3)	(4)
Fuel oil	9,161	55	8,414	54	747	1	70
Electricity	846	5	474	3	372	2	35
Coal/coke	162	(3)	541	3	(379)	(2)	(36)
Wood	63	(3)	25	(3)	38	(3)	4
Other	38	(3)	103	(3)	(65)	(3)	(6)
None	9	(3)	13	(3)	(4)	(3)	(3)
Region total	16,544		15,479		1,065		
South census region:							
Natural gas	11,449	48	9,626	50	1,823	(2)	41
LPG	2,367	10	2,106	11	261	(1)	6
Fuel oil	3,488	15	3,645	19	(157)	(4)	(4)
Electricity	5,498	23	2,544	13	2,954	10	66
Coal/coke	193	(3)	624	3	(431)	(3)	(10)
Wood	584	2	550	3	34	(1)	(3)
Other	4	(1)	40	(3)	(36)	(3)	(3)
None	159	(3)	123	(3)	36	(3)	(3)
Region total	23,742		19,258		4,484		
North central census region:							
Natural gas	13,803	70	11,708	67	2,095	3	96
LPG	1,337	6	1,106	6	231	0	11
Fuel oil	3,004	14	3,431	20	(427)	(6)	(20)
Electricity	1,366	6	546	3	820	3	38
Coal/coke	102	(3)	575	3	(473)	(3)	(22)
Wood	91	(3)	78	(3)	13	(3)	(3)
Other	14	(3)	84	(3)	(70)	(3)	(3)
None	5	(3)	9	(3)	(4)	(3)	(3)
Regional total	19,722		17,537		2,185		

[1] Households—Occupied units, rounded to nearest thousand.
[2] Included new construction, conversions, and removals from housing inventory.
[3] Negligible.

NOTES

Northeast census region: Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Vermont.

South census region: Alabama, Arkansas, Delaware, District of Columbia, Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia, and West Virginia.

North central census region: Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota, and Wisconsin.

Source: Annual Housing Survey: 1976, Part A General Housing Characteristics, Bureau of Census; sample survey.

Senator BENTSEN. Mr. Secretary, I've heard repeatedly along this table comments about your candor and your forthrightness. I'm very appreciative of that.

I also think about the incredible management job you have performed of taking a new Department and whipping it into shape—a sentiment that has come from many diverse sources and competing sources.

Then I look at the problem of convincing people that they ought to change their life styles. They ought to live more energy conscious. They ought to give up some of the things they've enjoyed, and then you have the job of getting reluctant allies to ignore their own domestic interest groups, at least for the moment, with the idea that cooperation in the long run helps us all. You have one of the toughest jobs in the administration.

I'm delighted we have a man of your integrity and ability, and I wish you well.

Secretary DUNCAN. Thank you very much.

Senator BENTSEN. Our next witness will be Secretary Bob Bergland.

STATEMENT OF HON. BOB BERGLAND, SECRETARY, DEPARTMENT OF AGRICULTURE, ACCOMPANIED BY DALE HATHAWAY, UNDER SECRETARY, AND HOWARD HJORT, DIRECTOR OF ECONOMICS

Secretary BERGLAND. Thank you, Senator Bentsen, for inviting us to testify before the committee today.

Senator BENTSEN. Mr. Secretary, we are very pleased to have you, and thank you for your patience. I want to tell you I'm aware of the responsibility you have as chief spokesman for the administration on matters of agriculture. You have certainly shown a welcome responsiveness to the needs of the American farmer. He is facing some very difficult commitments today in helping us achieve national foreign policy objectives. I also feel strongly—as I feel you do—that he must not be made to bear that whole burden by himself. It is a burden to be shared by all of the people as our Nation tries to do those things that are necessary in trying to discourage aggression around the world.

Mr. Secretary, we had talked earlier about the dependence on Persian Gulf oil by some of our allies. We have a situation where the Russians have had short falls in their production of grain. We have increasingly come to supply that short fall. For example, from 1974 to 1979, the U.S. share of all Soviet grain imports increased from 44 percent to where over 75 percent was being projected before the embargo. We are the biggest supplier of grain to the Soviets and the 17 million tons embargoed is a real loss to our economy.

Now, a study was released yesterday, I believe, by Senator Proxmire, that said that the embargo would only be as effective as the cooperation we receive from our allies.

Your office follows world grain markets. If the Soviets are going to make an endrun around our embargo, where are they going for that replacement grain? Which countries do we believe will not support us in that embargo? Who are they?

Mr. Secretary, I know we are running late, and for that reason, without objection, we will place your prepared statement in the hearing record at this point and continue with the questioning.

Secretary BERGLAND. Thank you, Senator Bentsen.

[The prepared statement of Secretary Bergland follows:]

PREPARED STATEMENT OF HON. BOB BERGLAND

Mr. Chairman and members of the committee, I appreciate the opportunity to appear before you to discuss the President's decision to suspend shipments of agricultural exports to the Soviet Union. This action and others were taken in response to the Soviet Union's invasion of Afghanistan, to demonstrate that such an act of aggression would result in serious and costly countermeasures.

The suspension of shipments of agricultural products was not the only action directed by the President. He directed a series of measures, including asking Congress to defer action on SALT II; delaying opening new American and Soviet consular offices; deferring most economic and cultural exchanges; calling for U.S. withdrawal from the Olympics if the Soviet troops are not withdrawn from Afghanistan by February 20; ordering the review of U.S. licensing policy on the exports of high technology and temporarily halting such exports; and restricting severely the fishing privileges of the Soviet Union in American waters.

However, the curtailment of grain shipments to the U.S.S.R. above the 8 million metric tons (mmt) allowed under the terms of the 1975 U.S.-U.S.S.R. Grain Supply Agreement and the suspension of contracts for delivery of oilseeds and oilseed products, livestock products, poultry and other strategically important items has generated the greatest attention, mostly because of the potential impacts on both the United States and the Soviet Union. These impacts and the measures taken to offset adverse impacts in the United States will be the primary focus of my statement today. However, I will also review the outlook for U.S. agriculture in the wake of the suspension.

UNITED STATES-SOVIET TRADE

U.S. agricultural trade with the Soviet Union in recent years has developed into one of the most important aspects of our relations. Stemming from a Soviet policy decision to upgrade the quality of the Russian diet and due in part to the unreliability of the weather in Soviet crop-growing regions, Soviet grain imports have meant large sales for U.S. producers and increased foreign exchange earnings for the U.S. economy. During the past decade, U.S. grain exports to the U.S.S.R. have helped make a more-than-25 percent increase in Soviet meat production possible.

However, because of the uncertainty of Soviet production and the consequent widely-varying import needs, U.S. agriculture and the domestic economy have been severely shocked by the extremes of Soviet purchases. Between 1971–72 and 1975–76, U.S. grain exports ranged from just under 3 mmt to nearly 14 mmt, on a marketing year basis.

In 1975, to help regulate those extremes and buffer our agriculture and domestic economy from future shocks, we entered into the current U.S.-U.S.S.R. Grain Agreement. It allows the U.S.S.R. to purchase a total of 8 mmt of U.S. corn and wheat and requires them to buy at least 6 mmt. Should the Soviets desire to purchase more than 8 mmt, the agreement requires an understanding between the two countries on the additional quantities to be purchased. For the year between October 1979 and September 1980, the Soviets were given permission to purchase up to 25 mmt.

In 1979, Soviet grain production was 179 million metric tons—58 mmt below 1978 production and 48 below their planned target. Total agricultural output was reported in the Soviets plan fulfillment statement to have fallen off 4 percent. Because of this shortfall, we believe the Soviets had intended to import a total of about 35 mmt of grains from all sources, but the bulk of those imports were expected to come from the United States.

At the time the President ordered the suspension, the Soviet Union had contracts for a total of 21.8 mmt—6.7 mmt of wheat and 15.1 mmt of corn—for delivery in the fourth year of the five-year agreement. About 5.5 mmt of both wheat and corn had already been shipped.

We still intend to honor our five-year agreement with the Soviet Union and allow the remaining 2.5 mmt of the 8 mmt covered by the agreement to be loaded and shipped. Because of the International Longshoremen Association's refusal to load this grain, this, so far, has not been done. However, the Department of Commerce has been meeting with exporters to allocate and issue licenses on the remaining tonnage; this is being done based upon exporters' shares of contracts with the Soviets.

Trading in other products such as fruit, nuts, dairy products, animal byproducts, lumber and other agricultural commodities was also halted, as all agricultural shipments were stopped. However, yesterday, this total ban was modified to allow certain agricultural products not related to the feed-livestock complex and with no strategic significance to be exempt from prior licensing review. Such products include feathers, fruits, nuts other than peanuts, tobacco, vegetables and wood.

The export of agricultural products which might be used for feed or meat replacements under extreme circumstances—items such as tallow, shrimp, meat extenders which in the past have been a part of normal commercial sales—will now be subject to a case-by-case licensing procedure. Exports of agricultural commodities and products needed by the Soviets for feed will continue to be prohibited. Therefore—besides wheat and feed grains—seeds, soybeans and animal feeds, meat poultry, dairy products and some animal fats will not be allowed to be shipped.

IMPACT ON THE USSR

This suspension has severe implications for the USSR. We believe the initial impact of the sales curtailment will begin late this winter. As I mentioned earlier, because the 1979 Soviet grain crop was well short of its plans and needs, the Soviets were forced to purchase record quantites of grain in 1979–80 in an attempt to prevent distress slaughter of livestock—especially hogs and poultry. These purchases began last summer and were designed to tide the already-declining Soviet livestock sector over until 1980 grain crops were available. Given this situation, the suspension of sales and shipments of 17 mmt is certain to have a significant impact on the USSR.

The suspension of grain sales to the Soviet Union will sharply reduce the availability of grain to the Soviet livestock industry, especially in the late winter and spring of 1980. While Soviet imports on an October-September year are expected to be 23 to 26 mmt—well below the 35 mmt expected before the suspension action—the main effect of the decrease will fall in the five-month period of March–July 1980.

We had forecast the U.S. would supply three-fourths of the Soviet imports between the end of October 1979 and September 1980. Between now and October, only about 2.5 mmt—the balance of the 8 mmt—will be going to them, instead of the 19.5 they expected.

Most major exporters have agreed not to offset the suspended U.S. exports through additional sales. Some additional portion of the cutback from 25 to 8 mmt of U.S. exports may be offset by those exporters that do not cooperate fully with the U.S. effort. But while the exact reduction cannot now be measured percisely, we believe there will be a sizeable reduction in Soviet grain imports.

In our first assessment since the Soviet sales suspension, we estimated that Soviet use of grain for feed during 1979–80 will drop at least 5 percent from the pre-suspension forecast and that the reduction in grain fed will be exacerbated by its concentration in the late winter and early spring. This is the period when U.S. exports will cease due to the trade suspension and when the Southern Hemisphere production is moving into position for export. Consequently, the relative shortfall during this period will be more severe and may force a reduction in hog and poultry numbers. Dislocation caused in transport and location of feed supplies also could worsen production performance.

Soviet meat production in 1980 could be down significantly from 1979 and mean reduced per capita consumption unless offset by meat imports. In a country where the average citizen's meat consumption has remained at about 57 kilograms—125 pounds—since 1975, a prospective drop of about 4 percent will be sorely felt.

OFFSETTING ACTIONS FOR U.S. AGRICULTURE

Obviously, while the suspension action will affect the USSR, its goals and its citizens, it might have meant serious repercussions for the U.S. agricultural sector—including disastrous declines in farm prices and farm income. However, it was not the President's intention that U.S. agricultural producers should alone bear this burden. He, therefore, directed a series of actions be taken to offset the domestic impacts resulting from the suspension of sales.

First, there was the potential immediate impact of the suspension on grain market prices, on private exporters who had valid contracts, and ultimately on the entire grain marketing system of the United States. Approximately 4 mmt of wheat and 10 mmt of corn contracted for the Soviet Union were suspended from shipment, and contracts backing those quantities extended to local grain firms and ultimately to wheat and corn producers.

If these contracts had not been honored, many of the grain exporters would not have been able to meet financing commitments, and would have been forced to sell the undelivered grain at any price. Prices would have plummeted, causing millions of dollars in losses and bankruptcies throughout the grain marketing system. Ultimately, local elevators and America's farmers would pay the price.

To avert this, the United States, through the Commodity Credit Corporation (CCC), offered to assume the contractual obligations of exporters for the undelivered grain, most of which was corn.

We are now in the process of completing our review of the actual document and formula which will be used in such a transaction and hope to have it ready for negotiations with exporters late this week. I would add that we have taken—and continue so take—careful steps to ensure that contracts assumed by CCC protect against losses—not guarantee profits—to exporters in this assumption process.

Regarding corn, the CCC will either take physical delivery or sell the assumed contract to a third party for domestic or export usage. If physical delivery takes place, under current regulation the corn cannot be sold back into the market at a price lower than $3.15 a bushel at the farm. This is equal to 150 percent of the loan price, set by law in the 1977 Food and Agriculture Act. Assumed contracts will be sold only if the farm price is above the level of January 4, before shipments were suspended.

The CCC also will assume all of the contractual obligations for wheat earmarked for shipment to the Soviet Union. However, none will move back into the commercial market. Instead, it will be reserved for use in our foreign food assistance programs.

To facilitate this action, President Carter will request the Congress to provide immediate supplemental funds to increase our foreign food assistance programs for the current fiscal year. The President has reiterated the Administration's request for passage of legislation to permit the holding of up to 4 mmt of wheat in reserve for food assistance during periods of short supplies. While we now have the authority to buy wheat, we will. But, we once again strongly urge the Congress to approve legislation to require use of such grain to honor foreign food assistance commitments, no matter what the circumstances.

The second set of actions we have taken will isolate grain still owned by farmers from the marketplace.

The farmer-owned grain reserve—the cornerstone of the Carter Administration's food and agriculture policies—is being amended to encourage farmers to place additional grain in reserve instead of in the market. By offering greater incentives to farmers to participate in this program, the supply of grain available to the commercial market will be reduced and farm prices will be maintained.

Specifically, the wheat and corn loan prices for the 1979 crop were boosted and the bands between release and call levels were increased. Before these actions were taken, wheat placed in the reserve could be released at $3.29 a bushel and the loan would be called at $4.11 a bushel. Under the new release and call levels, release price is hit at $3.75 a bushel and the call at $4.63.

For corn, the release price was $2.50 a bushel and the call price was $2.80 a bushel. Now, corn cannot leave the reserve without substantial penalty until prices reach $2.63 a bushel. Loans are not due until prices reach $3.05 a bushel. Similar increases have been made for the other feed grains.

Reserve storage payments were also increased, from 25 to 26.5 cents per bushel for all reserve commodities except oats, which was increased from 19 to 20 cents a bushel.

We are also waiving the first year interest charges for the next 13 million tons of corn entering the reserve. To be fair to producers who placed corn in the reserve before the President suspended shipments, one year's interest will be waived starting January 7. However, interest accrued before that time will still be owed.

Where congestion is backing up the marketing system, CCC will purchase corn from local elevators and producers.

The third set of actions consists of measures to expand U.S. grain exports in the short-term without reducing the exports of cooperating countries.

President Carter has announced that he is asking Congress not only to act quickly on his pending FY 1980 supplemental appropriation request of $96 million for food aid, but also add another $100 million to permit us to program a portion of the grain previously sold to the USSR to meet urgent food needs of international refugees and poor people in selected less developed countries. The additional $196 million would permit us to increase grain and soybean product exports this year.

The President also indicated that he would increase his FY 1981 P.L. 480 budget request by $100 million. That would provide for the export of as much as 450,000 tons of grain and soybean products.

The specific additional country and commodity allocations will depend both on the ability to identify concessional sales markets which will not undercut either U.S. commercial sales or exports of other countries, as well as the magnitude of rapidly increasing refugee and other emergency feeding needs.

We have announced that the CCC noncommercial risk guarantee program for financing agricultural exports will be broadened in the near future and will provide all-risk coverage on up to $2 billion. The additional guarantees will be used to stimulate new exports as long as they do not replace our own commercial (cash) exports or disrupt markets for cooperating countries.

The expanded all-risk guarantee program is expected to reduce long-range operating costs, provide the advantage of variable interest rates and broader program flexibility than provided by the current direct financing program.

Also domestically, the Administration has sought to stimulate the production of grain for alcohol fuels, better known as gasohol. This could provide an additional, significant factor in future grain production and demand. The administration has announced a program to greatly expand (quadruple) gasohol production this year, and provide enough gasohol to replace 10 percent of the nation's supply of unleaded gasoline next year, primarily through tax incentives, loans and loan guarantees. This program alone could be a market for up to 3 mmt of grain by the end of 1980.

The fourth set of actions consists of longer-term adjustments in supply and demand. While we have announced there will be no set-aside for 1980, we do have the legal authority to implement a diversion program should supply, demand and price factors warrant such a program. Presently we are reviewing these conditions and will announce our decision by March 1, in enough time to meet producers' planning needs.

THE COSTS

Throughout our history, the American people have always been willing to make whatever sacrifices are necessary to meet the challenges that such events pose. This is one time when some sacrifices will be called for. But I am firmly convinced that the actions we have taken will reduce the amount of sacrifice to much lower levels than one might expect.

What we have done is to pull out all the stops to make sure that the suspension does not alter supply and demand fundamentals. By taking out of the market every bushel of grain destined for the Soviet Union, there is no more grain available for trade than there would have been had the grain been delivered.

But that understates the scope of our actions. There are producers in your states who are going to put more into reserve than they had originally planned. That grain will not be available to the market unless wheat prices rise above $3.75 a bushel and corn prices surpass $2.63 a bushel.

These actions will not call for undue sacrifice by the taxpayers. We expect that total cost of those actions—the assumption of contracts, the changes in the farmer-owned reserve—to range between $2.5 and $3 billion for the combined fiscal years 1980 and 1981. That comes to less than $14 per person for that two-year period.

But that $14 is not a net cost. A significant part of the money we spend on these programs is in the form of loans or credits. Farmers will be putting more commodities into reserve, but these commodities will be available later to come back onto the market when prices move above reserve trigger and call points. When that happens, reserve loans will be repaid and a receipt will go back to the taxpayers. I believe that at least half the total expenditure will come back to the Treasury—which means the net cost of these actions will be about $7 per person.

1980 OUTLOOK

We, of course, have no crystal ball to predict with any certainty what 1980 will bring. But considering the fundamentals of world politics, economics and supply and demand factors, we can offer some likely prospects for 1980.

World demand for U.S. agricultural products continues to expand rapidly due to global economic expansion, population growth as well as favorable exchange rates and increased emphasis on improving diets in food-short developing countries. These factors were contributors to 1979's record agricultural exports and they boosted our agricultural trade surplus to nearly $16 billion last year.

By all indications, 1980 should still be a record year for U.S. agricultural exports. World grain production declined about 4 percent in 1979–80 but our own crops have never been larger. Although exports will be slightly lower than they would have been if Soviet sales and shipments had gone forward as planned the volume should come close to a record 150 mmt—compared with 137 mmt in 1979. This means an 11 percent increase in the volume of wheat exports, and an increase of about a tenth in feed grain exports and continued dominance of the world soybean market—at least through the 1980 Southern Hemisphere harvest. The value of our farm exports is expected to be $36.4 billion, contributing more than $18 billion to our balance of payments.

These numbers illustrate an important point. While the Soviet Union has been a major U.S. customer for the past few years, it is by far not the most important market for U.S. farm exports. The Soviet share of our export market can more clearly be understood by recognizing that exports to the rest of the world have accounted for more of the growth in our export sales—and those are steady, substantial and growing markets that are less dependent on the rapidly-shifting currents of weather and international politics.

As for world production in 1980, it is impossible to make any precise predictions. It is also difficult to predict our own. But should weather or other problems cut back our production levels, we have stocks on hand to meet world and U.S. needs. If weather is again favorable, we have legal authorities to offer programs to producers to try and bring supplies more in line with demand.

Through the series the Administration has taken in the wake of the Soviet sales suspension, farm prices and farm income should be about the same as they would have been without the suspension of sales. Initially after the suspension action was announced, we saw some slippage in farm prices. However, in the three and a half weeks since, most prices have recovered. For the balance of the 1979-80 crop year, we are still predicting grain prices will average higher than in 1978-79.

But while this is encouraging, it is not to say that all will be well with respect to U.S. agriculture in 1980. The rising cost of farm inputs is expected to erode much of the gains in higher farm prices and record farm receipts, leaving net farm income about a fifth below 1979-levels.

But that does not tell the whole story either. The typical midwestern corn and wheat farms and land extensive farming and ranching operations will likely be spared much of the burden of the income decline. For example:

Cow-calf and sheep producers' income will likely increase in 1980. The calf crop is smaller and feeder cattle prices may reach record high levels.

Dairy producers' financial outlook will continue to be favorable. Milk prices may be up 10 percent and milk production will be at least as large as last year.

Wheat, rice, corn and sorghum farmers will have higher cash receipts. Cash receipts from all crops—excluding the oil crops—are now expected to be 8 percent above the record 1979 level.

Prospects for soybean producers, however, are not as good as in the recent past. Soybean prices will be under pressure from larger supplies, and production expenses will be higher. Yet, it appears that returns still will be above costs for most growers. Southern Hemisphere developments and spring planting decisions are key factors in 1980 oilseed prices. Cotton producers are faced with large supplies as a result of last year's high yields but fortunately demand has been exceptionally strong. For the first time, exports will exceed domestic use.

Fruit and vegetable producers also face moderately lower returns. A large pack of both canned and frozen fruits and vegetables, together to increasing labor costs will narrow their profit margins.

Those who will be hardest hit by 1980 economic conditions will be the beef feedlot operators, hog producers and feeders and poultry contractors. These tend to be large-scale, highly specialized and highly capitalized operations who are less likely to have significant off-farm income. They also tend to have the highest debt-to-income ratios and to be the most vulnerable to cash flow problems.

After the past two years of strong farm prices and income, farmers are generally beginning 1980 in good financial condition. In spite of increases in debt, asset values are rising rapidly and are high relative to debts. Debt repayment rates appear to be normal and delinquencies are few. Farmland values appear to be continuing to rise steadily—reflecting current high farm incomes, optimism among farmers regarding long-term income prospects and the small number of parcels of land for sale. While interest rates are higher than in recent years, it appears that farm loan funds are in adequate supply.

Turning to another fact of U.S. agriculture, it appears that food prices in 1980 will rise 7 to 11 percent above 1979 levels. This compares with an 11 percent increase in 1979.

At present, we are predicting most of the increase—just under three-fourths—to come from the non-farm sector—attributable to higher labor, packaging, transportation and processing costs. Higher farm prices are likely to contribute one-fourth of the increase and foods with a non-U.S. farm base will contribute one-tenth percent to the 1980 total.

Although food prices are expected to rise seasonally in the first half of 1980, we do not expect to see increases of the magnitude seen in the early part of the last two years. Continued large production of pork and poultry as well as large supplies of oilseeds and citrus fruits will dampen overall rises. We may also see demand for some of the more expensive cuts of meat and food-away-from home diminished with a slowdown in the economy. Moderate increases are expected in the second half of the year as food price changes will be mainly caused by steadily increasing marketing costs.

Mr. Chairman, before concluding my remarks today I would like to add that I am not suggesting that we have succeeded in our every objective. Yet, I will state without hesitation that the record of the past two years—and indeed, the

past three weeks—has been very positive and the outlook remains good. However, our nation's agricultural plant and our producers still face many problems. In the coming months, we will look forward to working with our producers, consumers, agricultural industry, and you in the Congress, to try to make in-roads in solving the problems that remain. Thank you.

Secretary BERGLAND. Mr. Chairman, to answer your question on the Soviets evading the grain embargo, I don't think there is a country in the world with any commercial capacity that will cooperate with the Soviets in that adventure. As a matter of fact, the United States is the only country in the world with any quantity of grain and the capacity to deliver, and we have, of course, secured the cooperation of Canada, Australia, the Western European Economic Community, and Argentina in providing the Soviet Union with a united Western front.

They cannot make up this shortfall.

Senator BENTSEN. They cannot make up that shortfall? Then let me get to the next question because we had a chart up here earlier showing us the effect on the U.S. economy if we lost 2 million barrels a day of oil due to an interruption of supply from the Persian Gulf.

Now as I understand it, if this 17 million tons of grain is not available, and it approximates 10 percent of the supply consumed by the Russians, what kind of an impact is that going to have on the Russian economy?

Is its impact something more than cosmetic? Is it something that is going to have a substantial impact on the Russian economy, if, as you think, they cannot make an endrun around our embargo?

Secretary BERGLAND. Mr. Chairman, I've characterized this action and its effect on the Soviet as a major inconvenience for them. It's true no one in Russia will starve, but in fact about 8 years ago, the Soviet Government made a major decision to develop and expand its animal output to satisfy a growing consumer demand. Within the past 5 years, they have been building primarily poultry- and pig-producing facilities, both of which require grain. Cattle can, of course, get along on forage.

The grain requirements, they knew, must come increasingly from non-Soviet sources because they have such limited capacity to produce grain in their own country because of the hostile climate and other environmental limitations. And so, within the past 4 or 5 years, with large grain imports, their expansion and output of pork and poultry has been dramatic.

We, by this action, will force them to not only curtail the expansion but actually engage in a reduction. We think they will not kill their cows. It takes too long to replace them. They will feed their pigs and chickens in the current cycle and restrict the replacements, which would probably mean chicken shortages showing up by late spring or early summer, pork shortages by midsummer, early fall, and a matter which the Soviets will have to contend with.

I don't argue that this meat shortage will bring the Government to its knees, but we have known of other centrally planned economies that have had food shortages, and what they've had to contend with. Poland, for example, had food riots a few years ago—because food supplies are a major issue for that Government.

Senator BENTSEN. The embargo will deny ourselves a market for some 13 million tons of corn and some 4 million tons of wheat. Looking at the average increase of consumption of some of the other grain importing nations, how long is it going to be before that consumption is made up in other markets for us? How long are we going to have to be storing grain or trying to find some way to offset the impact of the embargo?

Secretary BERGLAND. Mr. Chairman, we are issuing our current export estimates this morning. It is worthwhile to note that the Russian business is a lot more interesting than important. We don't need them, if it comes to that.

We don't need to take much of a chance with our security. I can guarantee that, too. For example, our current estimates are that our current exports of grain and agricultural products this year will be 150 million tons without the additional Russian business, compared with 137 million tons last year.

Senator BENTSEN. Give me those numbers again.

Secretary BERGLAND. Let me break it down. We're going to exceed last year's wheat exports by 10 percent. It'll be 36.1 million tons. Feed grain exports are projected at a record 65.9 million, compared to last year's 60.2. Soybean sales are forecast to 22.2 million tons, up from last year's previous record, 20.5.

It goes on and on, Mr. Chairman. Business is booming, and one thing we've had to contend with is this myth that the Russians are so all powerfully important. They're not.

And so we're making arrangements to run for the long haul if need be. If we're not prepared to go back and do business with the Russians except on our terms, and when they decide to return to a safe and sane foreign policy that does not pose a threat to the United States, we're prepared to go back and do business with them.

Senator BENTSEN. Does that mean you are going to have a policy of paying American farmers not to produce—that you're not going to have some enormous storage problem in this country?

Secretary BERGLAND. We are not, Mr. Chairman. We have more than 11 billion bushels of one-farm storage capacity. We have more than 7 billion bushels commercial warehouse capacity. We have no overpowering burden, and we have a reserve program in place to temporarily reserve the grain that otherwise would have been loaded to the Soviet Union, holding it back on the farms to wait and see what the next 12 months hold. We don't know what the corn yeilds will be this year. We haven't any idea. It's between 90 and 115 bushels per acre, I suppose.

Senator BENTSEN. Along the lines of increasing markets, let's get into the question of gasohol and what we can do with that energy supply option. As I recall, the President's program calls for increasing the manufacture of ethanol for gasohol something like on a fourfold order.

The embargo may help satisfy grain requirements for that ethanol production. But in the longer run, does the gasohol program confront us with any tradeoffs between corn that we will need for cattle feed for example? Are we going to have to balance off whether we have gasohol or whether we have those feed stocks?

Secretary BERGLAND. There need to be some tradeoffs considered, but it's not an either/or choice. Our exports are much as though we were a colony. We're exporting raw materials. We think there can be a great deal done in the area of processing to extract the energy for alcohol and export protein, for example, The two are not exclusive.

This is a new industry, however, which is only now starting to become a commercial reality.

Senator BENTSEN. Then you're thinking that what might have been thought of as excess production would be going into things like gasohol.

Secretary BERGLAND. We think it will. Yes, Mr. Chairman. As recently as last July, the production of alcohol was not economically feasible. Today it is.

Senator BENTSEN. What's happened that makes it feasible now?

Secretary BERGLAND. The OPEC price increases have changed the domestic economics of alternative fuels substantially.

Senator BENTSEN. But it's more a price action than it is some major technological breakthrough?

Secretary BERGLAND. It's both, but mostly price. Yes, sir.

Senator BENTSEN. I think my time has expired. I turn to Congressman Wylie.

Representative WYLIE. Thank you very much, Mr. Chairman.

Mr. Secretary, I want to follow up on the questions about gasohol and alcohol and ask Secretary Duncan the same question. I might say that I'm now convinced that the Ohio Farm Bureau Federation's emphasis on alcohol is the right direction that we should take on alcohol, on alcohol fuel engines. And this Soviet invasion of Afghanistan, as I said before, may be a blessing in disguise in that it shows the necessity that we have to get off our dependence on Persian Gulf oil, and at the same time, we are apparently going to have a surplus of grain.

I might say that Brazil has done a lot in this area. They are producing automobiles, or having imported automobiles which run on ethanol and alcohol. Do you think there's enough coordination between your Department and the Energy Department to produce gasohol or an alcohol fueled engine for automobiles? Twenty percent of all the oil we use in the country is burned in our automobiles. Couldn't we cut down considerably on our dependence on foreign oil if we go this route?

Secretary BERGLAND. Substantially, yes, sir. We could. May I point out that if we could achieve—as I think we're about to achieve—a 10-percent reduction in home heating oil consumption through energy conservation programs, that represents as much diesel fuel as is burned up in all the tractors on all the farms in our country for an entire year.

Representative WYLIE. Good. What do you think about a Manhattan-type program to produce fuel for cars from farm products?

Secretary BERGLAND. I think we're in it, but it's in a more subtle way than the Manhattan exercise. It is coming. It will be driven or fueled by, in some cases, corn; in some cases, animal waste; in some cases, city garbage. We think for the long run the biggest feed stock will be wood material.

I think the day will come when we'll have energy orchards, Congressman Wylie. We'll be planting trees designed primarily for the capacity to gather the Sun's power and convert it to alcohol.

Representative WYLIE. OK. Right now we have this surplus of grain, and we need a use for it. We are dependent on the Persian Gulf for oil, and we know that automobiles can run on ethanol; they run on ethanol in the Indianapolis 500. As I say, Brazil is requiring that 10 percent of their imports run on methanol.

Isn't this a good time to put in place the capacity to produce alcohol from grain and then maybe convert it to other biomass? Mr. Ed Luzinski of Battelle-Morrell Institute in Columbus is even producing alcohol from ragweed, which he's using to fuel an automobile engine which he has converted. He used that.

I think that we need some lead time here vis-a-vis our energy problems, and it seems to me as if we could do something fairly quickly here in this area. I'm just wondering if you think that your Department is doing enough if there is enough coordination. Why aren't more loan guarantees being provided? Why aren't more tax incentives being provided? And I might say, I have a bill in to do that—to encourage the production of plants to make gasohol for alcohol-fueled engines from farm products.

Secretary BERGLAND. We think alcohol will be an important motor fuel source and will grow with time. And as we learn more about how to convert the various materials to liquid fuels, it will grow even more rapidly.

We are now in the business of making loans. We have a $100 million Farmers Home Administration program in place to finance the so-called small and medium scale plants. The problem is that we're had very limited experience with this new industry, and I'm not authorized to make grants. I have to make loans. And we have to have feasibility studies.

There's a lot about this that we don't clearly understand yet.

Representative WYLIE. I stand ready to try to be helpful to you in any way possible. As one Member of Congress, I think this particular area holds a lot of promise for us, and I thank you for being here and for your comments.

Secretary BERGLAND. We agree with your assessment, Congressman Wylie.

Senator BENTSEN. Congressman Long.

Representative LONG. Thank you, Mr. Chairman.

Mr. Bergland, with reference to the gasohol program and the financing available for its production, it is my understanding that B. & I. loans, within the Department of Agriculture, have been serving as the principal source of financing. And yet, as I understand the President's budget for this year, there has been a cut in the amount of money available for B. & I. loans.

Is this inconsistent, or does this fit with what you were just speaking of?

Secretary BERGLAND. May I yield to our Budget Director, Mr. Hjort?

Mr. HJORT. No; I don't think it is inconsistent. We have earmarked $100 million from that account—the business and industrial loans—for alcohol fuel loans for this year. We'll clearly have at least that much for the next year—in fiscal 1981. It is true that the total comes down about $100 million. We've had some problems with that account but not in this particular area.

Representative LONG. What you would do then is switch the emphasis of the program?

Mr. HJORT. Within that total program, we have $1 billion in the fiscal 1981 budget. We've had $1.1 billion this year, and within that total, we believe there are sufficient funds to finance alcohol fuel.

Representative LONG. But it would reflect substantial cutbacks in the other B. & I. programs?

Mr. HJORT. Yes, sir. It could on some things where we've made some very large loans under those authorities that some believe are not appropriate for our agency.

Secretary BERGLAND. We'd like to have that whole program reviewed, Congressman Long. We've gotten dragged into financing steel mills and railroads.

Representative LONG. It looks to me as though the program has been very widespread, at least from my experience.

Secretary BERGLAND. Yes, sir, it is.

Representative LONG. Perhaps going a little bit astray.

Secretary BERGLAND. Beyond our scope, really.

Representative LONG. Mr. Secretary, in the boycott that has been imposed with respect to the grain markets, the situation in Iran nearly destroyed perhaps the only major market that there was for U.S. long-grained rice. Our farmers were shipping it to Iran and the Middle East. You quickly developed a program to help grain farmers impacted by the embargo on Soviet sales by going into the market, and by doing other things.

Do you have any programs similar to that for the rice farmers?

Secretary BERGLAND. No, sir, we do not. The Iranians were about a $500 million market for U.S. agriculture until about last July, and they started taking their business elsewhere, and by November, we were selling them virtually nothing.

We are hopeful, of course, that this whole mess can be settled and we can resume a normal relationship with them.

Mr. Hathaway runs our Foreign Agricultural Service on other matters. What about the rice question?

Mr. HATHAWAY. Congressman Long, I recognize the importance of the Iranian market to particularly the long-grain-rice producers, and we are looking for other outlets for that including, to the extent it appears feasible within the budget and other constraints, some additional use of this for refugee feeding As you know, the President will be requesting a supplemental for Public Law 480. Some of the refugees, certainly in Asia, are traditionally rice eaters, and that is one area that we're looking at.

Because of the natural preference that the Iranian people had developed for the long-grain rice, the Secretary indicated if we resume normal economic relationships, it would appear that they would be very interested in obtaining such rice in the future.

Representative LONG. One additional question, Secretary Bergland.

All of the problems that we've been talking about here today—the U.S. economy's increased dependence upon agriculture, not only for its foodstuffs, but now for a considerable portion of its energy supply—makes the question of the disappearance of land for farm usage even more important than it was a few years ago.

As you know, when you were a Member of the House, we considered legislation related to this, to some extent.

Representative Foley, the chairman of the House Agriculture Committee appeared before the Rules Committee yesterday with a proposal for an additional study of this problem. And, as a part of his testimony, Congressman Foley said that the position of the administration has been against this additional study.

Do you know anything about that?

Secretary BERGLAND. Is that what we call the Jeffords bill?

Representative LONG. Yes, I believe it is.

Secretary BERGLAND. We have effectively implemented the essence of that proposal without a new law. And the only difference, I think, in that bill and in what we've done, what it provides for some substantial block grants to States to help finance some of this activity. We have a major study underway into this question of land use.

As a matter of fact, we're paving over about 3 million acres of land a year.

We now have about 90 million acres of the world's best land under cover. Pavement, mostly. And in my lifetime, and I'm only 51, we've covered over the equivalent of all the cropland in Ohio.

At the rate we're going, before the century's out, we'll pave over the equivalent of all the land in Iowa. And that's the magnitude of this matter.

The long-range implications——

Representative LONG. The long-range implications of the problem are very serious.

Secretary BERGLAND. They're disastrous in the long run. We've implemented a program which we think can help mitigate this. Federal programs have tended to go off like loose cannons and I've made some changes.

We have nine States now where we have contracts with Governors that say that we'all make no water, sewer, multiple-housing loans or grants in violation of local ordinances and land-use policies.

Representative LONG. I think it's an example of some of the other long-range problems that we have been recently facing in this country. In the past, we've turned our back on them, and walked away from them.

I encourage you to pursue this problem aggressively and I assure you that, from this end, I'll do whatever I can to help.

Secretary BERGLAND. Thank you, sir.

Senator BENTSEN. Senator Jepsen.

Senator JEPSEN. Thank you.

Mr. Secretary, I won't say anything on the grain embargo. You already know my feelings on that.

I would like to continue to pursue some of the things that I think are a little inconsistent in what we're trying to do.

It's my understanding that there are 17 million tons of embargoed grain. It also is my understanding that we have a contract with Russia for shipment of some 1 million metric tons of superphosphoric acid which is necessary for fertilizer, that will produce an increase of some 20 million metric tons of grain.

Now since we're embargoing 17 million, and still we're exporting to them superphosphoric acid necessary for the fertilizer to produce an estimated 20 million additional metric tons of grain; is that consistent?

Secretary BERGLAND. No; it's not. As a matter of fact, the Soviets have a contract with a private American business firm.

Senator JEPSEN. It's Occidental Petroleum, a contract from 1980 to 1997.

Secretary BERGLAND. That's right. And sir, you're right. It's not consistent.

Senator JEPSEN. That's all I have.

Secretary BERGLAND. As a matter of fact, though, may I point out, Senator, that the licenses for that whole question are under active review by the Commerce Department.

Senator JEPSEN. All right. I'm just pursuing every aspect of this subject.

If we don't need their business, then the farmers again are providing a very symbolic gesture. And others aren't putting very much on the line.

It doesn't really hold true with what we're attempting to get at.

Secretary BERGLAND. Well, I'm personally against shipping phosphoric acid to the Soviet Union. And I have made my advice known to the persons in charge of that enterprise.

Representative BOLLING [presiding]. Thank you, Senator.

Congressman Brown.

Representative BROWN. Mr. Secretary, I want to discuss a little bit of a predicate with you for this whole situation, that as one of my colleagues said, and I think said very accurately, that we are substituting the possibility of war for energy policy, and perhaps we are getting involved with trade policy.

The Eastern European countries, including Russia, have a current debt to the West of something like $75 billion.

Now based on their trade, let me just pick one country out, perhaps the worst of the lot of any size. Poland owes us and other Western countries with which we have traded $20 billion.

Given their annual trade with the West, that's the equivalent of 5 years or so of trade, maybe 6 years of trade.

Or to put it on our terms, if, based on our international trade, we owed somebody a similar amount of money, some foreign country a similar amount of money, or all foreign countries a similar amount of money, we would owe a trillion dollars more than our total current national debt.

It occurs to me that one of the reasons, then, that Russia might be interested in owning the oil from the Persian Gulf, or controlling it, is that that is a means of balancing off the debt that these countries have to us and other Western allies, including the Germans, the French, and so forth, who are heavily dependent on oil from the Persian Gulf area.

Now would it have made more sense for us to cut off the credits that are given by Western banks and financial sources to Russia and the Comecon countries than it made for us to cut off our trade in grain, so that we could have put the pressure on them to back off from that situation in the Middle East?

In other words, they would have then allowed for a prioritization of what they owe or what they need. And they might have decided that they would rather import U.S. grain than they would a product made in France or Germany or some other part of the Western alliance.

And we would have suffered less—those countries that are actually more in debt on that Mideast oil situation, the Persian Gulf oil situation, might have moved to us a little bit more closely as allies in that situation than is currently the case.

Do you understand what I've tried to lay out for you?

Secretary BERGLAND. I think I do, Congressman Brown. And I would ask my two colleagues, both of whom are skilled economists, to deal on the credit matter.

I would only say that we are engaging in separate policies with regard to Poland and that's similar to, but not quite the same as our trading relationship with Hungary and Romania and East Germany.

They're all different from the Soviet Union. We enjoy a very fine commercial relationship with those Eastern-bloc countries that we'd like to strengthen, frankly, because it's a good bridge to use for a lot of reasons.

Representative BROWN. It certainly ought to be strengthened if they owe us 5 years' worth of payments for what they're purchasing.

Secretary BERGLAND. We're aware of the current conditions and external debt of Poland. It is a serious matter.

Mr. Hathaway and his colleagues are struggling with that every day. Do you want to comment on that or the Soviet credit question?

Mr. HATHAWAY. Well, Congressman Brown——

Representative BROWN. It isn't just Soviet credit, you know, as I laid it out. It is Eastern Bloc credit, the Soviets and Poland, Bulgaria, and so forth.

Mr. HATHAWAY. As president of the Commodity Credit Corporation, I technically am one of the people who owns a lot of the debt for particularly Poland because we have financed substantial quantities of grain sales over the past few years to Poland with CCC credit on commercial terms, 3-year credit.

We have not financed any additional credit since, I believe, the last announcement was last October.

Other parts of the Government are looking at the broader credit issue and I think, because most of those activities and consultations fall outside the area of the Department of Agriculture, that the Treasury Department could more appropriately answer the question of what is being requested and considered in that regard.

We have been very conscious of the point that you raised about CCC credit. Inasmuch as we do not expect to have additional requests from that area, we would not expect to be granting additional CCC credit.

Representative BROWN. Well, if you'll go back on the record and look at the question again—and my time is up—implicit in that question is the suggestion that the embargo of grain was perhaps not the right choice and an embargo of credit might have been a better choice. They might have continued to buy our grain, but brought our allies into better understanding because they couldn't have used credit to purchase from them other products. That might have been a better way in an international sense to bring the allied position and the U.S. position closer together. It would have reduced the economic impact.

Secretary BERGLAND. May I suggest, Congressman Brown, that you bring that matter up—I think that Secretary Miller is due at your February 1 hearing—that would be something more in his line.

Representative BROWN. I hope to do that precisely. And I wanted to do it with the Secretary of the Department of Energy, but time didn't permit.

Secretary BERGLAND. I would only point out that 1 ounce of gold will buy 4 tons of grain. And the Russians have a lot of gold.

Representative BOLLING. Congresswoman Heckler.

Representative HECKLER. Thank you, Congressman.

Mr. Secretary, I am encouraged that you've discussed gasohol from cellulosic waste, cellulosic products. This is something that interests me greatly. I use a form of urban waste, ethanol, mixed with gasoline in my congressional van. This is bought from a laboratory in our area which is producing ethanol from urban waste.

We are now spending, as you know, $4 billion a year to dispose of waste and it's harder and harder to find places where that kind of disposition is going to be acceptable. We're running out of landfill sites and landfill policy is becoming a major problem.

At the same time we're discussing gasohol; it doesn't seem to me that we are accelerating the timetable which will make it possible for gasohol from cellulosic fibers or waste to be on the market. And it seems to me that there's a tremendous contradiction in this. All of the critics of gasohol have said that there is not a net energy savings. In fact, they maintain that there's a net energy loss. But we know that there would be an energy saving in terms of the gasohol that is produced from recycled waste or cellulose, wood chips, et cetera.

Now, what is the realistic timetable which can bring that type of ethanol or gashol to the marketplace? And what are you doing to accelerate this? What can we do to accelerate it?

How can it be a viable option at a time when we are really struggling with the gasoline consumption problem in America?

Secretary BERGLAND. The production of alcohol from grain is not a new science. We think that that's a matter which has been tested and developed commercially, and we'll continue in that regard. Incidentally, there are going to be several large-scale alcohol-producing facilities built this year with private resources in the private sector, as it properly should be.

One of the problems in producing alcohol from cellulose is that there are a number of new systems to extract the energy being developed and it's in the research stage yet. The anaerobic digesters, the enzyme processes and other new ways of extracting energy are being worked on at Purdue University. I hate to mention various colleges. I'll forget some. But, indeed, there's a lot going in this regard.

Those persons who are interested in that business from a commercial point of view are reluctant to invest many millions of dollars in a system today because the state of the art is advancing so rapidly. By the time they get onstream, a better process may have been developed. And it's in that stage at the moment.

We 're encouraged, though. We think it will be 3 to 5 years, probably, until these new processes have been perfected and applied commercially that were designed to gather energy from waste newspaper, city garbage, wood material, and the like.

Representative HECKLER. That would mean that the development of the process would be completed, possibly by 1985, and then it would go into the question of building plants and funding and so forth. Is that right?

Secretary BERGLAND. Yes, ma'am, commercially. Now we have financed an experimental project to test the feasibility of a process which has been developed at Purdue University using wood fiber. And that's now being built.

Hopefully, that will be demonstrated this year.

Representative HECKLER. I'm informed that my time has expired.

Representative BOLLING. Senator McClure.

Senator McCLURE. Thank you, Congressman.

Mr. Secretary, the farm community of the United States was very severely shocked when the embargo of grain was first announced. And, of course, this was the first question that many of us received from our constituencies: Do you support that action?

I said I would and do if the farmers of the country aren't the sacrificial lambs on that altar. In order to make certain that they do not become the ones who pay a disproportionate price for that policy, it seems to me that there are two or three things that need to be done. And I've heard the administration address themselves to a part of that but not all of it.

First of all, you've moved to make whole the people who had such contracts, pretty largely the grain traders.

You have assured individual farmers that the surplus would be removed from the market. But it does not remove it from the market if it is just put in storage and can return to the market at some future time. It overhangs the market and depresses prices and that is happening. It seems to me that the administration ought to, by its own initiative or in support of those of us up here who want to do so, remove that from the market permanently.

And I would suggest we might couple it with our concern about alcohol and dedicate that quantity to a new alcohol program so that it cannot return to the market. It would therefore be effectively removed and would not overhang the market.

Secretary BERGLAND. Senator, the so-called overhang in this case is perhaps 500 million bushels or so, as a consequence of the Soviet action. Although it's argued that much of that will be absorbed by other countries who have entered the markets and are buying grain that we wouldn't be able to deliver to Russia. Our bottleneck today is our capacity to load ships. And so the loss is not 500 million but something less.

But under the matter of dedicating grain for alcohol, our problem is that if we were to buy corn and sell it back in the system at a subsidized rate, we depress the corn markets generally because the corn markets will feel the impact of this new corn coming in at a lower rate. Alcohol producers are now buying corn in the markets. They're buying for both motor fuel and for medicinal purposes and other necessary applications.

And so we think it would be a mistake to sell at less than prevailing market prices.

Second, we can't get anybody interested in a one-shot deal. No one is going to build a $50 million alcohol plant on the strength of this reserve which we have now which may disappear by fall.

Senator McCLURE. That leads me to the second question, because I agree with you that that's one of the deterrents. As a matter of fact, another part of the problem that we have is that you can't ask the farmers to plant from fence to fence, and then restrict their markets, which has been done by this policy. And it seems to me that although there was no 1980 farm policy with respect to restricted production, that there now needs to be one to respond to the new reality, the market which this policy has created.

I have not seen the administration moving in the direction of helping the farmers as their markets shrank or were artificially reduced, assisting them in matching that with a reduction in production. They believe, whether it's fact or not, that the administration is again pursuing a cheap food policy, which will be at the expense of the farmer.

Secretary BERGLAND. Well, we could argue the cheap food question. but on the other side of the ledger, the fact is that consumption of grain, both foreign and domestic, is breaking all previous records.

Senator MCCLURE. So is production.

Secretary BERGLAND. Yes, sir, and production last year broke all records because of a fantastic 110-bushel-per-acre yield on corn.

Senator MCCLURE. I don't want to get into the question of why we always produce more than the targets.

Secretary BERGLAND. Well, that's right. The problem is that we engage in this fancy guesswork in November that tries to forecast the weather for the following year. We can't even forecast the weather for next weekend.

It's a dangerous business, trying to predict what yields will be. But to make a long story short, we are now looking at the feasibility of whether or not we need a paid diversion program for 1980. Such a program might encourage every corn grower or grain grower to stay within his or her normal crop acreage—and that's important. We're not encouraging land mining. We've got too much of that now. We've got at least 10 million acres of land, now in crops that should go back to grass.

And that's another question. But we don't want to do anything which will encourage or allow the breaking out of noncrop land to plant to various crops. We are supporting legislation for this year, which would only allow producers who adopt a sound conservation plan to be entitled to target prices, price supports, reserve benefits, and all the rest.

Now, back to your question—we're looking at the question of whether we should have an additional paid diversion for corn only. It's a close call. We could go either way. On the basis of current supply and demand estimates, if I were forced to make a choice today, I would say that paid diversion is not necessary.

But if we decide that it should be, because of events which we'll watch very carefully over the next 2 or 3 weeks, we almost certainly would have a paid diversion program targeted at erodible land.

Senator MCCLURE. Let me just follow on one moment, because again, you can't ask the farmers to plant from fence to fence and then restrict their markets without having some impact upon the market price.

Secretary BERGLAND. We agree.

Senator MCCLURE. That's happening and they're concerned about it, and I think they're not being fairly treated when, as a matter of fact, their segment of the economy is thus treated as a matter of policy in trade with the Soviet Union.

Second, if you do enter into any kind of a diversion program, I would hope that you might utilize that provision of the law, which is law as the result of an amendment that I offered two different times, to allow you to designate production from diverted acres to alcohol production.

You've indicated in the past that you think that makes some sense. It may make sense, but nothing's ever been done with it. It was very difficult to get it through the Congress, and of course with no diverted acreage, it doesn't apply. But if there are any diverted acres, then we begin to strike at that other side of the alcohol question: how do you get people to make investments when they don't know they have a short supply of the raw product?

Secretary BERGLAND. Senator, the fact is, of course, that our corn exports this year will be 200 to 250 million bushels ahead of last year, and growing steadily. When you see the growth charts in exports you see a steady increase.

Senator McCLURE. But we're not going to keep that grain away from Russia if, as a matter of fact, that's our policy, as we expand exports. All we're going to do is create additional middlemen.

Secretary BERGLAND. No; the major growth area is not the Western World. The major growth potential is in the developing countries. That's where we're looking for new markets.

Senator McCLURE. But they made a calculated shift a number of years ago, in 1974 and 1975 as a matter of fact, as they began to get off of a cereal diet with a little bit more protein, which resulted in the world's food prices shooting up suddenly. Energy prices shot up suddenly. They made the calculated decision in much of the Third World to buy energy and go back to the cereal diet.

Secretary BERGLAND. That's true.

Senator McCLURE. And I think the same thing is true here. If they have the opportunity to exchange that cereal bought from us to the Soviet Union for things that are of more value to them than that food supply, they will do so. I am not at all convinced you can treat this food market as though it is in neat little packages and we'll just embargo the shipment to Russia but expand shipment elsewhere and also believe that that isn't going to get back to Russia.

I think that's naive in the extreme. There are going to be middlemen, and I don't know who they're going to be, but there might even be some retired or active Members of Congress who are involved in that sort of thing.

Secretary BERGLAND. We know about them, too, and we're watching them like a hawk.

Senator McCLURE. But it's going to happen.

Secretary BERGLAND. Senator, on the matter of the set-aside acres and alcohol, may I just make one comment? Everybody in our business is looking at increased export demand the world over, and no one is prepared to make a major commitment to an alcohol fuels program on the assumption that we're going to have corn surpluses this year. We're going to build up stocks because of an exceptional yield. But if we have a 1974 kind of weather pattern come back this year, our reserves are all gone, and we can't get people to invest in a major alcohol program on such flimsy feedstock assurances.

Senator McCLURE. Well, Mr. Secretary, corn isn't the only feedstock. It just happens to be the one that's in surplus. We had a record surplus of potatoes. They're also a pretty good feedstock.

Secretary BERGLAND. Yes, sir, they are.

Senator McCLURE. There are a number of things that can be fed into such a plant. As you know, we have no sugar program that's going to keep the sugar industry alive. Sugar can move into alcohol production as they've done in Brazil. That's the basis of their alcohol program down there. Sugar cane, rather than sugar beet, but nevertheless, it's not just one product that can move in there.

And I would agree with you, anybody building an alcohol plant isn't going to depend just upon corn. We ought to be able to depend upon the productive capacity of the acres of farm land in this country, and we ought to be looking at what's good for the United States in terms of meeting our own requirements, before we start talking about or worrying about simply expanding foreign food markets.

And I'm not opposed to expanding foreign food markets, but I am very much concerned that we don't so concentrate on that that we ignore the potential.

Secretary BERGLAND. We think the potential is substantial, Senator. But it must come on a market which is fundamentally sound, economically speaking.

We are opposed to subsidies to the industry because it sets up a false set of economic parameters that can't be sustained.

Senator MCCLURE. Well, it would be better than going to war.

Secretary BERGLAND. I agree.

Senator MCCLURE. Over energy policy.

Representative BOLLING. My closing comment will be that I had the misfortune, Mr. Secretary, to have an otherwise scheduled meeting with members of the Kansas City Board of Trade on the first working day after the embargo announcement. I knew so little about it that I indulged in my usual act of faith where the Department of Agriculture is concerned, and said that I have great confidence in ~~Bob~~ Bergland, who's an old friend, and I'm sure it will go well.

I think you're doing a fine job. I'm delighted to see you. And I'm sorry we don't see more of each other.

Secretary BERGLAND. Thank you, Congressman Bolling.

Representative BOLLING. The committee stands in recess.

[Whereupon, at 12:10 p.m., the committee recessed, to reconvene at 10:30 a.m., Friday, February 1, 1980.]

THE 1980 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 1, 1980

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

The committee met, pursuant to recess, at 10:30 a.m., in room 318, Russell Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen, Proxmire, Sarbanes, and Javits; and Representatives Bolling, Reuss, Hamilton, and Heckler.

Also present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Lloyd C. Atkinson, William R. Buechner, Kent H. Hughes, Mayanne Karmin, Bill Maddox, and Helen Mohrmann, professional staff members; Betty Maddox, administrative assistant; Charles H. Bradford, minority counsel; and Carol A. Corcoran, Stephen J. Entin, and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. If we may have order, I also promised Chairman Volcker I would have him out of here by 12 o'clock, so I would hope that members would again apply the 5-minute rule.

We are very delighted to have you here, Mr. Secretary. This is the second of our five near- and medium-term outlook hearings on the economy. We are fortunate to have with us today testifying two of the principal architects of the administration's economic policies.

The problems currently plaguing the economy are really tough. We are looking at a situation where inflation has worsened. We are looking at an increase in the unemployment figures, and we are looking at a downturn in productivity.

We are looking at a job situation in which jobs for blacks, Hispanics, and teenagers have become an increasingly difficult goal for them to attain.

As I look at the economy, at least for the short term, I can't help but be very worried about it. I look at the administration's forecast for inflation of 10.4 percent. If you talk about 10.4 percent for inflation, you have to assume in that forecast that the OPEC nations are going to behave a lot more responsibly in 1980 than they have in the past. And you have to assume that the high cost of home financing and the high cost of home purchases, will not be spilling over into wages and prices in 1980.

And I am concerned about the 7.5 percent forecast on unemployment because that has to assume a labor force growth dramatically lower than even last year's growth, which was a low one.

I am concerned that very high rates of inflation and unemployment will be with us for some time, because I don't think we are doing enough to increase investment in this country.

I know that we are told that tax incentives will not raise investment spending unless businessmen are confident that we have a strong and a stable economy. Fair enough. But in my view, the budget planned by the administration virtually guarantees that we will have precisely the kind of weak economy that will further reduce investment incentives.

I believe that we need a modestly targeted tax cut—and I emphasize the word "targeted"—at enhancing the modernization of the productive capacity of this country.

Mr. Secretary, I just returned from the Far East chairing a series of Joint Economic Committee meetings and, frankly, many of those countries are beating the pants off of us. They are extremely competitive, and their workmen have the most modern tools that can be put in the hands of their working force.

And I believe that we have to be doing the things that for the long term will help us balance this budget by growth, not just balancing this budget by inflation by forcing people up into higher tax brackets.

I hope you will address my concerns this morning, Mr. Secretary, and that you will now proceed with your testimony.

STATEMENT OF HON. G. WILLIAM MILLER, SECRETARY, DEPARTMENT OF THE TREASURY

Secretary MILLER. Thank you very much, Mr. Chairman.

Mr. Chairman, I believe you have before you a joint prepared statement, together with exhibits 1 to 26, from James McIntyre, Director of the Office of Management and Budget, and Charles Schultze of the Council of Economic Advisers, and myself, and I would hope that that rather broad testimony might be made a part of the record.[1]

In addition, I have filed a brief prepared statement of my own, which I also think might be made a part of the record, and I might take time for just a brief summary of some of the points you have mentioned and spend most of our time in responding to your questions.

Senator BENTSEN. Without objection that will be done.

Secretary MILLER. We have made considerable progress in our economy over the last few years, coming out of the very deep recession of 1974–75. We have seen considerable growth in real output and really quite encouraging expansion over that time of real business fixed investment. I will come back to that because even that expansion has not yet tipped the scale in terms of productivity gains required. We have also seen a record period of increasing employment so that we have put more Americans to work in this period of time than any like period in our history.

And yet, with all of this progress, the underlying issue that has dominated our concern, and has to be our first priority, is inflation. Inflation has built up over some 15 years. It has become deeply imbedded in our economy. There are a number of reasons for it. And while we cannot overlook all of those reasons, we certainly had a

[1] See the joint prepared statement, together with exhibits 1 to 26, beginning on p. 141.

disappointing year in 1979 with the doubling of oil prices which made our general strategy to deal with inflation more difficult in that particular year. The root causes are deeper than just the energy problem, although that will hit us from time to time.

To deal with inflation and to be sure we keep that effort as the No. 1 priority in our economic policy, we feel that it is important to carry on a comprehensive strategy, to marshal a series of policies that together can represent a substantial arsenal of weapons to carry on the war against inflation.

One of the first, of course, is fiscal posture; that is, our fiscal policies. This year we are submitting to the Congress a budget that contemplates that there will be a mild recession in the economy. Having come through a period of economic expansion, the economy is now in a period where it appears to be going into a mild recession. And in the face of that, we have proposed a budget that on the spending side, in terms of constant dollars, would hold Federal spending in fiscal year 1981 at the same level, approximately, as in fiscal year 1980.

On the taxing side, we have elected to forgo any tax increase at this time, either a general one or a targeted one, in view of the priority we believe should be given to reducing the Federal deficit and demonstrating domestically and internationally that we intend to bring our deficit spending under control and move progressively toward a balanced budget.

The holding of expenditures constant does not mean we have a standstill budget. We have a dynamic budget. There are changes in the spending mix. And a few of them I'd like to point out would be, as you well know, an increase in real spending for defense—and this is incorporated in an overall budget program that contemplates constant spending. The other is that there have been some initiatives taken in this budget to address, on a targeted basis, some of the underlying causes of the productivity problem that we face.

For example, there is an expansion of research and development, which we believe is important to lay the foundation, the technological foundation, for contributions to gains in productivity.

There also are targeted expenditures, expanded expenditures, to deal with the problem of structural unemployment, particularly among youth. You have mentioned the problem of high unemployment among young people, particularly minorities. There is a very important component to productivity besides capital, and that is human skill. If we have large bodies of unutilized labor and if we have unskilled labor that cannot contribute to the productivity levels that we need, we will lag behind. So using this period of time to accelerate and to achieve greater skill development is part of the initiative to contribute to the longer term structural problems.

There are other initiatives in the budget which we think address the balance between maintaining austerity in spending and beginning to tackle some of the important areas that are of concern.

Now, this budget has to be taken in the context of also maintaining a disciplined monetary policy. I know you are going to have Chairman Volcker here in a moment, but I do want to emphasize that it is important that we have a proper role for fiscal and monetary policy both; that we do not become expansionary on fiscal and leave it all to the Federal Reserve, nor could we offset in fiscal policy an overexpansion of money.

So I think it is important that we do seek to have a discipline in both fiscal and monetary policy.

We are also pursuing policies, as you know, of voluntary wage and price restraint, to endeavor to avoid ratcheting into our cost structure the unusual price increases that we have experienced in recent times, many of them from uncontrollable factors.

In addition, we do need to maintain a stable dollar as part of our anti-inflation program. A weakened dollar increases the cost of imports and increases domestic prices. And to do this we need to maintain a relatively strong current account balance. We were able to come from a large deficit in 1978 to virtual balance in 1979. With the increase in oil prices that we have now experienced, we are likely to incur a deficit in 1980, but one which is smaller than the deficits of Germany and Japan.

Another important policy must be to look at the investment and productivity aspects of our economy that you mentioned. And I concur with you that we need to plan for conditions that will encourage investment. One of the first conditions to encourage investment is a convincing posture that we are attacking inflation and there is a chance of bringing it down. Nothing will encourage business investment more than the belief that there is going to be progress in combating inflation. And that is why we are taking the stance of a fairly austere budget. But it is true that as we bring that budget under control we look forward to taking, at the right time, some initiatives in the tax area that will contribute to encouraging investment.

Another important policy area is to continue the efforts to reduce the burden of Government regulations which go into prices and costs and into inflation.

And finally I want to mention how critical it is, if we are to control inflation, that we solve our energy problem; that we reduce our dependence upon imported oil. That is perhaps our greatest long-term threat to inflation because the uncertainty of availability and price are destructive in themselves but the scale of increases we have seen in the last 10 years, if repeated, would also be very damaging to the prospects for controlling inflation.

As you know, between the administration and the Congress, we have been working on a very comprehensive program to address the issues of conservation, domestic production of oil and gas, domestic production of synthetic fuels, the domestic production of renewable sources of energy, and progressive reduction of imports of oil so we will retain control of our destiny and will be able to deal with that component of inflation.

Mr. Chairman, the overall economic strategy has been a continuing one in the last 2 years. We will endeavor to carry this forward and welcome the opportunity to consult with you and inform you and appreciate your guidance in an effort to achieve these aims.

Thank you.

[The prepared statement of Secretary Miller follows:]

PREPARED STATEMENT OF HON. G. WILLIAM MILLER

Mr. Chairman and members of this distinguished committee: I appreciate this opportunity to appear before the Joint Economic Committee to discuss the administration's 1981 budget and economic program. OMB Director McIntyre and Council of Economic Advisers Chairman Schultze will be testifying at a later date and we have submitted a joint statement for the record.

This morning I thought it might be useful to summarize briefly the administration's view of the economic situation, how the 1981 budget fits into our overall program for containing and reducing inflation, as well as to address some issues I know are of particular interest to this committee.

We have made substantial economic progress over the last 3 years. Since this administration came into office, real GNP has increased almost 12 percent, real after tax per capita income has risen 7½ percent, and real after tax profits have grown almost 15 percent. There are now 9.3 million more jobs than there were in 1976, a record of employment growth that has no parallel in the postwar period.

The most significant economic disappointment of the last few years has been inflation. At the beginning of last year it was widely expected the rate of price increase would moderate. However, just as our programs for reducing inflation were becoming effective, we were overtaken by events in the international energy market. The doubling of world oil prices was the single most important factor in the more than 13 percent increase in the Consumer Price Index last year.

Reducing inflation must be the first priority of economic policy for next year. To contain inflation now it is essential that we prevent the recent huge increases in energy prices from spilling over and becoming embedded in generalized wage and price inflation. To reduce inflation over the longer run we must improve the structure and efficiency of our economy to restore growth in productivity—the basis for future gains in real income. The 1981 budget will help us meet these challenges.

The 1981 budget attacks inflation both by fiscal discipline and through its programmatic priorities. The growth of budget outlays is held to the lowest rates consistent with our national and economic security. The 1981 budget proposes an increase in Federal spending in real terms of only two-tenths of 1 percent. Budget outlays would be $615.8 billion and receipts $600 billion. The resulting $15.8 billion deficit would be the lowest in 7 years and equivalent to only six-tenths of a percent of GNP. The 1981 budget would be balanced if it were not for the mild economic decline we are forecasting in the first half of this year.

Over the four quarters of 1980, real GNP is forecast to decrease by 1 percent; in 1981, an increase of 2.8 percent is expected. This forecast is broadly in line with many others, including that of the Congressional Budget Office. If this recession does not occur and the unemployment rate remains at the current level, the 1981 budget would be in surplus by about $15 billion.

Fiscal discipline combined with monetary restraint will provide the macroeconomic climate necessary for containing and reducing inflation. However, in the current environment, inflation cannot be reduced by these policies alone, without enormous losses in output and employment. In addition, we must have programs designed to alleviate the underlying structural causes of inflation—in the areas of energy, productivity, investment and Government regulation. Because fundamental reforms will take time to become effective, we must also have pay and price policies to help keep inflation under control until basic improvements take hold.

The 1981 budget provides for programmatic increases in two general areas: national defense and efforts to enhance our longer run economic efficiency. The 1981 budget continues the administration's pattern of increased outlays for U.S. energy security. All of our efforts to reduce inflation will be ineffective if we remain vulnerable to continued shocks from increases in the price of imported oil. Twice in the last 10 years we have seen huge increases in OPEC oil prices. Both times the United States and world economy have suffered badly. During the first 4 years of this administration, spending on energy programs will have increased over 90 percent. These programs promote increased conservation as well as expanded domestic production from conventional, unconventional and renewable energy sources.

The 1981 budget also makes provisions for addressing our underlying productivity problem through increased research and development. Over the long run, increases in productivity are dependent upon technical advances. The primary source of these advances are basic research and development. Obligations for research and development will increase by 13 percent in the 1981 budget.

The 1981 budget also contains important new initiatives to reduce structural unemployment through programs designed to prepare today's youth for the labor markets of the 1980's. While we have made tremendous advances, unemployment among some groups, particularly minority youth, remains unacceptably high. Attempting to address this problem through macreconomic policies alone is likely to be both inflationary and ineffective. Targeted programs will help us to reduce unemployment among disadvantaged youth without inflationary consequences.

Mr. Chairman, I know that this committee is particularly interested in promoting capital formation. In last year's joint Economic Report, your committee recommended, from a longer run perspective, the adoption of tax incentives to increase savings and investment. In particular, liberlization of depreciation allowances and other incentives were recommended to stimulate capital formation.

The 1981 budget contains no new tax incentives for investment. In our view, reductions of significant magnitude in business taxation would have been inconsistent with the basic policy of fiscal restraint that must characterize this budget. I agree, however, that as budgetary conditions permit we should consider the tax incentives that offer the greatest long-run potential for stimulating savings and investment. As you know, I have supported the concept of accelerating tax depreciation as an appropriate approach.

Mr. Chairman, let me conclude by emphasizing the importance of moving back toward budgetary balance. The administration urges the Congress to join in focusing on the fiscal discipline that is essential in order to contain and reduce inflation.

Thank you.

Senator BENTSEN. Mr. Secretary, I certainly agree that balancing the budget is a very laudable goal. But it seems to me we ought to be trying to balance the budget with revenues derived out of real growth, rather than with revenues derived out of inflation by people being bumped up into a higher tax bracket.

Demand has really not been the big kick to inflation in the last year. It hasn't been as important as the increased price of energy for our country.

In effect, what we have seen is the OPEC countries levying a tax on the American people. Now, we have that followed by a tax through inflation. And I just don't see the rationale in not doing some things for the long-term change that has to be made in this country in order to increase productivity. And that again gets back to finding a way to beat inflation by a more efficient and cheaper way of putting products on the shelf.

That is what we are seeing happen elsewhere. We are seeing that happen in Japan. I saw it in South Korea. We are seeing other countries accomplish that.

I don't believe that inflation is endemic to our economy. We have seen the Japanese go from 22 percent down to 3 percent and they are more dependent on outside oil than we are. But we are also seeing them do some things on productivity much more substantive than we are doing.

And I am concerned that we have looked at the short-term goals rather than the long-term goals.

Secretary MILLER. We have endeavored, Mr. Chairman, to look at both. Let me give you a little more insight into our thinking about why we believe there should not be tax initiatives at this point.

What you say is true about the drag on our economy that comes from oil prices, like a tax: the purchasing power goes elsewhere. And it doesn't recycle very quickly, so sometimes it doesn't turn up in the economy as a tax initiative by the Federal Government might.

But our experience in this unprecedented period of inflation causes us to come to certain conclusions about priorities in taking action in taxing and spending. In the decade of the 1970's we had the longest period of high rates of peacetime inflation that we have ever experienced. Our economic models do not predict accurately what happens when we deal with the economy in this type of environment.

We have seen, for example, over the last year, all of the well-known economists of this country, and economic organizations, forecast that there would be a downturn, a recession, that should have been here by now. That was based on models indicating that the fiscal drag and higher interest rates would bring a reduction in demand.

It turned out that people in the face of inflation were willing to dip into savings and reduce them to very, very low levels in order to maintain purchases. So the economy behaved differently than we expected. It has shown remarkable resilience in the face of this inflationary psychology.

Therefore, it is important that we change that psychology and that expectation, and it is important that we err on the side, at this point, of perhaps exercising too much restraint rather than exercising too much stimulus. If we should at this point introduce a more stimulative fiscal policy, and we are wrong about the recession and the resilience of the economy is demonstrated once again, what we will have done is add to inflationary forces and we will see them showing up again in the economy and we will have many years where we will be set back a long way in our effort to starve out inflation.

On the other hand, if we are more restrained and it turns out the economy deteriorates, we can move quickly to respond, and we would prepared to move quickly to respond in some counteraction.

So our posture is: In light of the experience that we have had of this remarkable resilience, we should move very cautiously in taking any steps that would bias us on the side of inflation and we should hold our powder dry and we should act only if we see deterioration actually taking place.

Senator BENTSEN. Well, Mr. Secretary, if we are trying to keep our powder dry and trying to curb inflation and trying to hold back on demand, we also should encourage savings. And I just happen to have a little amendment that passed the Senate; it squeaked through by a vote of 94 to 4. And that is now in conference. And there are those who say it just rewards those who have already saved. Mr. Secretary, I think it is about time we reward people who have already saved and encourage more.

I would hope that you and the administration would give serious thought to supporting that amendment. We are the only major democratic country that I know of that doesn't have a very substantial incentive for savings.

I am told that my 5 minutes have expired.

Secretary MILLER. Perhaps my answer was too long.

Senator BENTSEN. I defer to my colleague, Congressman Reuss.

Representative REUSS. Secretary Miller, recently with some other members of the House Banking Committee I asked the Treasury whether it wouldn't be a good idea for the Treasury to mint and to aggressively market a new U.S. gold bullion coin, like the South African Krugerrand or the Canadian Maple Leaf, containing an ounce of pure gold and selling at a premium. The value of the U.S. gold store in current terms is in excess of $200 billion.

Our thought was that by taking a limited portion of it, say one-twentieth, we could do some great things for our Federal budget deficit, practically eliminating it: for our excrutiating foreign trade deficits which leads to weakness of the dollar and to inflation; and we could do something to lower interest rates by reducing the need for Treasury to go into the market and bid up interest rates as it has had to do recently.

The feeling was that that would be a sensible thing to do in our present situation, say next year. What is your reaction to that?

Secretary MILLER. Congressman Reuss, I certainly think we ought to examine that proposal that you have suggested. There are some concerns that I'd like to point out.

We do have a large stock of gold. We do not have any particular program to dispose of it. We may, from time to time, and have, from time to time, and still stand ready to sell gold at such time and in such amounts that we think appropriate under the circumstances.

Your suggestion offers the opportunity, perhaps, even to achieve a premium against the current price.

On the other hand, any effort, any actions, that tend to suggest that we are remonetizing gold I think have very large implications. And while Congress has already instructed us to strike some gold medals and sell them, which is somewhat different than your suggestion, I believe, as you spoke of coins rather than medals, I would like to see us proceed very cautiously in evaluating whether the idea of a gold coin is appropriate. It is true selling gold, whether in the form of coins or bullion, helps finance our deficit. The question is whether that would also tempt those of us in Government to feel that we had some ready cash and easy money that would cause us to lose our discipline on spending. And I think we don't want to open that possibility, either.

I would be happy, and I would like more opportunity to evaluate some of the underlying concerns I think we ought to address before we make a decision.

Representative REUSS. Yes. Of course, I was talking about a very limited amount, so that the temptation to become a loose spender would be resisted.

It seems to me that one of the problems of our country generally is that we have seen our automobile industry, our consumer electronics industry, our steel industry, other basic industries, go overseas, as Chairman Bentsen has just pointed out. What we need overall, it seems to me, is some import substitution to revitalize America.

And a good place to start would be a little import substitution on the Krugerrand and the Maple Leaf. Why give all the business to foreign premium operators?

We imported about a billion dollars worth of these Krugerrand-type gold pieces last year. Why don't we make them here in America? They are what small people want to supplement their collection of antiques and paintings and Tiffany glass.

Think it over and let us know.

Secretary MILLER. I shall. I just mentioned, that last year, much of the gold sold by the United States did go abroad, and we had a net favorable balance of trade in gold. Even though we imported some we exported more.

Representative REUSS. Yes; but if you'd put the same moxie into your gold sales program that you are putting into the Susan B. Anthony dollar program, we would have made a bundle.

The gold bars that you sell, they cost $3 billion a bar; it takes an upper-bracket type to buy those. I want to let the little fellow in.

Secretary MILLER. I hope we don't let the little fellow in to lose money, that's all. It's a very volatile market and very dangerous for the uninitiated.

Representative REUSS. Well, I don't know that this form of consumer protection of Sheiks of Araby is in the best Nader tradition.

Senator BENTSEN. Senator Javits.

Senator JAVITS. Mr. Secretary, do I gather correctly from you in your answers to the chairman that the administration's prescription for dealing with a serious inflation problem of 13 percent—so that makes interest rates, by the way, cheaper than they have been in modern times in this country; the minute you deduct inflation from 15 percent, we are getting 2 percent money.

But leaving that aside, though it is critical, is it a fact the administration is basing its anti-inflation fight on a nearly balanced budget, roughly $16 billion, and on oil conservation, and that it rejects what Chairman Bentsen has suggested, which is increasing the aggregate income of the country through a conscious effort to raise the gross national product?

Secretary MILLER. Senator Javits, we have felt that fighting inflation requires both a very comprehensive series of policies, more than the ones you mentioned, and that it requires application of those policies consistently over a period of time. Inflation has built up over 15 years and is deeply imbedded. It is structural in our system, not just a cyclical phenomenon we can deal with in the business cycle.

It is for that reason that we have felt that moving back toward a balanced budget, and establishing the norm that we can have a balanced budget at times of normal output, is an essential discipline that we must impose. We must forgo the temptation to try to live beyond our means and accumulate enormous deficits over time.

That is only one of the policies. The other includes a disciplined monetary policy, maintaining wage and price moderation; it includes having a sound dollar and balanced international accounts; it includes the reduction of unnecessary Government regulation and burdensome prices; it includes the search for productivity gains both in technology and human resource and investment improvement; and it includes reducing our dependence on imported oil.

When we talk about inflation, we are deeply concerned and we don't mean to suggest that we should apologize and duck the responsibility to deal with 13-percent inflation as measured by CPI. But we have put some exhibits before you, and it might be worthwhile to look at exhibit 4 if you have those exhibits; I don't know if they were distributed or not. If they weren't, I won't refer to exhibit 4. If they were, I will just suggest to you that one of our problems in measuring inflation is that the CPI is not a cost-of-living index; it is a price index. It has a defect in that it assumes that each and every month every American is renegotiating his home mortgage at current interest rates, which doesn't happen, and therefore it overstates the cost of living as distinguished from a price index. This is the price if you went out to buy things today, but housing is not entirely a daily consumption. It is both something that is consumed and an investment. And sometimes when housing gets into the index, it has an increase in cost that may increase the cost of occupancy, but on the other hand it also gives an increased wealth factor and investment value.

If you take that factor and look at the second row, you will see the Department of Commerce index, which is on a fixed, weighted index of expenditures as distinguished from a price index; you will see inflation is still terrible but somewhat less than the CPI measurement.

If you take out energy, you will see how badly we were impacted in 1979 by the energy problem.

Senator JAVITS. If the problem of inflation is so deeply embedded in all sections of the economy, and if the productivity of the United States puts it in the cellar—and it's been declining consistently—and only what the country produces is going to give you the resources to do what you need to do and to deal with inflation, isn't that entitled to just as long-term and as bold a swing as what you people are doing?

In other words, aren't you completely overlooking what Churchill did in 1940 when he had two armored divisions and he sent one to North Africa? Aren't we being timid about our anti-inflation fight? We are making a lot of noise about it, but are we really hitting the target? That is what Senator Bentsen is asking you and what I'm asking you.

I must say to you I am completely dissatisfied with what we are doing on that score. The American people are in a mood for boldness now, and you are still being timid. You're still running.

Secretary MILLER. Senator Javits, it takes considerable courage not to fall into the temptation, it seems to me, to expand this to a $40 or $50 billion deficit to try to cover some of our hopes and aspirations for the future. Because it does require in each and every year, in the face of the first time an administration has predicted a recession, for that administration to hold tight on budgetary discipline and suggest that we do not accept a tax cut of any kind, targeted or otherwise, at this point.

It is our judgment that the risk of error is greater if we start with a stimulative posture, and if the economy for reasons of behavioral patterns in inflationary times should show itself to be stronger than we think, then the stimulative actions we take will imbed inflation even deeper. If it turns out the other way and the economy is weaker than we think, then we'd be prepared to come back to you with some suggestions.

Senator JAVITS. My time is up. But, Mr. Secretary, then it will be too late. And we won't be talking about a $50 billion deficit. We may be talking about a deficit no greater than you are talking about, a $16 billion. And the fact is the American people will accept cuts they wouldn't otherwise accept if you are on the road to going somewhere instead of retreating to fortress America.

Thank you.

Senator BENTSEN. Senator Proxmire.

Senator PROXMIRE. Mr. Secretary, I am not going to get into the Textron matter because it wouldn't be fair to the committee or fair to you, obviously, and there isn't enough time. I am very concerned about that, as I am sure you are, too. But let me get into matters that are appropriate for this committee.

In 1981, beginning 1981, you have an unbalanced budget of $16 billion. You assume an inflation of 8 to 9 percent. You assume falling employment during this period. And yet you give us a budget which is unbalanced by $16 billion. I can't understand that psychology.

You said this morning a little earlier, and I quote "Nothing would encourage investment more than a showing that the Government means business in fighting inflation." Certainly to provide for a surplus, even a modest surplus, would be a step in that direction that would have strong psychological effect. So why can't we find a way in this

$615 billion budget to reduce it by the relatively modest amount to give us a surplus?

Secretary MILLER. Senator Proxmire, if we were to have economic conditions in 1981 that maintained the current level of unemployment, this budget would be in surplus by $15 billion.

If you will look with me at exhibit 10, you will see that we are proposing quite a courageous and austere position in the face of the outlook for economic conditions. We have moved in exhibit 10 from a high employment deficit of $29 billion, in fiscal year 1978 to about a $12 billion deficit in fiscal year 1979, looking for a surplus of 4.5 in 1980 and a high employment surplus of $56 billion in 1981.

Senator PROXMIRE. If you look at these figures you will see the reasons you don't have is because of the windfall profits tax. You add that to your roughly $16 billion and you'd have another $30 billion deficit.

What I am getting at is I agree wholeheartedly with Senators Bentsen and Javits that we do need an anti-inflationary tax cut, and I know you feel that way, too, if we could do it. But to do it you have to earn it, and to earn it we have to hold down spending. It is very hard to do it now because of the military situation, but I think that a tough-minded approach on the part of the administration, even cutting housing, education, health, and cutting military below what the President recommended, knocking out the gold plating, recognizing the tremendous waste of personnel in the military, that we would have a good shot at reducing spending, enough so you could accommodate both of those things. That seems to me to be the real challenge we are missing.

Secretary MILLER. Senator, would you just look for a moment at exhibit 15. Because one way to look at this budget for fiscal year 1981 is to look at what would happen at the current service levels. And you will see there have been changes to increase outlays from the current service levels. The overall result has been an increase from current service outlays of $3.8 billion from fiscal year 1980 to 1981.

In terms of the constant dollar outlays, there has been virtually no increase.

Now, I don't disagree with you that if we can find places within a budget that has many items that are entitled and committed and we cannot control and we can find ways to reduce them, we'll certainly favor that.

Senator PROXMIRE. Well, Mr. Secretary, I think what you are saying is dead right, and I would accept that notion. The problem, however, is that it is not good enough at a time where the No. 1 problem facing this country, domestic problem, economic problem, is inflation. It is not simply enough to have the current services maintained close to the current level or even cutting them slightly. It seems to me we have to have a much bolder decisive action than that.

I think there is overwhelming feeling in the country that government has gotten too big and burdensome and awesome and we have to make these cuts as tough as they are. I realize you are not head of the Office of Management and Budget but, nevertheless, if we are going to have a tax cut, we have to accommodate it, it seems to me, with a spending reduction which is going to be extraordinarily difficult but we can do it.

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Secretary MILLER. Senator, I think we should recognize that last year the administration asked for a number of legislative inititives that would reduce costs. Not many of them were adopted. This year we are proposing a cost-reduction package that would save us $5.6 billion in fiscal year 1981 and more in later years. The first thing we need is the help of Congress to enact those savings.

Senator PROXMIRE. I agree.

Secretary MILLER. We are going to push very hard for those reductions.

Senator PROXMIRE. My time is up.

Senator BENTSEN. Congresswoman Heckler.

Representative HECKLER. Mr. Secretary, I'd like to thank you for the important session we have had over the discussion of speculation in gold and silver and the subsequent actions taken by the Treasury Department in terms of creating more flexibility in sales which have been helpful. Along that line some problems still continue in terms of the gyrations of the market and one looks for solutions. Certainly we are beginning to see the impact of the silver costs and of gold and silver in terms of consumer prices. The prices of photographic film have just increased by almost 100 percent and dental work is about to be accelerated in costs, and all of these things—we know, of course, today that the single silver teaspoon is in the range of $98 apiece.

Now, at the same time we have in our strategic stockpile an excess quantity of silver which the GAO assessed last year as being in excess, not only for our present needs but even during military warfare, and there will be proposals before Congress to sell some of this surplus from the stockpile and potentially purchase some of the minerals that we are in deficit for, for example, platinum, radium, et cetera.

What position would you take in terms of that potential sale?

Secretary MILLER. Well, it is very hard to decide in times of political upheaval in parts of the world whether it is in the U.S. interest to dispose of its assets. Pricing has been so erratic in these precious metals because of the political uncertainty in the Middle East, and as a consequence there has been an acquisition of these precious metals as a hedge, as a safety haven for those who are fearful for their own well-being in the future.

And in that kind of uncertainty, I don't know whether it is in our interest to make large dispositions of our gold assets or whether we should wait until we see the outcome of all this change and make a decision on the longer term basis.

I am hesitant, as you know, to see us trying to play the market. I don't think we should do that. I think we should have a strategic purpose. And you may be correct. Maybe our strategic purpose should be to shift what ever kind of metals we hold as strategic reserves. And I would be willing to examine that, but I would prefer to do it in the context of a continuing policy and not just opportunistically jumping in to take advantage of the market which may turn out to be the wrong time to do anything.

So your point is well taken, and I will have to give consideration to whether we should change our present policy.

Representative HECKLER. Mr. Secretary, yesterday in the Washington Post there was a story on the President's economic policy, and I wonder about its accuracy. Mr. John Berry says, "The cornerstone of the Carter anti-inflation policy is to create a significant slack in the American economic policy and keep it there long enough to bring down inflation."

Further, the Council of Economic Advisers' Chairman, Mr. Schultze said inflation would be a 10- to 12-year battle. Berry says, "Over the years the demand for goods and services will have to be restrained compared to what could safely be tolerated if inflation were low."

So this seems to be the policy of the administration, managing the economy by managing demand.

I wonder if the administration has read the Joint Economic Committee Annual Report. For the first time there was not a minority or majority report. Our approach basically in the recommendations of the Joint Economic Committee Report called for increased capital formation, labor productivity, and output in the fight against both inflation and unemployment. Of course, this requires expanding the capacity of the economy to produce goods and service, and that was considered by the committee as the most effective way to combat the major ill of inflation, or stagflation.

I would like to have your comment on the Joint Economic Committee Report, and I would like to know what the administration is doing about these policies which received so much favorable press last year when they were presented.

Secretary MILLER. Congresswoman Heckler, I was impressed by the Joint Economic Committee Report last year. I thought it was a very constructive document, and I would say that in the general philosophy of that report—and I am generally in accord with it—timing and transition are important considerations. Judging what has happened since that report in terms of oil price increases which none of us expected at that time and their impact and how we deal with it, there is no doubt that we need to pay more attention, on the supply side, to productivity.

One of the items on the supply side is oil. We are paying for enormous programs that are designed to cut by 1990 our present imports of oil but to cut them to a much smaller fraction of what they would have been had we not shifted policies. These involve the most massive undertakings of shifting of funds that we have seen in any 10-year period in our history.

So we are doing major, major things. We don't see them every day but they are underway. We hope Congress will complete that package so we can complete that effort, which I think will be the major threshold of expansion in business investment. Our willingness to recycle funds, to help provide better transportation, finance the development of synthetic fuels, not to mention other fuels—I hope along the way as we prepare young people to address these things we will be able to add to the incentives for business investment in other areas, such as the energy programs.

It is our judgment that in the face of economic experience in recent times it would be best at this time to try to restrain and hold down the deficit and to not be adding a stimulus to the economy at this point in the absence of confirming information that the economy will deteriorate.

It is just a question of time. It is my hope that there will be a time when we will be carrying out many of the objectives of that report. I believe we are beginning to do some of them now in our encouragement and expansion of research and our efforts to develop skills in young people, and I hope in the not too distant future our willingness to encourage more investment.

Representative HECKLER. Mr. Secretary, my time has expired, but I'd like to ask one final question. Would you at this point, at this time, in terms of what you have said about the Joint Economic Committee recommendations, favor a tax cut which would be designed to increase productivity this year?

Secretary MILLER. At the moment we do not favor it. The administration does favor targeted tax cuts that would address productivity, and our only argument, I think, would be whether now is the proper time to do it or whether it should come later when we see more control over the business situation. And our judgment is we should wait.

Senator BENTSEN. Thank you.

Representative BOLLING. Mr. Secretary, some time ago in another place we had a discussion of so-called countercyclical assistance and its relationship to the tax cut and other matters.

Secretary MILLER. Yes.

Representative BOLLING. I am interested in whether you have had an opportunity to examine the bill that passed the House yesterday—I know that is very recent—and compared it with the proposal of the administration and if you are in a position where you could give me an idea as to how it compares. If you are not, I would be delighted to have it later in writing.

Secretary MILLER. May I comment briefly and then perhaps give you a written report.

The Senate, of course, passed that proposal earlier, and the Senate's proposal is closer to the administration's. It involves larger sums of money—the Senate bill does—on the targeted fiscal assistance.

The formulas are slightly different. On the countercyclical part, I believe the aggregates come out roughly the same.

We are pleased to have the House bill. It is within the framework of what we were proposing, and I think if we can take the Senate bill and the House bill and put them side by side, I hope there can be a compromise that will see that enacted quickly. I think we should have it. It would be one of the targeted things we could do that would help distressed communities right now. And then, if the economy does deteriorate we'd be prepared by the fourth quarter of this year to begin to aid communities based on a more targeted effort to cushion the effects of a weak economy.

Representative BOLLING. What I am interested in, if possible, is a comparison between them.

Secretary MILLER. We will get a comparison up to you.

Representative BOLLING. Thank ~~you~~ very much.

[The information referred to follows:]

COUNTERCYCLICAL FISCAL ASSISTANCE: A COMPARISON OF THE KEY PROVISIONS OF THE SENATE AND HOUSE BILLS

1. NATIONAL TRIGGER

Senate Bill. Payments would begin in the second quarter following one in which the national unemployment rate is 6.5 percent or more.

House Bill. Payments would begin in the quarter following the second consecutive quarter that real wages and salaries fall short of their level in the immediately preceding quarter; providing that the two quarters are immediately preceded by, concurrent with, or partially preceded by two quarters in which the real GNP falls short of its level in the quarter immediately preceding the two quarters.

2. TERMINATION OF PAYMENTS

Senate Bill. The final payments would be made in the quarter following a decline in the quarterly unemployment rate below 6.5 percent.

House Bill. The final payments would be made in the quarter following that in which real wages and salaries exceed the "national-base-period amount" of real wages and salaries increased at 0.3 percent per quarter. The national-base-period amount is the average of the peak and preceding quarter in the wages and salaries data. The peak quarter is the quarter immediately prior to the first quarter for which funds are to be paid.

3. FUNDING LEVEL

Senate Bill. The Senate bill would provide $125 million per quarter plus an additional $30 million for each 0.1 percent that the national unemployment rate exceeds 6.5 percent in the second-preceding quarter.

House Bill. The House bill would provide $15 million for each 0.1 percent that actual real wages and salaries fall short of the adjusted "national-base-period amount" in the second-preceding quarter.

4. MAXIMUM ALLOCATION

Senate Bill. The maximum allocation of funds would be capped at $1 billion in fiscal year 1980.

House Bill. Same as the Senate bill.

5. STATE-LOCAL SHARES OF THE PAYMENTS

Senate Bill. One-third of the funds would be distributed to State governments, two-thirds to localities. Off the top, 1 percent of the funds would be set aside for the territories.

House Bill. Same as the Senate bill.

6. ELIGIBILITY FOR PAYMENTS

Senate Bill. A State or local government would be eligible to receive payments if its unemployment rate is 6.0 percent or more. These unemployment rates are to be adjusted for governments located within SMSA's to use the pre-January 1, 1978 method to calculate unemployment rates, when the method yields a higher rate (Nelson option).

House Bill. State governments would be eligible after two consecutive quarters in which State real wages and salaries fall short of the level achieved in the quarter preceding the two; a State may qualify for eligibility at any time within a year prior to the date the payments are initially authorized.

Local governments would be eligible if they are located in a county in which excess unemployment is larger than zero. Excess unemployment is the amount by which a county's unemployment rate in the second quarter preceding a payment quarter exceeds its rate in the comparable quarter of the year before the recession began. An eligible local government's per capita personal income must be less than 140 percent of its State average.

7. ALLOCATION OF PAYMENTS

Senate Bill. Each eligible State and local government would receive a proportionate share of the funds calculated as: the product of its unemployment rate in excess of 4.5 percent and its General Revenue Sharing payment, divided by the sum of these products, calculated separately for eligible States and localities.

House Bill. Each State government would receive funds based on its share of the sum of the national amounts for all States of the economic-decline factor multiplied by the tax-effort factor. The economic-decline factor is the dollar amount by which a State's actual real wages and salaries in the second quarter preceding a payment quarter falls short of its adjusted-base-period amount. The adjusted-base-period amount is the base-period amount of real wages and salaries for a State increased by 0.3 percent per quarter. A State's base-period amount is the average of the two calendar quarters in that State immediately preceding the first eligible State quarter.

Localities. The fund allocation to a county would be based on its excess unemployment, weighted by a factor determined by the county's unemployment rate in the recession quarter, multiplied by its General Revenue Sharing allocation. The weights are:

0.2 for an unemployment rate less than 3 percent.
0.4 for an unemployment rate of 3 percent or more but less than 4 percent,
0.6 for an unemployment rate of 4 percent or more but less than 5 percent,
0.8 for an unemployment rate of 5 percent or more but less than 6 percent, and
1.0 for an unemployment rate of 6 percent or more.

Excess unemployment is the amount but which a county's unemployment rate in the second quarter preceding a payment quarter exceeds its rate in the comparable quarter of the year before the recession began. Within counties, the funds would be allocated on the basis of each eligible locality's share of the total General Revenue Sharing payment to the county area.

8. MINIMUM PAYMENT

Senate Bill. The minimum payment to any jurisdiction would be $2,500 per quarter.

House Bill. The minumum payment would be $1,500 per quarter.

9. PURPOSE

Senate Bill. Requires that funds be used only for purposes allowable for a locality's own revenues except that the use of funds for construction purposes is prohibited.

House Bill. Would allow localities to use the funds for any expenditures allowed for the government's own revenues.

10. TIMING OF FUND APPROPRIATION

Senate Bill. The Senate bill would require that jurisdictions appropriate countercyclical funds within six months of receipt.

House Bill. No comparable provision.

COMPARISON OF THE KEY PROVISIONS OF VARIOUS
COUNTERCYCLICAL FISCAL ASSISTANCE PROPOSALS WITH THE ACTUAL ARFA PROGRAM

Provision	Antirecession Fiscal Assistance Program (1976-78) (1)	Administration Proposal (March 1979) (Subtitle B) (2)	Senate Bill (S. 566) (August 1979) (Subtitle A) (3)	House Bill (H.R. 5980) (January 1980) (Title IV) (4)
Trigger: On:	- 1 Qtr. Nat'l Unemp. ≥ 6.0%	- 1 Qtr. Nat'l Unemp. ≥ 6.5%	- 1 Qtr. Nat'l Unemp. ≥ 6.5%	- 2 Consecutive Qtrs. Real Wages & Salaries and Real GNP below a preceding peak Qtr. The two Qtrs. of shortfalls in real wages and salaries must be concurrent with or subsequent to Qtrs. of real GNP shortfall.
Off:	- 1 Qtr. Nat'l Unemp. < 6.0%	- 1 Qtr. Nat'l Unemp. < 6.5%	- 1 Qtr. Nat'l Unemp. < 6.5%	- 1 Qtr. in Which Real W&S Exceed Adj. Base Period Amt.[a]
Funding Level:	- $125 Mil./Qtr + $30 Mil. for each 0.1% above 6.0% - Maximum Allocation of $2.25 Bil. for 5 Qtrs.	- $125 Mil./Qtr. + $25 Mil. for each 0.1% above 6.5% - Maximum Allocation of $1 Bil. in Any Fiscal Year	- $125 Mil./Qtr. + $30 Mil. for each 0.1% above 6.5% - Maximum Allocation of $1 Bil. in FY 1980	- $15 Mil./0.1% Actual Real W&S Fall Short of Adj. Base Period Amt. - Maximum Allocation of $1 Bil. in FY 1980
Eligibility:*	- State & Local Governments - Unemp. Rate > 4.5% (1 Qtr. Under Current BLS Method)	- State & Local Governments - Unemp. Rate > 5.0% (1 Qtr. w/Nelson Option Applied to Unemp. Rates)	- State & Local Governments - Unemp. Rate > 6.0% (1 Qtr. w/Nelson Option Applied to Unemp. Rates)	- States: . 2 Consecutive Qtrs. of Decline in Real Wages & Salaries - Locals: . In a County (or an Independent City) whose Excess Unemp.[b] > .1% . Per Capita Income < 140% of State Average
Distribution:	- States = 1/3 Share - Locals = 2/3 Share - Territories = 1% Set-Aside - Excess (> 4.5%) Unemp. Times GRS Allocation	- States = 1/3 Share - Locals = 2/3 Share - Territories = 1% Set-Aside - Excess (> 4.5%) Unemp. Times GRS Allocation	- States = 1/3 Share - Locals = 2/3 Share - Territories = 1% Set-Aside - Excess (> 4.5%) Unemp. Times GRS Allocation	- States = 1/3 Share - Locals = 2/3 Share - Territories = 1% set-aside - States: Econ. Decline Factor[c] Times Tax Effort Factor[d] - Counties: (Excess Unemp. Times GRS Allocation) Weighted by Pre-recession Unemp. Rate - Locals: GRS distribution within county areas
Minimum Payment:	- $100 Minimum/Qtr.	- $5,000 Minimum/Qtr.	- $2,500 Minimum/Qtr.	- $1,500 Minimum/Qtr.
Payments:	- Quarterly	- Quarterly	- Quarterly	- Quarterly

*All references to unemployment rates in this exhibit refer to the average quarterly rate in the second quarter preceding that in which payments are to be made.

[a]Adjusted-base-period amount is the base-period amount of real wages and salaries (average of the peak and preceding quarter) increased at 0.3 percent per quarter from the peak quarter.

[b]Unless otherwise noted by (> 4.5%), excess unemployment is the amount by which a locality's unemployment rate in a payment quarter exceeds its rate in the comparable quarter of the year before the recession began.

[c]Economic-decline factor is the dollar amount by which a State's actual real wages and salaries in the second quarter preceding a payment quarter fall short of its adjusted base period amount.

[d]Tax-effort factor is total State tax collections divided by State personal income.

Office of State and Local Finance
Department of the Treasury
February 13, 1980

Targeted Fiscal Assistance: A Comparison of the Key Provisions of the Senate and House Bills

1. NATIONAL TRIGGER

Payments would begin soon after enactment by the Congress and approval by the President. Neither the Senate nor the House Targeted Fiscal Assistance (TFA) program proposals has a national trigger to initiate payments based on national economic indicators.

2. TERMINATION OF PAYMENTS

Senate Bill. Quarterly payments would be suspended if the national unemployment rate is 6.5 percent or more in the second-preceding quarter.

House bill. The bill provides for a single payment.

3. FUNDING LEVEL

Senate Bill. For each quarter of fiscal year 1980, $85 million would be provided, for a maximum possible annual payment of $340 million.

House Bill. One annual payment of $200 million.

4. ELIGIBILITY: THE UNEMPLOYMENT TEST

Senate Bill. A local government is eligible for payments if its unemployment rate is 6.0 percent or more during the six-month period that ended three months to the beginning of the payment quarter. The use of a prior Bureau of Labor Statistics method for calculating unemployment rates would be authorized for jurisdictions that are assisted by that calculation (Nelson option).

House Bill. As in the Senate bill, only local governments would be eligible. A locality in a Standard Metropolitan Statistical Area (SMSA) would meet the unemployment eligibility test if its unemployment rate exceeds the national average unemployment rate for SMSA's for the relevant year. A locality entirely outside an SMSA would meet this test if its unemployment rate exceeds the national average unemployment rate for non-SMSA areas in the relevant year. The current expectation is that 1979 benchmarked unemployment rates would be available in time to make the allocations required under this provision.

5. ELIGIBILITY: THE PER CAPITA INCOME TEST

Senate Bill. Per capita income would have to be less than 150 percent of the national average. There would be an exception for Alaska if the relevant unemployment rate exceeds 10 percent.

House Bill. Per capita income would have to be less than 135 percent of State per capita income or less than 135 percent of national per capita income.

6. ELIGIBILITY: GROWTH OF REAL WAGES AND SALARIES

House Bill. A local government would have to be located in a county for which the rate of growth of real wages and salaries in the three most recent calendar years available (1975 to 1978) was less than 150 percent of the national rate of growth in real wages and salaries.

7. STATE LIMITATION

Senate Bill. No limitation on the total amount allocable to localities in any State.

House Bill. The total allocated to the localities in any one State could not exceed 12.5 percent of the national payment.

8. ALLOCATION OF PAYMENTS

The remainder would be allocated among localities so that each obtains an amount that would be the ratio of its excess unemployment multiplied by its General Revenue Sharing payment to the national sum of those multiples for all eligible localities, multiplied by the total funds available. Excess unemployment is calculated as the locality's unemployment rate minus 4.5 percent. The unemployment rates to be used for the Senate bill are specified above in the **Item 4.**

House Bill. The calculations would be the same as those for the Senate bill, except that:

(a) for local governments not located in SMSA's, excess unemployment would be calculated as more than 4.0 percent; and

(b) average unemployment rates for calendar years 1975–1978 without the Nelson option would be used in the calculation of excess unemployment.

9. MINIMUM PAYMENT

Senate Bill. A minimum payment of $2,500 per quarter (equivalent to $10,000 per year) would be required before any payment at all is made to a locality.

House Bill. A $6,000 annual payment would be required before payment would be made to a government located inside an SMSA. A $3,000 annual payment would be required before payment would be made to a government entirely outside an SMSA.

10. PAYMENT TIMING

Senate Bill. Payments would be made quarterly.

House Bill. A single payment would be made not later than April 1, 1980.

COMPARISON OF THE KEY PROVISIONS, SENATE BILL (AUGUST 1979), HOUSE BILL (FEBRUARY 1980), FOR A PROGRAM OF TARGETED FISCAL ASSISTANCE

	Senate Bill (S. 566) (subtitle B)	House bill (H.R. 5980) (title V)
Trigger	On: None. Payments begin with enactment. Off 1 quarter of national unemployment $\geq$ 6.5 percent in the second preceding quarter.	On/off: None.
Funding level	$85 million/quarter in fiscal year 1980	$200 million in fiscal year 1980.
Eligibility	Local governments only	Local governments only.
	Unemployment rate $\geq$6.0[1] (Nelson Option applied to unemployment rates).	Unemployment rate > national average in most recent year for SMSA's or non-SMSA's.[2]
	Per capita Income <150 percent of national average (except Alaska if unemployment rate >10 percent).	Per capita Income <135 percent of State PCI or national PCI, whichever is higher.
Distribution	Territories equals 1 percent set-aside	Territories equals 1 percent set-aside.
	Excess (>4.5 percent) unemployment times GRS allocation for the Government.	Excess (>4.5 percent for SMSA's and >4 percent for non SMSA's) unemployment 1975–78[3] GRS allocation for the Government.
State limitation	None	Allocations to local government in any 1 State may not exceed 12.5 percent of the total allocated to all local governments, and amounts in excess are to be reallocated to local governments of other States.
Minimum payment	$2,500 minimum quarterly allocation (equivalent to $10,000 per year).	$6,000 minimum annual allocation for Governments in SMSA's, or $3,000 for Governments outside SMSA's.
Payment	Quarterly	1 payment by Apr. 1, 1980.

[1] During the 6-mo period ending 3-mos before the beginning of the payment quarter.

[2] For small communities normally assigned unemployment rates by the Secretary of Labor, the unemployment rate may be provided, if correctly prepared, by the State governor.

[3] The unemployment rate utilized could be the most recent available if there has been, or is expected to be, a major increase in the unemployment rate as a consequence of the closing of major industrial facilities.

Senator BENTSEN. Congressman Hamilton.

Representative HAMILTON. Thank you, Mr. Chairman.

Mr. Secretary, I suppose the central decision on economic policy was that there would be no tax cut. What would have to happen in the economy before you would advocate a tax cut? What specific things would you be looking for?

Secretary MILLER. As I say, the experience in recent times is that the economy has performed better than the economic forecasts have been able to predict. And because of that, we are cautious about adding a stimulus that would come from a tax cut.

We do not have any specific trigger in mind that would cause us to propose a tax cut because of the peculiarities of economic data which leave us preferring to look at all of the factors.

Let me give you an example.

This morning you heard that unemployment has picked up. At the same time you get a report that new orders are up.

Well, does that mean the economy is deteriorating, or does it mean there is a temporary lull waiting for new orders to come on stream to be produced?

It is that type of problem we have. Given a precise formula that we would do something on the basis of such and such a number would foreclose us from judging whether the economy is having a temporary lull, preparing for a major thrust one way or the other.

So we have felt we should wait and examine all the data.

Representative HAMILTON. There has been much talk about a rapid buildup of military expenditures. Such a buildup might fuel inflation.

Secretary MILLER. Yes.

Representative HAMILTON. Because of the inflationary risk, are you further away from the recommendation of a tax cut than you were when this budget was firmed up?

Secretary MILLER. It cuts both ways. I think that if the economy performs better than we expect because of a greater subsequent buildup in military needs, or because of the psychological effect of this event causing general economic conditions to improve, then we might end up with a budget moving closer toward balance earlier and we might find ourselves in a position to begin to think of tax cuts.

On the other hand, to put a tax cut in, in anticipation of that, might accelerate and unleash inflationary forces prematurely.

So I think we have to again see how that develops and see where it develops.

Representative HAMILTON. How do you feel about the economy at the present moment? Is it weakening or strengthening?

Secretary MILLER. As you know, we have forecast a recession, with the economy, in real terms, fourth quarter to fourth quarter, declining 1 percent in this calendar year, after only a 0.8 percent growth last year, and then recovering in calendar year 1981 to a 2.8 percent growth.

My feeling is, if you'd asked me a couple of months ago, I'd have said the risk was that the economy would be a little softer in 1980. Now I'd say the probabilities are that it might not be as soft because of developments in the Middle East which are having a psychological effect on behavior that shows up in people doing certain things. I have heard it said that if you hear a snowstorm is coming, very often a family goes out and buys an extra bottle of milk. And when people see threats of military intervention coming along in the Middle East, they tend to speed up decisions they might have put off.

Representative HAMILTON. If the economy is not as soft, you would be less likely to propose a tax cut?

Secretary MILLER. Right, sir.

Representative HAMILTON. If I understand the main criticism that has been lodged against the budget in the last few days by the Members of Congress and several commentators, it is that the budget really does not measure up to our problems, that the administration lacks a sense of urgency about the problems, and that your prescriptions may be long term while the problems are immediate. The members of the panel, of course, have discussed such matters with you today.

You have been testifying for a good many days on the budget. The main criticism is as I have described it, it seems to me. How do you respond to it? How do you feel about it after your testimony of the past few days?

Secretary MILLER. I have not really felt that there was universal criticism. I think many people have felt that this was a very responsible budget in terms of both economic conditions and the outlook for employment that we face.

The budget is not a document that can be shifted in major ways quickly because so much of it is of an uncontrollable character. It is either entitlements or contracts. And the areas of change are significant.

In future years we would like to continue to recognize the need for improving our defense posture. We would like to recognize the need for continuing to deal with structural unemployment. We would like to recognize the need for technological improvement. We'd like to recognize the need for productivity gains, both in human skills and investment. And we would like to roll these out on a sensible basis that does not unleash stimulative Federal deficits again and put us back on the cycle of domestically induced inflation.

Representative HAMILTON. Do you have the sense that the budget has been well received, Mr. Secretary?

Secretary MILLER. I think it has had mixed reactions. I recall the first day it came out one newspaper headline said, "The budget is very optimistic," and 2 days later the headline came out saying, "Very gloomy." So I think it's been a mixed reaction.

Representative HAMILTON. Thank you, Mr. Secretary.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Secretary, for your testimony this morning. It will be very helpful to us in preparing our economic report.

Chairman Volcker, we are very pleased to have you here this morning. We know your schedule as well as our own. So far we are on schedule and we will try to stay on it. I won't interrupt with a long speech, so you may proceed.

STATEMENT OF HON. PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Thank you, Mr. Chairman.

I am delighted to be with you this morning at a rather crucial point in our economic development and economic policy. I thought perhaps the most expeditious way for me to proceed would be to pick up, at the latter part of my prepared statement, when it becomes a little more forward-looking, and just make a couple of preliminary points.

You all know economic policy has been made considerably more difficult by the kinds of dramatic changes that have been occurring. And the uncertainties created by these developments are perhaps best highlighted by the almost universal failure of forecasts made at this time last year, and throughout most of the year, to predict accurately the course of the economy.

I think there is a lesson there. It shows how limited our ability reinforces the wisdom of holding firmly the monetary and other economic policies directed toward the continuing problems of the economy, of which I think inflation ranks first. In retrospect, recharting policy to respond to tentative signs of a faltering economy last year would have proven extremely costly to our anti-inflation effort.

I won't review the material in my prepared statement about what went on in the economy last year. With respect to monetary policy, I don't think I need to describe in detail for the members of this committee the actions we took, particularly in October, to deal with the situation that we found then. I would note that I have attached to my prepared statement a rather technical description of the new operating procedures that we introduced at that time, the point being that those procedures were designed to give us greater assurance of controlling the expansion of money and credit. And, if we look at the results of those actions in a rather technical perspective with regard to the immediate objectives of controlling money and credit, I think I can say the results have been remarkably in line with the intentions expressed in October. There has been a very clear and significant moderation in the growth of money and credit; and growth rates for virtually all the aggregates have subsided rather remarkably from the rather excessive pace of the early spring and summer.

But at the same time I have to say, in terms of the ultimate goals for inflation and the economy, the picture is less clear. On the one hand, the rather precipitous drop in economic activity that some people feared has not at all developed: the economy has continued to grow at a modest pace. But I point out, too, that that growth is reflected by consumer buying on credit or out of savings in anticipation of continued inflation, and that is not a situation that bodes well for the long run.

I will note that other developments since October have not been encouraging. Inflation remains just about where it was. The commodity market is once again highly volatile, and that is a development that I think grew directly out of the disturbed international situation. That situation had some impact on the dollar in the exchange markets, but it is interesting how steady the dollar has been for a number of weeks now.

I don't think we could have expected to see any considerable damping of inflation over this period, but we need to recognize that clear progress on prices rises has been set back at least by a quarter or two as a direct result of the oil price increases that we have had recently and the fact that the international disturbances have reinforced concern about future inflation. And that is not a happy picture.

But I would also remind you that we know there are lags between action and reaction, and we shouldn't be at all surprised or disheartened by what has happened. Monetary policy is only effective over time, and I think experience clearly shows that with perseverance it can and will be effective.

From my experience, what has happened recently—I am thinking particularly of international developments—has only reinforced the need for disciplined policy, and I am hopeful that we will make progress during the course of this year.

Now, with that in mind, let me turn to a discussion of appropriate policies from here on out. Monetary policy has a central role to play in combating inflation. Our recent experience underscores the complexity of the inflationary process. And, in view of that, I do think that we have to develop a coordinated set of policies designed to attack inflation from a number of directions, instead of putting the entire burden on monetary policy.

In theory, monetary policy could do the job alone; but, in practice, complementary policies are needed to smooth the path and build the base to sustain growth. And if we are going to return to a noninflationary environment, we have to recognize the persistent application of anti-inflation policies over an extended period is essential. I am happy to note that the administration has emphasized these same points in the discussions of policies for stability and growth.

As we develop such policies, I would note that our margins for error in some important respects are smaller today than they used to be. In particular, I would underscore the importance of avoiding errors on the side of excessive stimulus in an environment in which inflation is already deeply imbedded, a point also stressed in the President's Economic Report. When inflationary expectations are so volatile, we run the grave risk that stimulation will be dissipated to a large extent in higher prices rather than increased output. That is one price we pay for having permitted inflation to make the headway it has for so long.

The potential costs of acting on the basis of forecasts of slack that later prove to be incorrect are all the higher in view of potential strains or disruptions that could arise—for example, in the energy sector—that would further exacerbate inflationary pressures. In that connection, I am aware, as I am sure you are, that decisions on defense spending will need to be taken into account in appraising the outlook.

I know the committee does not expect me to deal in detail with our monetary objectives, pending testimony in relation to the Humphrey-Hawkins procedure. But, in terms of the broad posture of monetary policy, these considerations translate in my mind into a prescription for persistently working toward noninflationary growth of the money supply.

In this context, let me make an important analytic point—maintenance of restraint on money and credit is consistent with our movements in interest rates in response to market forces as they reflect credit demands, trends in economic activity and, over time, inflation. Whether, when, and to what extent interest rates move higher or lower, these changes should not be misinterpreted or misconstrued as a departure from our intent to maintain disciplined growth in money and credit over time.

In that connection, I would emphasize that the prospects for sustaining any declines in interest rates that might develop in any cyclical downturn will ultimately depend on success in the fight against inflation. In that context—but only in that context—lower interest rates would not only be appropriate in facilitating recovery, they would be evidence that the foundations were being laid for a healthier domestic economic situation and one consistent with a stronger dollar internationally.

Turning to the fiscal side, I believe it is imperative to keep the goal of budgetary balance in the forefront of our thinking about spending and revenue decisions, even though our progress may at times be interrupted by cyclical developments. It is particulary important, in my view, that tight control be exercised on total expenditures, and that we work away at the objective often stated by the President in the past that the share of Government spending to total GNP be reduced.

In the current international environment, that may not be feasible every year, but if and as defense priorities rise, the clear implication is that we cannot shrink away from even more intense scrutiny of nondefense spending. Moreover, budget revenues must be managed prudently, and I especially applaud the President's decision to refrain from recommending any new stimulative tax incentives at this time.

I am well aware that a strong case can be made for well-structured tax changes; as you have often pointed out, Senator, we should act to remove "supply-side" disincentives from the tax system. But desirable as some types of tax cuts may be, particulary to help deal with the urgent underlying problems of productivity, costs, and incentives, such a program needs to respect the fiscal priorities. Otherwise, the potential favorable effects would be swamped by a new spur to inflation, even more congested credit markets, and more economic instability. Put simply, net tax reduction can only be earned by restraint in expenditures over time, and that time has not yet come.

When the time does come for tax reduction, it should be designed with a sharp focus on achieving the Nation's goals. A number of possible tax measures to reduce costs could be considered in this regard, including, for example, reexamination of the extent to which we rely on payroll taxes. But, it seems to me, tax restructuring should place major emphasis on stimulating business investment and enhancing productivity growth. To my mind, it would be a policy mistake of the first magnitude to dissipate opportunities for tax reduction, when and if they do arise, in measures that simply add to spending without helping to resolve the underlying problems.

Over the longer run, productivity growth is certainly the major underlying problem alongside inflation, and it is one of the keys to containing inflation. Recent performance in that respect has been dismal. I won't recite all the figures; you know that productivity actually declined last year. Looking broadly at recent trends, I think we have to have some concern over the slackening rates of capital investment and capital accumulation.

It is clear, then, that we must design our economic policies in a way that will encourage saving and investment, and improve the rate of capital formation, if we are to insure the ability of the economy to provide sustained advances in living standards and to meet those other objectives not captured in the production statistics—our social and environmental concerns, and so on.

Another element in any long-range program to increase productivity and living standards seems to me to be a new look at the Federal Government's regulatory activities, both social and economic. This year's economic report discusses the need for striking a proper balance in regulation, an area where, I sense, sound concepts of comparing costs with benefits have been sorely lacking. I know this is a difficult area, Mr. Chairman, but it is an area I really don't think we can afford to neglect.

Also, I welcome any assistance in the anti-inflation program that can be obtained through cooperative and voluntary programs by way of educating business and labor as to the need for restraint and in heading off excesses. An effective program, emphasizing the ultimate futility of attempts to recover losses of real income required by productivity declines or external shocks potentially can dampen a ratcheting up of the wage-price spiral. But let us recognize, too, that experience here and abroad confirms that such programs cannot be the backbone of an anti-inflation policy. And let us also appreciate, and avoid, the risk that such programs may lull us into thinking they are a substitute for monetary and budgetary discipline; the net effect would be counterproductive.

I won't get into the energy area other than to note its relevance to our problems. I have no particular expertise in that area, but it certainly does seem to me that recent developments underscore the need to come to grips with the problem, and a part of the solution requires that we recognize the need to allow increases in the price of all related products to reflect their true scarcity. Sometimes the short-term impact of such a policy on the price indexes is cited as an almost insuperable obstacle to such an approach. To be sure, the short-term dilemma reinforces the need for firm anti-inflationary policies to avoid further increases in inflationary expectations. But I also think the benefits over time will be substantial, for the longer we delay adjusting to the realities of the energy markets, the longer we are going to be vulnerable to spiraling prices at inopportune times in the future, to say nothing of being vulnerable to physical shortages.

We all know the period we are now in surely will test our patience, our wisdom, and our commonsense. The problems we face are not easy ones, and the policy decisions they call forth are not necessarily going to win popularity contests today. But I am encouraged by the understanding by the American people of some basic truths: The need for economic restraint, applied consistently and persistently; the fact that creation of money is no substitute for production and productivity; the absence of painless quick fixes.

You are a better judge of the national mood than I. Events of recent years have given a'l of us—from our national leaders to the most humble citizen—some insight into what it means to really have to worry about the value of the dollar, at home and abroad, not just its implications for economic stability and for our national pride, but for our sense of value and our ability to exercise leadership in the world. There is no longer any soft or easy option of simply accepting another turn of the inflationary screw as a byproduct of buying our way out of stagnation or slump. I also know the "payoff" over time from policies to restore stability and productivity can be huge for all Americans. That is why I feel so strongly we must "stick with it" until the job is done.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Volcker, together with the attachment referred to, follows:]

Prepared Statement of Hon. Paul A. Volcker

I am pleased to be here today to participate in these hearings on the President's Economic Report, to present to you my views on the state of the economy and to comment on what I consider to be the advisable course for economic policy. I believe there is now widespread recognition of the priority that must be given to controlling inflation. I welcome this opportunity to discuss the role of monetary policy in achieving the goal of price stability, and to explore ways in which other policies also can contribute toward this end.

Shaping economic policy is not an easy task even at the best of times. But the task has been made considerably more difficult by the dramatic changes that have been occurring recently in the economic environment, both at home and abroad. Actions by OPEC continue to place sharp upward pressures on the price of oil imported into the United States, while political disturbances in Iran and Afghanistan—among other things—have increased uncertainties about future petroleum supplies and defense spending. Here at home inflationary pressures have intensified, and these pressures have been accompanied by a heightening of inflationary expectations. While much of the acceleration in prices can be attributed to rising energy costs, our dismal performance in productivity has also contributed appreciably. In financial markets, high interest rates—themselves a by-product of rapid inflation—have induced further financial innovation and institutional changes, which in part have required changes in the way monetary policy is now conducted.

The uncertainties created by these developments are perhaps best highlighted by the almost universal failure of forecasts made at this time last year, and throughout most of the year, to predict accurately the continued expansion of economic activity in 1979. Despite the shocks from very large oil price hikes, fuel shortages, and major strikes, as well as the imposition of restraining macroeconomic policies, the economy proved to be remarkably resilient. Growth in real economic activity did slow in 1979 from the unsustainable 5 percent rate posted in the preceding year, but real GNP still advanced 1 percent over the four quarters of 1979; the much-heralded recession never appeared.

The 1979 experience underscores how limited our ability is to project future developments. It reinforces the wisdom of holding firmly to monetary and other economic policies directed toward the evident continuing problems of the economy—of which inflation ranks first—rather than reacting to possibly transitory and misleading movements in the latest statistics or relying too heavily on uncertain economic and financial forecasts. In retrospect, recharting policy to respond to tentative signs of a faltering economy last year would have proven extremely costly to our anti-inflation effort.

One of the major reasons why the forecasts for 1979 went wrong was the unanticipated behavior of consumers. Despite the virtual cessation of growth in real disposable income over the year, consumption outlays continued to advance. The desire of households to accumulate goods was, no doubt, induced in part by the expectation of worsening inflation. Indeed, surveys of consumer attitudes showed inflationary expectations in the double-digit range virtually throughout the year. Consumers could see both their savings and income being eroded by inflation and were willing to incur more debt and to save less in order to sustain their standards of living or to buy tangible assets in anticipation of further price rises. As a result, debt burdens reached new highs in 1979 and the saving rate at the end of the year was down to its lowest level since the Korean War. One of the major uncertainties as we enter 1980 is how long consumers may be willing and able to maintain behavior without much earlier precedent.

It was encouraging that the nation's trade balance improved somewhat last year despite a dramatic increase in the value of our oil imports. Export volume—for both agricultural and nonagricultural products—increased by about 10 percent. Export markets thereby helped significantly in sustaining domestic production in 1979.

If the forecasts have proven to be wrong about a recession in 1979, they do, I believe, reflect elements of potential weakness in some key sectors and an increased overall vulnerability following five years of expansion accompanied by the distortions of inflation. One major area of weakness has already been evident—the auto sector. Auto demand was damped last year by a series of shocks—large gasoline price hikes, gas shortages, and concerns about future fuel availability. Car sales dropped sharply in the spring and car stocks backed up. Price cutting and company-sponsored incentive programs helped work off excessive inventories in the summer. On balance, however, demand appears to have weakened, with auto sales in the fourth quarter at the lowest level since 1975. Indeed, sales have dropped to the point that much of that adjustment may be completed.

Housing sector activity also slackened substantially. The rate of private housing starts moved down early in 1979 from the 2 million unit pace that prevailed in 1978 and averaged 1¾ million units during the first three quarters of 1979. Late last year starts fell again, to an average of 1½ million units in the final two months; permits for new construction declined even faster. The decline in residential construction last year reflected tighter conditions in mortgage markets as well as some reduction of demands owing to weaker financial positions of potential homebuyers.

In the business sector, there was a loss of momentum in capital outlays during 1979 as the fundamental determinants of spending became less favorable. Growth of final sales slowed considerably after the first quarter, the capacity utilization rate in manufacturing edged lower, nominal financing costs rose throughout the year, and business sector balance sheets came under increasing financial pressure. Reflecting these developments, advance indicators of capital spending—such as orders and contracts—showed no real growth during the year, and surveys of planned outlays for 1980 also suggest a further moderation in real capital outlays.

The slowing of economic activity during 1979 was accompanied by a less rapid increase in employment, but the moderation in employment growth did not keep pace with the deceleration in output growth. Although real output rose by 1 percent over the year, total employment increased 2 percent. At the same time, however, growth of the labor force slowed. As a result, the overall unemployment rate remained within a narrow range of 5¾ to 6 percent.

Despite the moderation of output growth last year, inflation worsened and inflationary expectations became more deeply inbedded. The acceleration in overall inflation in 1979 was due in significant measure to the sharp rise in the price of imported crude oil that resulted from the series of price hikes instituted by OPEC. In addition, prices of domestic crude oil and many other energy items also rose dramatically. Inflation, however, was not confined to the energy sector as underlying cost pressures intensified throughout the economy and prices excluding energy and food rose faster than in the year earlier.

By last fall it was evident that inflationary conditions had deteriorated further and threatened not only the stability of the U.S. economy, but also our position in the world economy. In response to the measures taken in November 1978, the value of the dollar had risen, and this strength continued into the first five months of 1979. However, the failure of the U.S. inflation rate to moderate, an acceleration of money and credit, and the rapid rise in oil prices all contributed to downward pressure on the dollar in the summer. The dollar's weakness intensified in September despite heavy intervention purchases of dollars by U.S. and foreign authorities.

MONETARY POLICY IN 1979

Early in 1979 growth of the monetary aggregates was effectively under control. But during the spring and summer money growth was much faster than the Federal Reserve's longer-run targets. The System took a series of actions, through its open market operations and through increases in the discount rate, designed to contain excessive growth of money and credit. But with continuing rapid growth of the aggregates and with foreign exchange developments contributing additional upward price pressure and exacerbating inflationary expectations, it became clear that firm action was needed to avoid even higher inflation. The risks were underscored by an apparent buildup of speculative pressures in commodity markets in September. The danger was that the bidding up of prices in these markets not only would in itself reinforce the inflationary trends, but that it would also lead to an unsustainable surge of buying. This was the setting in which the Federal Reserve took its October 6 policy actions to deal with inflationary pressures and defuse expectational forces. It was a setting, too, that emphasized the fundamental point that defense of the dollar internationally depends first of all on actions at home to deal with our domestic economic problems.

As I have indicated on previous occasions, the new steps did not involve any change in our basic targets for the various monetary aggregates in 1979, but they did provide added assurance that those objectives could be achieved. Indeed, our immediate objective was to rein in money and credit growth.

Although explicit targets for monetary growth have been a central feature of monetary policy for several years, the operational guide for day-to-day open market operations before October had typically been the federal funds rate. However, the translation of money stock objectives into day-to-day management of this rate presupposes a stable and predictable relationship between the public's demand for cash balances and short-term market rates of interest. This relationship becomes particularly difficult to appraise in an environment of rapid price increases, changing inflationary expectations, and financial innovations. Consequently, the Federal Open Market Committee decided to emphasize controlling the volume of reserves available to support deposits in the banking system.[1] This change in procedure was supported by two other measures—an increase in the discount rate and a marginal reserve requirement on increases in the managed liabilities of larger banks. Our purpose in this program was to signal clearly and forcibly our unwillingness to finance an accelerating rate of inflation and our desire to "wind down" inflationary pressures.

Following these actions taken nearly four months ago, there was a period of turmoil and unsettlement as the markets appraised and adjusted to the new approach to implementing monetary policy. Initial reactions in some markets may have been exaggerated, but at least they reflected an appreciation of the seriousness with which we viewed the problem of containing inflation. Now the financial markets appear to be functioning in a more orderly fashion.

[1] A technical description of the new procedures is attached to the statement.

With regard to our immediate objectives of controlling monetary and credit developments, I can report that the overall results have been remarkably in line with our intentions. Specifically, there has been a clear and significant moderation in the growth of money and credit. Growth in M–1 over the September to December interval was well within the interim target of 4½ percent or lower set by the Federal Open Market Committee in early October, and growth rates for virtually all the aggregates have subsided markedly from the excessive pace of the spring and early summer of last year.

In terms of our ultimate goals, the picture is much less clear. Fears expressed by some of a precipitous drop in economic activity have not been borne out, as the economy has continued to grow at a modest pace in spite of the tighter policies. But the economy's strength reflects in part consumer buying on credit or out of savings in anticipation of continued inflation, and this does not bode well for the long run. Other developments since October have not been encouraging. Inflation remains about where it was, and ~~gold~~ and commodity markets are once again highly volatile—a development certainly related in large part to international political and economic developments. These same developments had an impact on exchange markets. The dollar retraced most of its rise after October 6, but has held steady in recent weeks.

We could not reasonably have expected to see any significant damping of inflation over such a short period of time. But, we must also recognize that clear progress on the price front has probably been set back by at least a further quarter or two as a direct result of the round of oil price changes since early December, and the international disturbances have seemed to reinforce concern about future inflation. This part of the picture is not a happy one. But, I would remind you that the lags between action and reactions are well-known, so we should be neither surprised nor disheartened by the recent data. Monetary policy—restraint on growth of money and credit—is only effective over time; but experience shows that, with perseverance, it can and will be effective. Recent events seem to me only to reinforce the need for disciplined policy, and I remain hopeful that signs of progress will emerge over the next year.

LOOKING AHEAD

With this background in mind, let me now turn to a discussion of appropriate public policies over the near term. Monetary policy has a central role to play in combatting inflation. But our recent experience underscores the complexity of the inflationary process—prices respond to a host of factors, including credit growth, demand management policies, external price shocks, productivity trends, expectations, and many others. In view of this, I believe that we must develop a coordinated set of policies designed to attack inflation from a number of directions rather than placing the entire burden on monetary policy. In theory, monetary policy could do the job alone; in practice, complementary policies are needed to smooth the path and build the base for sustained growth. Moreover, if we are to return to a noninflationary environment it must be recognized that persistent application of anti-inflation policies over an extended period is essential. I am happy to note that the Administration has emphasized these points in its discussion of policies for stability and growth.

As we develop such policies, I would note that our margins for error in some important respects are smaller today than they used to be. In particular, I would underscore the importance of avoiding errors on the side of excessive stimulus in an environment in which inflation is already deeply imbedded, a point also stressed in the President's Economic Report. When inflationary expectations are so volatile, we run the grave risk that stimulation will be dissipated to a large extent in higher prices rather than increased output. That is one price we pay for permitting inflation to make the headway it has for so long. The potential costs of acting on the basis of forecasts of slack that later prove to be incorrect are all the higher in view of potential strains or disruptions that could arise—for example, in the energy sector—that would further exacerbate inflationary pressures. In that connection, I am aware, as I am sure you are, that decisions on defense spending will need to be taken into account in appraising the outlook.

I know the Committee does not expect me to deal in detail with our monetary objectives, pending testimony in relation to the Humphrey-Hawkins procedure. However, in terms of the broad posture of monetary policy, these considerations translate into a prescription for persistently working toward non-inflationary growth of the money supply. There are questions on how fast money growth should be cut back, and technical issues of how to implement monetary policy, but I see no satisfactory alternative to slowing the growth of money. Our policy, viewed in a long-term perspective, rests on a very simple premise—that the inflationary process is ultimately related to excessive growth in money and credit. This relationship is of course a complex one, and there are many facets of it that are sensitive to nonmonetary economic variables. But, in spite of all the nuances, it is clear that inflation cannot persist over the long run in the absence of excessive monetary growth.

In this context, let me make an important analytic point—maintenance of restraint on money and credit is consistent with movements in interest rates in response to market forces as they reflect credit demands, trends in economic activity, and, over time, inflation. Whether, when, and to what extent interest rates move higher or lower, these changes should not be misinterpreted or misconstruced as a departure from our intent to maintain disciplined growth in money and credit over time. In that connection, I would emphasize that the prospects for sustaining any declines in interest rates that might develop in any cyclical downturn will ultimately depend on success in the fight against inflation. In that context—but only in that context—lower interest rates would not only be appropriate in facilitating recovery, they would be evidence that the foundations were being laid for a healthier domestic economic situation and one consistent with a stronger dollar internationally.

OTHER ANTI-INFLATION POLICIES

I pointed out earlier the need for a coordination of policies in order to avoid unnecessary costs and disruptions as we work to restrain inflation. Fiscal policy potentially can play a key role. In the past, however, there has been far too much of a willingness to accept budget deficits, in good as well as bad years.

I believe it is imperative to keep the goal of budgetary balance in the forefront of our thinking about spending and revenue decisions, even though our progress may at times be interrupted by cyclical developments. It is particularly important, in my view, that tight control be exercised on total expenditures, and that we work away at the objective often stated by the President in the past that the share of government spending to total GNP be reduced. In the current international environment, that may not be feasible every year, but if and as defense priorities rise, the clear implication is that we cannot shrink away from even more intense scrutiny of nondefense spending. Moreover, budget revenues must be managed prudently, and I especially applaud the President's decision to refrain from recommending any new stimulative tax incentives at this time.

I am well aware that a strong case can be made for well-structured tax changes; as the Chairman of this committee has often pointed out, we should act to remove "supply-side" disincentives in the tax system. But desirable as some types of tax cuts may be, particularly to help deal with the urgent underlying problems of productivity, costs, and incentives, such a program needs to respect the fiscal priorities. Otherwise the potential favorable effects would be swamped by a new spur to inflation, even more congested credit markets, and more economic instability. Put simply, net tax reduction can only be earned by restraint in expenditures over time, and that time has not yet come.

When the time does come for tax reduction, it should be designed with a sharp focus on achieving the nation's goals. A number of possible tax measures to reduce costs could be considered in this regard, including for example reexamination of the extent to which we rely on payroll taxes. But, it seems to me, tax restructuring should place major emphasis on stimulating business investment and enhancing productivity growth. To my mind, it would be a policy mistake of the first magnitude to dissipate opportunities for tax reduction, when and if they do arise, in measures that simply add to spending without helping to resolve the underlying problems.

Over the longer run, productivity growth is one of the keys to containing inflation, as well as being the prerequisite for raising living standards. Recent performance in that respect has been dismal. During the two decades following World War II output per hour worked was rising on average about 3 percent per year; since the mid-sixties, the increase has trended lower, climaxed by an actual decline in 1979.

One of the reasons for the slowdown in productivity growth over the past decade has been a slackening in the rate of capital formation. Indeed, the nation's stock of capital grew at only a 2½ percent rate over the last five years—about half the pace of the preceding decade. Capital accumulation per member of the labor force has slowed even more dramatically; the stock of capital per worker has actually declined on average since 1975, and more of our present capital stock appears less directly "productive" in the sense that it is motivated by environmental or other considerations. It is clear, then, that we must design our economic policies in a way that will encourage saving and investment, and improve the rate of capital formation, if we are to ensure the ability of the economy to provide sustained advances in living standards and to meet those other objectives not captured in the production statistics.

Another element in the long-range program to increase productivity and living standards, and reduce inflation, would be a new look at the federal government's regulatory activities—both social regulations and economic regulations. This year's Economic Report discusses the need for striking a proper balance in regulation, an area where, I sense, sound concepts of comparing costs with benefits have been sorely lacking. I do not underestimate the difficulty; reality is complex and each new regulations seems to generate its own vested interests, with talented and vocal advocates. Yet, instances where obsolete government intervention actually hurts, rather than helps, the consuming public have often been cited, and newer regulations can be challenged on the same grounds. Even in areas where elimination of government regulation would clearly be inappropriate—such as the protection of the environment, health, and safety—I feel certain we can do a better job in assuring that the benefits of protection are weighed carefully against the costs of achieving them.

In the context of declining productivity it is even more apparent that moderation in wage growth is needed if we are to gain control over inflation. Last year hourly compensation increased about 9 percent. Combined with an actual decline in productivity of more than 2 percent, these wage increased drove unit labor costs up more than 11 percent—a marked acceleration from 1978 and thus a substantial source of added inflationary pressures. I welcome any assistance that can be obtained through cooperative and voluntary programs by way of educating business and labor as to the need for restraint and in heading off excesses. An effective program, emphasizing the ultimate futility of attempts to recover losses of real income required by productivity declines or external shocks potentially can dampen a ratcheting up of the wage-price spiral. But let us recognize, too, that experience here and abroad confirms that such programs cannot be the backbone of an anti-inflation policy. And, let us also appreciate, and avoid, the risk that such programs may lull us into thinking they are a substitute for monetary and budgetary discipline; in that event, the net effect would be counter-productive.

Of course, we will remain highly vulnerable to external developments so long as we are heavily dependent on imported oil. I will note, without belaboring a point that has been made so many times, that recent events only underscore the need to come to grips with this problem.

Part of the solution seems to me to require that we recognize the need to allow increases in the price of oil and related products to reflect their true scarcity. Sometimes the short-term impact of such a policy on the price indices is cited as an almost insuperable obstacle to such an approach. To be sure, the short-term dilemma reinforces the need for firm anti-inflationary policies to avoid further increases in inflationary expectations. But benefits over time would be substantial, for the longer we delay adjusting to the realities of the energy markets, the longer we will be vulnerable to spiraling prices at inopportune times, to say nothing of physical shortages.

The period we are now in surely will test our patience, our wisdom, and our common sense. The problems we face are not easy ones, and the policy decisions they call forth are not necessarily going to win popularity contests today. Yet, what strikes me is the understanding by the American people of some basic truths: the need for economic restraint, applied consistently and persistently; the fact that creation of money is no substitute for production and productivity; the absence of painless quick fixes.

You are better judges of the national mood than I. But I do have certain convictions. Events of recent years have given all of us—from our national leaders to the most humble citizen—some insight into what it means to really have to worry about the value of the dollar, at home and abroad, not just its implications for economic stability and for our national pride, but for our sense of value and our ability to exercise leadership in the world. There is no longer any soft or easy option of simply accepting another turn of the inflationary screw as a by-product of buying our way out of stagnation or slump. I also know the "payoff" over time from policies to restore stability and productivity can be huge for all Americans. That is why I feel so strongly we must "stick with it" until the job is done.

Attachment.

The New Federal Reserve Technical Procedures For Controlling Money

As part of its anti-inflationary program announced on October 6, 1979, the Federal Reserve changed open market operating procedures to place more emphasis on controlling reserves directly so as to provide more assurance of attaining basic money supply objectives. Previously, the reserve supply had been more passively determined by what was needed to maintain, in any given short-run period, a level of short-term interest rates, in particular a level of the federal funds rate, that was considered consistent with longer-term money growth targets. Thus, the new procedures entail greater freedom for interest rates to change over the short-run in response to market forces.[1]

This note describes the new technical operating procedures and how the linkage between reserves and money involved in the procedures is influenced by the existing institutional framework and other facts. This linkage is relatively complicated and variable, particularly over the short-run, so that, for example, it does not necessarily follow that rapid expansion of reserves would be accompanied by, or would presage, rapid expansion of money. The exact relationship depends on the bahavior of other factors besides money that absorb or release reserves, and consideration must also be give to timing problems in connection with lagged reserve accounting.

In setting reserve paths to control money under existing conditions account must be taken of: (i) the prevailing reserve requirement structure, with varying reserve requirements by type of deposit (some of which may not be included in targeted money measures) and by size of deposit; (ii) the public's demand for currency relative to deposits; (iii) availability of reserves at bank initiative from the discount window; (iv) lags in response on the part of the public and banks to changes in reserve supply through open market operations; (v) the growing amount of money-supply type deposits at institutions not subject to reserve requirements set by the Federal Reserve; (vi) lagged reserve accounting. To help insure that operations are undertaken most effectively, the Federal Reserve has the new operating technique and related factors under continuous examination in light of experience gained. At present, studies are under way on such elements as lagged reserve accounting and the role of the discount window. Possible changes in other elements involved with the technique would require Congressional action—such as extending reserve requirements to nonmember institutions and certain aspects of simplifying reserve structure.

The principal steps in the new procedure are outlined below.

(1) The policy process first involves a decision by the Federal Open Market Committee on the rate of increase in money it wishes to achieve. For instance, at its October 6 meeting, taking account of its longer-run monetary targets and economic and financial conditions, the Committee agreed upon an annual rate of growth in M–1 over the 3-month period from September to December on the order of 4½ percent, and of M–2 of about 7½ percent, but also agreed that somewhat slower growth was acceptable.

(2) After the objective for money supply growth is set, reserve paths expected to achieve such growth are established for a family of reserve measures. These measures consist of total reserves, the monetary base (essentially total reserves of member banks plus currency in circulation), and nonborrowed reserves. Establishment of the paths involves projecting how much of the targeted money growth is likely to take the form of currency, of deposits at nonmember institutions, and of deposits at member institutions (taking account of differential reserve requirements by size of demand deposits and between the demand and time and savings deposit components of M–2. Moreover, estimates are made of reserves likely to be absorbed by expansion in other bank liabilities subject to reserve requirements, such as large CD's, at a pace that appears consistent with money supply objectives and also takes account of tolerable changes in bank credit. Such estimates are necessary because reserves that banks use to support expansion of CD's, for example, would not be available to support expansion in M–1 and M–2. Thus, if the reserves required behind CD's were not provided for in the reserve path, expansion in M–1 and M–2 would be weaker than desired. The opposite would be the case if the reserve path were not reduced to reflect contraction of large CD's. For similar reasons, estimates are also made of the amount of excess reserves banks are likely to hold.

[1] Consistent with this, the federal funds rate range adopted by the Federal Open Market Committee for an intermeeting period has been greatly widened.

(3) The projected mix of currency and deposits, given the reserve requirements for deposits and banks' excess reserves, yields an estimate of the increase in total reserves and the monetary base consistent with FOMC monetary targets. The amount of nonborrowed reserves—that is total reserves less member bank borrowing—is obtained by initially assuming a level of borrowing near that prevailing in the most recent period. For instance, following the October 6 decision, a level of borrowing somewhat above that of September was initially assumed. Following subsequent meetings, the assumed level of borrowing for the nonborrowed path was always close to the level prevailing around the time of the FOMC meeting, though varying a little above and below that level.

(4) Initial paths established for the family of reserve measures over, say, a 3-month period are then translated into reserve levels covering shorter periods between meetings. These paths can be based on a constant seasonally adjusted rate of growth of the money targets on, say, a month-by-month basis, or can involve variable monthly growth rates within the 3-month period if that appears to facilitate achievement of the longer-run money targets.

(5) Total reserves provide the basis for deposits and thereby are more closely related to the aggregates than nonborrowed reserves. Thus total reserves represents the principal over-all reserve objective.[3] However, only nonborrowed reserves are directly under control through open market operations, though they can be adjusted in response to changes in bank demand for reserves obtained through borrowing at the discount window.

(6) Because nonborrowed reserves are more closely under control of the System Account Manager for open market operations (though subject to a small range of error because of the behavior of non-controlled factors affecting reserves, such as float), he would initially aim at a nonborrowed reserve target (seasonally unadjusted for operating purposes) established for the operating period between meetings. To understand how this would lead to control of total reserves and money supply, suppose that the demand for money ran stronger than was being targeted—as it did in early October of last year. The increased demand for money and also for bank reserves to support the money would in the first instance be accompanied by more intensive efforts on the part of banks to obtain reserves in the federal funds market, thereby tending to bid up the federal funds rate, and by increased borrowing at the Federal Reserve discount window. As a result of the latter, total reserves and the monetary base would for a while run stronger than targeted. Whether total reserves tend to remain above target for any sustained period depends in part on the nature of the bulge in reserve demand—whether or not it was transitory, for example—and in part on the degree to which emerging market conditions reflect or induce adjustments on the part of banks and the public. These responses on the part of banks, for example, could include sales of securities to the public (thereby extinguishing deposits) and changes in lending policies.

(7) Should total reserves be showing sustained strength, closer control over them could be obtained by lowering the nonborrowed reserve path (to attempt to offset the expansion in member bank borrowing) and/or by raising the discount rate. A rise in the discount rate would, for any given supply of nonborrowed reserves, initially tend to raise market interest rates, thereby working to speed up the adjustment process of the public and banks and encouraging a more prompt move back to the path for total reserves and the monetary base. Thus, whether adjustments are made in the nonborrowed path—the only path that can be controlled directly through open market operations—and/or in the discount rate depends in part on emerging behavior by banks and the public. Under present circumstances, however, both the timing of market response to a rise in money and reserve demand, and the ability to control total reserves in the short run

[3] In the control process, the monetary base in practice is given less weight than total reserves. This is principally for a technical reason. If currency, the principal component of the base, is running stronger than anticipated, achievement of a base target would require a dollar-for-dollar weakening in member bank reserves. But, because of fractional reserve requirements, the weakening in reserves would have a multiple effect on the deposit components of the monetary aggregates (it could weaken the demand deposit component by about 6 times the decline in reserves). Achievement of a base target in the short run could therefore lead, in this example, to a much weaker money supply than targeted. If a total reserve target were achieved, the money supply would be stronger than targeted, but only by the amount by which currency is stronger than expected. Thus, the variation from a money supply target would be less under total reserves than under a monetary base guide. Of course, should currency persistently run stronger or weaker than expected, compensating adjustments could be made to either a total reserves or monetary base target.

within close tolerance limits, are influenced by the two-week lag between bank deposits and required reserves behind these deposits.[3]

(8) Other intermeeting adjustments can be made to the reserve paths as a family. These may be needed when it becomes clear that the multiplier relationship between reserves and money has varied from expectations. The relationship can vary when, for example, excess reserves and non-money reservable liabilities are clearly running higher or lower than anticipated. Since October 6 such adjustments during the intermeeting period have been made infrequently. Given the naturally large week-to-week fluctuations in factors affecting the reserve multiplier, deviation from expectations in one direction over a period of several weeks would be needed before it would be clear that a change in trend has taken place.

A variable relationship between expansion of reserves and of money is implicit in the description of procedures just given. This is illustrated by experience in the fourth quarter, as shown in the table on the next page. It can be seen from panel I that M–1 increased at only a 3.1 percent annual rate (seasonally adjusted) in that period and M–2 at a 6.8 percent rate. At the same time, as shown in panel II, nonborrowed reserves, total reserve and the monetary base rose at substantially more rapid rates—by annual rates of about 13, 13¾, and 8 percent, respectively.

CHANGES IN RESERVE AND MONETARY AGGREGATES, SEPTEMBER TO DECEMBER 1979

[Seasonally adjusted]

	Percent annual rate[1]	Change (millions)
I. Changes in monetary aggregates:		
A. M–1	3.1	$2,845
1. Currency outside banks	5.3	1,400
2. Member bank demand deposits	2.3	972
3. Nonmember bank demand deposits	2.1	473
B. M–2	6.8	15,961
II. Changes in reserves and related items:		
A. Nonborrowed reserves	12.9	1,309
B. Borrowings		131
C. Total reserves (A+B)	13.8	1,430
D. Currency[2]	5.9	1,606
E. Monetary base (C+D)	8.1	3,046
	Percentage points contributed toward growth of total reserves	**Change (millions)**
III. Total reserves absorbed by:		
A. Private demand deposits	1.1	$111
B. Interbank demand deposits	2.7	280
C. U.S. Government demand deposits	0	3
D. Large, negotiable CD's	3.6	378
E. M–2 time and savings deposits	4.5	466
F. Nondeposit tiems	0	–3
G. Excess reserves	2.0	205
Addendum: Impact of lagged reserve accounting on:		
1. Total reserves		[3] 287
2. Reserves against private demand deposits		–64
3. Reserves against M–2 time and savings deposits		121
4. All other items subject to reserves		230

[1] Growth rates of reserves adjusted for discontinuities in series that result from changes in regulations D and M.
[2] Includes vault cash of nonmember banks.
[3] Reflects change in total reserves during period attributable to fact that required reserves are based on deposits 2 weeks earlier, rather than on deposits contemporaneous with reserves. Thus, adjusted to a basis contemporaneous with deposit growth from September to December, total reserves would have expanded $287,000,000, or 2.8 percentage points less than they actually did.

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[3] Under lagged accounting, banks are not required to hold reserves against deposits until two weeks later. With required reserves fixed at that time, the Federal Reserve in its operations is limited in its ability to control total reserves within a given week (since the total of reserves is determined by required reserves and banks' excess reserves), but can more readily determine whether the banking system satisfies its reserve requirement through the availability of nonborrowed reserves, or is forced to turn to the discount window (or to reduce excess reserves, though most banks are usually close to minimal levels in that respect).

There were a number of reasons for the much more rapid growth in reserves and the base than in the monetary aggregates. Only about 1 percentage point of the 13¾ percent annual rate of increase in total reserves supported growth in the member bank demand deposit component of M–1 (as may be seen from line III.A of the table). An additional 4¼ percentage points supported the member bank interest-bearing component of M–2 (line III.E). Thus less than half of the increase in reserves supported expansion in targeted monetary aggregates. More than half of the reserves supported expansion in interbank demand deposits, excess reserves, and large negotiable CD's. If these reserves had not been supplied, growth in M–1 and M–2 would have been much slower. In fact, actual growth in M–1 and M–2 was a bit slower than targeted, though not less than the Committee found acceptable.[4]

As this example from recent experience helps demonstrate, the behavior of reserve measures in relation to money can be expected to vary with shifts in the currency and deposit mix, with changes in bank demands for excess reserves and borrowing, and with timing problems related to lagged reserve accounting. But even in evaluating money growth itself, which the Federal Open Market Committee sets as a target in the policy process, recognition has to be given to the likelihood that money growth can vary substantially on a month-to-month basis in view of inherently large and erratic money flows in so vast and complex an economy as ours.

Senator BENTSEN. Thank you very much, Mr. Volcker.

You and I certainly agree on the need for monetary and fiscal prudence and restraint, and I think the public shares that view, too. And I think we agree to a very substantial degree on the question of increasing productivity and how serious a problem it is for this country.

Our basic disagreement, I think, is in the timing. It is my personal viewpoint that the longer we wait, the more problems we will have like the steel industry, and the more difficult it will be to get a response and to turn the situation around; the more we will have lost our market share in the world, and the more difficult it will be to regain that market share. It is always much easier to sustain it than to go back and reestablish it.

As I said earlier, I just chaired a series of Joint Economic hearings in the Far East, and I was amazed by the response of American businessmen over there who are on the cutting edge—I am not talking about executives back here but those who are out there trying to sell. It is of deep concern to me that it is an exploding trade area. Trade out there is expanding at the rate of about 20 percent compounded each year. And we find our two-way trade with them is now passing that of Europe, and again we see our market share decreasing. I think that is because we are not staying up in a competitive way with the processes of production.

The Japanese modernize their production facilities about every 10 years now; we do it about every 30 years. You don't have to be a genius to know their people are going to have more effective tools than ours.

It is not going to turn around overnight. And regardless of what we try to do by tax measures and otherwise put incentives out there for modernization, it is going to take time. We all agree with that. But I think it is one of the essential tools we have to defeat inflation.

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[4] Moreover, the relatively rapid expansion in reserve measures was not associated with strength in bank credit, which in the fourth quarter grew at only about a 3 percent annual rate, well below its earlier pace. The slow expansion in bank credit during the fourth quarter reflected, on the liability side, a sharp reduction in the outstanding amount of borrowing by banks through Euro-dollars, federal funds, and repurchase agreements.

Now, back to a more definitive question. It is my understanding that you supported the policy of accommodating the OPEC increases in price by a one-shot increase in the growth of the money aggregates; is that correct?

Mr. VOLCKER. No; I think that would be a misinterpretation.

Senator BENTSEN. Is that an oversimplification?

Mr. VOLCKER. I think it is not only an oversimplification, but I really would not recognize the position as you stated it. I don't think we can take the view that any so-called shock that comes along to affect the price level should be met with a response on the part of the monetary authorities of jacking up the money supply.

Senator BENTSEN. That was of concern to me, and I was trying to find out your rationale.

Mr. VOLCKER. I had commented at one point in an earlier hearing some months ago that if we have a very large increase in oil prices—I was thinking then in terms of an increase perhaps even larger than what we have had, which is very large—that is one of the factors that has to be taken into account, along with a variety of other factors, in setting these targets. I can't say to you—take the extreme opposite position—that it would never have any influence on the target that we set. But I did not mean that to be interpreted as supporting any mechanical formula, as I say, to simply raise the money supply in proportion to any external shock.

Senator BENTSEN. Thank you for that clarification of the statement. Congresswoman Heckler.

Representative HECKLER. Thank you, Mr. Chairman.

Mr. Volcker, I'd like to say to you I welcome you and am delighted to see you in this position today.

Mr. VOLCKER. Thank you.

Representative HECKLER. At the Banking Committee, we have used your advice on many occasions, and now we have a chance to question you from a different perspective.

I'd like to question you on questions I receive from Main Street. These are some of the questions being raised by the people, and sometimes they are harder to answer than some of the more esoteric questions.

Mr. VOLCKER. I sit here fearful.

Representative HECKLER. Not at all. The fact of the matter is this committee has been discussing recession and so forth, the contours of recession, the duration, the depth, et cetera. We heard this morning that we have experienced a significant increase in unemployment and a dip in employment, and the fact is that is an onerous signal of difficulty. I am wondering: Would you say that we are in a recession now? What type of recession is it? How long is it likely to last?

I know there are many factors that come into an analysis of that, but the recession that we have anticipated—is it upon us? Is it going to be mild, as some economists have said? From your vantage point, how would you view this?

Mr. VOLCKER. Let me repeat the point I made right at the start; the essence of the situation in which we find ourselves is that we shouldn't be too certain about the answers to questions of the sort you ask. We are likely to make policy mistakes if we approach them with great certainty. The essence of policy today is coping with uncertainty.

Are we in a recession now? I don't know. If we are, it started in a matter of weeks. You can't make a pronouncement in that circumstance. The only thing I can fairly say is that there are factors in the economy that make us vulnerable, particularly the relationship between consumption and income. Savings are low. We have been expecting consumption to be weaker than it was, weaker than it has been for some time; it hasn't been, partly because of inflationary expectations. But I'd be kidding you if I sat here and said I think the savings rate is going to increase this quarter or next quarter and consumption is going to be down; for all I know I might have said that two or three quarters ago and it didn't happen and may not happen for some more quarters.

Given those vulnerabilities which I think we should recognize, I suppose my general judgment would be that as a consequence of the international disturbances—and, if necessary, a review of the defense spending outlook—the prospects or the risks of substantial acculating downturn are reduced. The difference in the situation today as compared to evaluations some time ago is that I think you now have to weigh more strongly the fact that if we have a recession it will be milder, or the chances of avoiding it altogether might still exist. That does not mean I think, that all the vulnerabilities in the economy have disappeared; they clearly have not.

Representative HECKLER. Then you are saying that if we are having a recession, it's going to be a mild one; is that correct?

Mr. VOLCKER. I think that is a reasonable working hypothesis, a hypothesis upon which I would work now. But I don't exclude either the possibility of no recession or of a more serious affair; it can only be evaluated as time passes.

Representative HECKLER. Of course, one of the questions we'd have in terms of monetary policy would be a credit crunch and the impact on small business in that likelihood. As we know, traditionally, whenever credit tightens, small businesses suffer and have a harder time meeting their needs, and therefore find it more difficult to survive.

Have you heard any reports from any of your regional offices of pressures on small businesses, or any small business dimension to the present credit policies?

Mr. VOLCKER. That is an area in which we try to keep ourselves up to date, but we are forced to rely on pretty informal indications that we get through the district banks and otherwise.

My judgment would be that many small businesses are feeling more pressures now than earlier. You can say that about a lot of sectors of the economy.

I do not have the sense now of disproportionate pressures, so to speak. The pressures are certainly there. There are some indications—mostly, but not entirely informal—that rates on small business loans have not gone up nearly as fast as the prime rate did last fall, let's say.

One thing I have been struck by, Mrs. Heckler, is the paucity of very precise information that we have on that. We are putting some effort into collecting more information, even at the expense of temporarily creating a little heavier reporting burden, but that takes time, by the nature of the problem. We are talking about small businesses and small banks. You can't get the information generated easily in a hurry, but I hope to have more information some months from now. We always talk about this problem, but I find there is almost really no hard analytic evidence on it.

Representative HECKLER. I think it would be useful if you could set up a mechanism to collect that kind of evidence because the problem comes to Congress ultimately, as you know, and it always comes after the agony has set in, and it is excruciating. And I think if we could have a mechanism to anticipate such situations, some redress could be taken.

Mr. VOLCKER. Let me say this, which applies not only to small businesses but also, I think, to the homebuilding industry in general which feels the pressures of the immediate situation. My point is, there is no escape from the problem, as I see it, by accepting inflation. It is the inflationary process that has given rise to this situation in the first place. A kind of easy, surface reaction of saying let's deal with this problem by easing money generally in an effort to relieve the pressures has the implication that we don't deal with inflation. It seems to me absolutely inevitable that if we don't deal with inflation, these problems will intensify over time; they won't ease. These industries, in particular, have an enormous stake in dealing with the inflationary problem. I have been interested, and I suppose encourage, by the number of small businessmen and those involved in the housing industry that have made precisely that point to me.

Representative HECKLER. Thank you.

Representative REUSS [presiding]. Thank you, Chairman Volcker. As you pointed out, your post-October 6 monetary policy is working and is anti-inflationary. You are the monetary policy people and you do not fault your monetary policy. I don't fault it either.

Mr. VOLCKER. No; I think we got a bad break, to some extent, because these external developments arose.

Representative REUSS. As you say, inflation continues at a disastrous rate. So my question is this: The faults of our response to inflation—since it isn't, in the view of yourself and myself, the monetary policy—must lie in other policies—structural, import, tax, control, whatever.

What should the administration be doing right now that it is not doing in order that we may arrest this disastrous inflation?

Mr. VOLCKER. I think maybe your comment doesn't emphasize sufficiently that there is a pure timing problem here. You say monetary policy is perfect—I overstate your position perhaps a little bit—and, therefore, inflation must come from other factors. Well, a brief period of time has elapsed; we wouldn't have expected any obvious impact on inflation in this period of time. I am not going to argue that monetary policy takes no responsibility for the inflationary situation that we have found ourselves in that has built up over a decade or more; other policies are also responsible. It is not a case where, if you put a whole series of effective policies into place all at once, you are going to see that situation unravel very promptly.

In that context, I do think the most important single contribution can be made through responsible fiscal policies and working on that budgetary problem that has been so chronic and difficult.

The real dilemma we have, to which the Senator was referring, is on the need for tax measures to deal with the productivity problem, the cost problem, the incentive problem. Those measures could make a great contribution, but I simply don't think, on balance, they can make a contribution at the expense of a big revenue loss when the budget isn't in shape or if such measures would put the budget out of shape.

So the quicker we can get into a budgetary position that permits that kind of action, the happier I will be. It is a long-term problem, but I think that is the most important thing that can be done in terms of the inflationary outlook.

Representative REUSS. You don't see, then—I don't want to misread you—anything that can be done by the non-Federal Reserve authorities of this country to stop inflation which is not now being done?

Mr. VOLCKER. Virtually every day I can see instances of actions that could be taken. In the regulatory area, I think there are a whole series of things that either promote inflation or detract from the possibility of reducing inflation. I'd like to see that whole situation cleaned up in 3 days. I know it is not going to be; it is something that takes time. It is another urgent area where the faster the administration and the Congress and the public can get together, the better.

But that is something that takes time. But I don't want to suggest that it is not important, or we should not be working on it as a matter of urgency.

If you are suggesting there is some rabbit I can pull out of the hat, some policy that the administration and everybody else has overlooked that is going to dramatically change the inflation outlook right here and now, I haven't got that rabbit.

Representative REUSS. I wasn't suggesting a rabbit. I was simply asking: Is the administration doing everything right now that in your judgment ought to be done in order to make the day when we will get a handle on inflation come sooner?

Mr. VOLCKER. Of course, from where I sit, I would be delighted if many of the things that the administration and Congress have referred to quite rightly could be done with even more intensity than I see at present. The two areas requiring intensity, I think, are the fiscal and regulatory side, both of which have been emphasized in the President's own report, so it is simply a matter of, in a sense, the intensity with which that course is pursued.

Representative REUSS. My time is up.

Senator Proxmire.

Senator PROXMIRE. Mr. Volcker, before a subcommittee of the Senate Banking Committee, Barry Bosworth appeared and, as you know, he is an eminent economist now at Brookings, and he was our principal income policy executive in our Government until recently. I think he can speak a little more freely now, and he said this:

> There is no policy that can break the current momentum of the wage-price spiral without high costs. A mild recession is too weak and voluntary incomes programs have lost their credibility. Given a desire to slow the inflation, the choice is rapidly being reduced to one of severe recession versus wage-price controls.

What is your reaction to that? It looks pretty grim to me if we have that choice.

Mr. VOLCKER. Let me take up the latter alternative that he presented first, the wage-price controls.

I don't think that is an alternative in and of itself. It is counterproductive, in my judgment—apart from all its other difficulties—if it is not accompanied by the kind of monetary or budgetary policies that I have referred to.

If it is accompanied by those policies, you could argue somewhat differently. But the lesson of history has been that controls are considered substitutes. I don't want to put any words in your mouth or Mr. Bosworth's mouth, but if there is any sense in which these wage and price controls are somehow considered substitutes for other policies, I think that would be unfortunate.

Now, the Senator, in inviting me to come to these hearings, posed a question in general terms that was: How much do you have to rely upon slack in the economy to deal with inflation, and how much can you rely on a change in inflationary expectations?

It is not so easy to separate these factors, but I thought it was an interesting question because I think a great deal does depend upon expectations. If people are convinced that the outlook for inflation is improving, in the sense of lower wage and price increases, that will affect their behavior.

Senator PROXMIRE. All right. Now, what do we do about that?

Mr. VOLCKER. They are not going to become convinced, I think, unless they see, over a period of time, the fact that public policies in general—and I think monetary policies more importantly, but also in general—and I think monetary policies more importantly, but budgetary policies and some of these other policies, also very importantly—are directed toward that end.

Senator PROXMIRE. Isn't it true that fiscal policy is most generally by the general public than monetary policy, and wouldn't a surplus balanced budget or a surplus in the budget help convince people that we meant business and therefore lower their inflationary expectations?

Mr. VOLCKER. I would agree with that.

Senator PROXMIRE. Would you favor a balanced budget in 1981?

Mr. VOLCKER. If we could get a balanced budget in 1981, I would favor it. Now, I don't consider the President's budget in any sense irresponsible——

Senator PROXMIRE. Neither do I.

Mr. VOLCKER [continuing]. In that he is moving as fast as he thinks is possible.

Senator PROXMIRE. It is so close to a balanced budget now—$16 billion or $15.9 billion of out a $160 billion budget—it seems to me it wouldn't take a great deal to bring into balance one way or the other. And the psychological benefits of having a balanced budget, it seems to me, would be very substantial.

Mr. VOLCKER. There certainly would be psychological benefits. But let me say that while I think generally it is a responsible budget, it seems to me to have essential vulnerabilities on the side of a larger deficit instead of a smaller one, as I look ahead. That vulnerability is on the side of defense spending, which obviously is a priority, too.

So there is a question, I suppose, of what is practical. I wouldn't want to see the prospect of a balanced budget held out if it turned out shortly to be very unrealistic; I don't think that would be good for our credibility.

Senator PROXMIRE. On October 6 you started a historic new monetary policy. Since that time the discount rate has not changed. Member banks have borrowed when the rate became tight. This undercuts your ability to control reserves and also provides a pretty large subsidy to banks who are borrowing. They borrow from you at 12 percent and relend it at 15 percent or more. Why hasn't the Fed kept its word about flexibility in discount?

Mr. VOLCKER. This gets into a quite complicated, technical situation that I think you will find discussed—not the particular discount-rate point at any length, but the framework for these decisions—in the attachment to my prepared statement.

We approached these decisions during this period in a manner that of course reflects constant assessment of what is going on. After the first few weeks of the new policies, it seemed to us pretty clear that the monetary aggregates were on track, and we were exerting a degree of restraint on the banking system and on the markets that was consistent with our objective.

Under those circumstances, we could not feel that an increase in the discount rate was necessarily appropriate, but rather under those particular circumstances it may have led to more pressure on the market than was consistent with our objectives. There are some interesting technical analyses which support that conclusion; we could get into them in more detail if you want to.

Senator PROXMIRE. Well, my time is up, but would you give an answer in writing to Representative Reuss and myself so that we have a report on that?

Mr. VOLCKER. Yes. This statement, as I say, goes a good distance in that direction, but I can simply supplement it with a very short statement on the relevance of the discount rate in that area.

Senator PROXMIRE. Thank you.

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

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM,
Washington, D.C., February 11, 1980.

Hon. WILLIAM PROXMIRE,
U.S. Senate,
Washington, D.C.

DEAR SENATOR PROXMIRE: At the recent hearings held by the Joint Economic Committee you asked why the discount rate has not been more flexible since the October 6 policy shift—in particular, why it was not raised when member bank borrowing surged and money market conditions tightened further in the latter part of October.

The sharp rise in member bank borrowing in the last half of October occurred because the demand for reserves to meet expanded required reserves of banks—reflecting strong deposit and money growth—exceeded the amounts of reserves being supplied through open market operations. The need to raise the discount rate under such circumstances depends in large part on whether or not adjustments by banks and the public that will bring growth in total reserves and money back toward FOMC targets are seen to be in process.

Growth in deposits had been particularly strong in the first half of October. Because of lagged reserve accounting—with required reserves based on deposits two weeks earlier—the accompanying expansion in demand for reserves was not reflected in markets until the last half of the month. At that time, banks had no choice but to find funds needed to meet the large rise in required reserves that were given by earlier deposit levels. Since these reserves were not being supplied through open market operations, the banking system had to find the reserves either through an increase in borrowing at the discount window or by reducing excess reserves. In practice, banks keep excess reserves near minimal levels, so that the needed reserves under the circumstances generally have to be obtained by an increase in member bank borrowing.

In the second half of October member bank borrowing rose to around \$3 billion from about \$1½ billion at mid-month. At the same time, the federal funds rate and other short-term rates rose further, with the funds rate reaching a high of around 15¾ percent (on a weekly average basis). This rise in borrowing would have occurred, given lagged reserve accounting, whether or not the discount rate had been raised from its 12 percent level. Banks simply had no choice except to borrow to obtain the required reserves generated by earlier deposit expansion, given the limited reserve supply through open market operations. If the discount rate had been increased under the circumstances, there would have been virtually no change in borrowing at that time, but short-term market interest rates would have risen even further.

Therefore, the decision about whether a rise in the discount rate was needed for the most part hinged on whether added upward pressure on short-term rates, beyond those that were already in train, were desirable. An important factor in that decision was evaluation of the response of banks to the pressure on their reserve positions and of ongoing behavior of the money supply.

Since short-term market rates were rising further, it seemed clear that the banking system was making other adjustments that would probably constrain money growth, though necessarily adding to their borrowing to meet current required reserves. These adjustments took forms, such as tightening lending terms and selling securities, that were generating upward interest rate pressures and that would tend to reduce deposit growth. In fact, in the latter part of October, money growth weakened considerably and the monetary aggregates moved back onto the target track set by the FOMC at the October 6 meeting. Thus, no further rise in the discount rate seemed necessary, and member bank borrowing, as well as short-term market interest rates, subsequently declined as demand for money and bank reserves eased.

I realize that strong arguments have been made for more flexible use of the discount rate as a monetary policy instrument, or, on the other hand, for tying the rate to market rates. Our recent experience suggests to me the complexity of the issues involved. The various issues are being evaluated in a comprehensive staff study that is under way of the relationship between our new open market operating procedures and the management of the discount window and discount rate.

I trust these comments help to clarify policy considerations affecting recent discount policy. As you suggested, a copy of this letter is also being sent to Congressman Reuss.

Sincerely,

PAUL A. VOLCKER, *Chairman.*

Representative REUSS. Senator Javits.

Senator JAVITS. Mr. Volcker, first may I greet you—it is the first time you have testified before us as Chairman—as an old friend and I congratulate you.

Mr. VOLCKER. Thank you.

Senator JAVITS. And second, I apologize for being absent when you gave your testimony. I went out, on behalf of Lake Placid, N.Y., to greet the Olympic flame that had just arrived.

Mr. VOLCKER. I have been worried about whether there's enough snow at Lake Placid.

Senator JAVITS. I think there is now, and we have great confidence in Lake Placid's temperature, and also the fact that they can supplement the snow.

But it is so important that it always be successful, as we won't be—I hope that we will be in Moscow and that the Russians will pull out of Afghanistan, but it doesn't look very likely.

May I ask, Mr. Volcker, knowing you well, whether you'd feel free to answer a few questions on the international monetary situation. This worries me very much, and I'd like to lay my concerns before you.

For many years now, since 1973–74, the nonoil LDC's have been essentially carried by banks, including U.S. banks, and we always felt that it was well within their capital, so if they were engaged in risk-taking, no depositors would be hurt.

Now, that has continued a long time. These nonoil LDC's are very heavily loaned up. We hear estimates as high as $230, $250 billion.

They have now got a new drain, $50 billion, an imbalance with the oil-producing countries, instead of the $30 billion, which they had before.

We are in the process of materially increasing IMF capital. As a matter of fact, the fact that the U.S. tranche has not yet been appropriated is a very worrisome thing.

Seeing where you are and in the great spirit of your predecessor Arthur Burns, whom I always felt that we had a right to call on as a world authority on money, could you tell us: One, whether we would want to reconsider what would seem to be the judgment in the President's Economic Report that things will go on as they were, that the banks will be around to lend the money, and we can take a rather calm view of the whole situation; and, second, whether this does not call for some massive negotiation with the OPEC countries in order to deal with the solvency of the whole world's monetary system in view of the other strains which have just been put on it in connection with the international emergency in Afghanistan, the freezing of Iranian assets, and the general condition of prices in the world.

Mr. Volcker. So far as the LDC problem, or the general problem of financing balance-of-payments deficits, is concerned, you are quite right that an increase in the oil price will increase the magnitude of the deficits this year and presumably even beyond this year. We make judgments and analyses of this as time passes, but we are in a rapidly changing kind of situation when the oil price is as much out of control as it seems to be. Anything I say goes with the caveat that these potential strains obviously become more difficult the more the oil price goes up, and there is going to be some point where those strains, in some sense—in some more discrete way—lead to breakdowns. But I don't think that necessarily follows, and I don't think it will follow from what has happened so far.

In very general terms—and I think consistent with the figure you cited for LDC deficits in the aggregate for 1980, at least—it does not seem unreasonable to think that adequate sources of financing will develop consistent with the institutional structure we now have and consistent, in general terms, with the bank lending practices that have developed. Specifically, I am not sure that American banks would be called upon to increase their foreign lending at a much greater rate than has been true the last few years.

Now that has been a substantial rate, but not an alarming rate, in my judgment, over this period of time, and the institutional limitations that you referred to are not likely to be sharp in the time period that I'm talking about.

One of the reasons I come to that conclusion is that in recent years developing countries, as a whole, have been increasing their reserves quite rapidly, and if they simply, for a time, did not increase their reserves so rapidly, that would in a sense make up for some of the higher oil prices.

I recognize that what looks reasonable for one year, or maybe a little beyond one year, in the aggregate leaves you with the question of what happens as the trend continues out to the future. It also leaves you with particular questions about particular countries. I think that comes back to the question of whether we get this energy situation under control, which has a lot to do with our own energy policies, and the very high priority that must be attached to that, not just in the interests of the world monetary system but in the interests of the United States directly; and in that sense the interests coincide.

I do not see, frankly, the possibility of some grand monetary conference resolving all these conflicting interests easily or in a negotiated framework nor some grand new institution being put in place promptly. I should say that one of the reasons why I think this is a manageable situation, with increasing pressure, is that the IMF itself now is in a quite liquid position, and a completion of that exercise you referred to will improve that situation further.

The IMF, essentially, has not been lending in recent years; in fact, I think they have more repayments. So they are in good position to deal with potential and actual sources of strain for some time. The resources are available in that public institution to deal with foreseeable problems, in my judgment.

We have the challenge—perhaps too little progress has been made in meeting it—of finding some procedures, some methods of cooperation between the IMF and the banks, so that together their leverage, in a sense, could be maximized in terms of usefulness in dealing with the problem. I think that is an area in which some fruitful work could be done.

Senator JAVITS. May I have one more question?

Representative REUSS. Certainly.

Senator JAVITS. I just want to ask you about the banks and the IMF. Don't you think it's time we consider some institutional link for a closer relationship between them, especially as you yourself agree that we are looking at the very short term, relatively speaking, in saying it is manageable? We just had another price increase yesterday.

And, second, don't you think that emphasizes the need for us to explain to America what is the link between IMF's ability to step in when nations are really in trouble and the need for a close relationship between the IMF and the commercial banks—what is the need for that in terms of U.S. money? Why are we so interested? Or is this just some hypothetical idea out in the wild, blue yonder that a few bankers and Senators who are interested fuss around with?

Mr. VOLCKER. We are interested in the health of the world economy and the health of our financial system as well as the international system. You said institutional link, I don't know whether you meant to convey a new institution.

Senator JAVITS. No.

Mr. VOLCKER. A relationship.

Senator JAVITS. Yes.

Mr. VOLCKER. There are relationships now, so I don't want to suggest we are starting from ground zero. But for a variety of reasons—including matters of sensitivity of borrowing countries—these relationships have not been developed to the extent they might be useful. I think that should be reviewed and pressed during this period.

Senator JAVITS. And also what about the increase in the IMF's capital? How important is that to our own situation, to U.S. money?

Mr. VOLCKER. It is important for the reasons I suggested. Increasing the quota of the IMF obviously does not have a direct and visible effect on the average American citizen, but I think he or she is affected by the repercussions of a breakdown in international monetary cooperation and a breakdown in orderly international flows of funds. And our quota of participation is obviously essential to the whole; you can't manage the IMF without the U.S. proportional contributions, so it is essential to the viability of the whole process.

Senator JAVITS. So would you therefore put a high priority on it in terms of U.S. legislation?

Mr. VOLCKER. No question about it.

Senator JAVITS. Thank you.

Representative REUSS. Thank you, Mr. Volcker. We very much appreciate your testimony.

We will stand in recess now until next Tuesday at 10 a.m.

[Whereupon, at 12:35 p.m., the committee recessed, to reconvene at 10 a.m., Tuesday, February 5, 1980.]

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

RESPONSE OF HON. PAUL A. VOLCKER TO ADDITIONAL WRITTEN QUESTIONS POSED BY REPRESENTATIVE BROWN

Mr. Chairman, On January 31, a number of Minority Members of this Committee had breakfast with Dr. Martin Feldstein of Harvard.

Dr. Feldstein said that interest rates were very misleading. They look high, but they are barely above the rate of inflation, which is now 11 to 13 percent, depending on which index you use. Borrowers can repay their loans in cheaper dollars, while savers see the value of their savings slipping away. Thus, the real cost of borrowing and the real reward to saving is about zero.

He went further. Interest paid is tax deductible. Interest earned is taxed. After taxes, for someone in the 25 percent tax bracket, a 12 percent mortgage costs only 9 percent, and the real cost of money after taxes is a negative 3 percent. The same is true for savers. If they earn 12 percent on a Treasury bill, they keep 9 percent after taxes, and lose 3 percent in real terms.

Dr. Feldstein said that we were punishing savers and subsidizing borrowers, and beating investment over the head with inadequate depreciation allowances. The inflation, in other words, is reducing the nation's savings, and steering most of our available savings into consumer borrowing and away from investment in plant and equipment, which cripples productivity and opens the door to imports. (Business borrowers also see a lower real interest rate, but this is offset by a lower rate of return on investment.)

We have sharply lowered the incentive to save since the late 1960's In 1967, Treasury bills were paying 4 to 5 percent. Inflation was just under 3 percent. There was a 1 to 2 percent real interest rate (before taxes) for both borrowers and lenders. There was even a ½ to 1¼ percent real interest rate after taxes to both borrowers and lenders, depending on their tax bracket. Saving was encouraged, at least a little. Today, the real interest rate is zero before taxes, and 2 to 6 percent below zero after taxes, depending on the tax bracket. Yet we thought interest rates were low in 1967, and we think they are high today. Is it any wonder that saving was 7.5 percent of personal income in 1967, and only 4.5 percent in 1979 (3.5 percent by year-end 1979)?

Chairman Volcker, I have three questions:

First, is monetary policy tight or isn't it, judging from real after-tax interest rates; and is it really fighting inflation?

Second, hadn't we better make room in the budget to reduce the tax burden on savers if we want to get more economic growth?

Third, hadn't we better make room in the budget to do something about the depreciation problem?

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM,
Washington, D.C., March 17, 1980.

Hon. CLARENCE J. BROWN,
House of Representatives,
Washington, D.C.

DEAR MR. BROWN: I am pleased to respond to the questions you raised in regard to Professor Feldstein's remarks at your recent hearings.

With respect to the first question, I must note that it is very difficult in practice to assess the level of "real" interest rates, since they involve the expectations of the the public about inflation and these cannot be measured. Actual inflation rates are only a crude proxy—one based on the overly simple assumption that people expect future price increases to match those in the current period. Moreover, in terms of assessing the impact of any given level of interest rates on aggregate demand and thus on inflationary pressures, it is necessary to ask whether, after taking all the risks into consideration, businessmen and consumers view the expected real returns on investments as exceeding the real costs of credit. In a sense, the only real test of whether monetary policy is "tight" enough or not is whether excessive borrowing and inadequate savings are contributing to the inflationary process. Certainly the performance of the economy and inflationary pressures at this time would be difficult to reconcile with overly tight policies.

More generally, monetary policy—as represented by the ranges we have specified for the monetary aggregates—should exert sustained restraint on inflationary forces in the months ahead. As the Federal Reserve pursues its monetary growth objectives, there will be a tendency for interest rates to move in an "automatically stabilizing" fashion—that is, as inflation or inflationary expectations rise and credit demands intensify, there will be a tendency for interest rates to rise and thereby exert some restraint on borrowing and spending.

Your second question deals with the effects of taxes on saving and borrowing. It is quite clear that higher levels of saving are necessary to free additional resources for capital formation. Higher after-tax rates of return should promote increased saving, and the kind of problem that Dr. Feldstein indicates seems to me serious indeed. I should note that voluminous research over the years has not indicated that as a practical matter personal saving is higher responsive to changes in interest rates, but those studies do not reflect a period of high inflation and interest rates when the difference between before- and after-tax yields is so large. While some tax relief for savers could be helpful in enhancing capital formation, I would caution the Congress to look very closely at the design of any proposed incentives. Many that have been mentioned, including the exemption for interest and dividends agreed to recently by the conference committee on the windfall profits tax, would likely produce very little additional saving in the aggregate while giving up sizable amounts of federal revenue.

I believe that a more cost-effective means of enhancing business capital formation is likely to be found by improving incentives for investment. There are any number of devices that might be used. More generous depreciation allowances may be one of the more desirable options—and they do represent one indirect way of compensating for the impact of inflation on corporate tax burdens—but others should be considered as well. Unfortunately, however, this does not appear to be an appropriate time for tax actions that will cut into federal revenues and enlarge the government's budget deficit. A deeper deficit would add to inflationary forces and to pressures on credit markets. Neither of these developments would be favorable to capital formation. I would hope that sometime soon, having turned the corner on our present difficulties and having achieved adequate restraint on the spending side of the federal budget, there will be an opportunity to modify the structure of taxation in such a way as to promote greater investment.

Finally, I must say that the present problem for savers has become so acute because of the strength of inflationary pressures. Getting control of that situation is the first priority today.

Sincerely,

PAUL A. VOLCKER,
Chairman.

THE 1980 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 5, 1980

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

The committee met, pursuant to recess, at 10:10 a.m., in room 2212, Rayburn House Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen and Javits; and Representatives Reuss, Brown, and Rousselot.

Also present: John M. Albertine, executive director; Charles H. Bradford, minority counsel; William R. Buechner and Mayanne Karmin, professional staff members; Mark R. Policinski and Stephen J. Entin, minority professional staff members; and Betty Maddox, administrative assistant.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

This is the Joint Economic Committee's third day of hearings on the short- and the medium-term prospects for the American economy.

The Economic Report of the President and the fiscal 1981 budget message make up the administration's economic game plan for 1980 and 1981.

Mr. Schultze, looking at that plan it doesn't look like the plan of a team that wants to play offense. The numbers are not good. You know it. Inflation is as high as we have seen since 1946. Unemployment is on the way up. Productivity is down.

From what I have seen in the administration's recommendations thus far, I think they are just going to guarantee more of the same.

The administration is pinning its hopes on trying to curb inflation by demand restraint. Yet, there seems to be widespread agreement that the only way you get serious demand restraint is with a very serious recession.

We saw, following the 1974–75 recession, that that kind of relief is really temporary. When it comes to long-range policy, aggressive policy, bold policy that I think has to be made in order to turn this thing around and really get some long-term effects where we finally break it out and really curb inflation, I don't see anything in the President's Economic Report for real productivity gains. That disturbs me very much.

I think the administration compromised for the short-term gains that they think are necessary in this year and next year. I think we have to pay a price in this country in the way of moderate tax cuts. I think that targeted tax cuts very definitely are in order to encourage the kind of investment that's necessary to turn this economy around.

I really believe that one of the best ways to curb inflation is to put more products on the shelf cheaper and more efficiently and more competitively.

I have just returned from chairing a Joint Economic Committee series of hearings in the Far East. In that area, trade is just exploding. It's increasing at a compounded rate of some 20 percent. I watched some of those countries over there with their productivity gains as compared to us, and they are just really beating our ears off.

I think that the American people, with the kind of numbers we are looking at today, want something bold, something that will provide them some hope, that we are not going to see a decline in the standard of living of the American people.

We can turn this problem of productivity around, and we can encourage the kind of business investment that is necessary to modernize the productive capacity of this country.

While I was there, I was told the Japanese are modernizing, turning over their industrial base once every 10 years. Back in the United States, we are turning ours over once every 30 years. It doesn't take any economic genius to understand that before long the Japanese workers, and some of those other countries, are going to have more effective, more efficient tools in their hands than ours.

I know the argument that people aren't going to invest unless they see stable economy out there and a growing economy; but I don't think this kind of policy is going to get you that, either. I think the administration's policy is one that is not going to accomplish these goals. Today, the American people could be asked and would accept something much more substantial and much more aggressive.

Frankly, Mr. Schultze, I think it would be good politics, too. I think the mood is there and the time is right to bring about that kind of change.

I would like to defer to my colleague, Congressman Brown, for any comment he might have.

Opening Statement of Representative Brown

Representative Brown. Thank you, Mr. Chairman. First, let me echo everything the chairman said and pick up on his terminating remark with my own thought about the political advantage of a policy of growth and expansion in this country. I, too, am disappointed there is no provision in the President's proposals for a tax cut of the nature that has been most publicized currently; that's the tax cut for business depreciations; but I am also disappointed there isn't a tax cut designed to specifically stimulate savings in the United States. I think any careful study of the proposals with reference to savings is backstopped by the fact that the Germans, the Japanese, and, as a matter of fact, most of the other growing economies in the world, are those that are enjoying high rates of savings.

We seem to be discouraging that by the very inflation and tax policies that we have in this country. That's the political advantage, I think that both this administration or another administration could take advantage of by encouraging tax cuts; but that's not the major purpose of a tax cut.

The major purpose is to get the country turned around so we are a growing economy. Therefore, it seems to me it makes it graceful for you to change the policy. In the last decade, the average American was not a great deal better off at the end than he was at the beginning of that decade. The situation literally is that his income has doubled; but he is no better off because of the inflation increases and the tax increases that he has experienced.

If you will look at the tax increases implicit in this budget, he's going to be a great deal worse off. The inflation bonus for Government comes out of somebody's hide, and it's the taxpayer's. You will find that he is going to be a great deal worse off in the years ahead if that trend continues.

The idea of little or no or only a marginal improvement in one's life and living standard in the last decade seems to me is not acceptable to most Americans. There is a political advantage in our trying to improve that situation. I see the flurry of activity. I am sure you are trying to find statistics that disprove my allegations. I will be glad to go toe-to-toe with you on that issue as we get into questions.

Thank you, Mr. Chairman.

Senator BENTSEN. Mr. Schultze, please proceed.

STATEMENT OF HON. CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SCHULTZE. Thank you for the introduction, Mr. Chairman.

Let me just note to start—in a departure from the normal procedure—the three major fiscal officers of the Federal Government, the Secretary of the Treasury, the Chairman of the Council of Economic Advisers, and the Director of OMB, have put together a joint prepared statement, together with 26 exhibits, for our appearances this year in discussing the President's budget and economic report; and I would like to submit that statement, if I could, for the record.[1]

Senator BENTSEN. We are delighted to have it.

Mr. SCHULTZE. I had planned to go through some brilliant extemporaneous testimony based on the exhibits to the joint prepared statement. After that introduction, maybe I better start with still a third fallback and discuss directly what your introduction implies.

First, let me note that while I am far from an expert on football, I noticed in your opening remarks that our program does not sound like a team that's on the offense. I had not thought that offense was solely throwing a long bomb; winning a football game and possibly even winning the fight against inflation requires a combination of good defense and a good, solid offense that can last, that can deal with the problem that has been with us for 10 to 12 years; and it isn't hinged on just one single solution.

First, let me start by saying there is absolutely no substitute, there is no substitute in the situation we now confront for some demand restraint. We face a world in which largely, but by no means solely, on account of an explosion of oil prices we have had a year in which inflation has been running—depending on how you measure it—with the CPI, 13 percent; if you substitute another measure of housing costs, 10½ to 11 percent—and a world in which wages have been going up at 8½ percent

[1] See the joint prepared statement, together with exhibits 1 to 26, beginning on p. 141.

It is absolutely essential in order to prevent an acceleration of our underlying rate of inflation in 1980 to have an economic policy which provides such demand restraint so that those 1979 price increases do not slop over, spill over into the rest of the economy and become a double digit price-wage spiral in 1980 and/or 1981. As I say, there is no escape from the painful need for demand restraint.

At the same time, Mr. Chairman, the administration does have a fairly substantial set of policies either in being or on the way toward being, which deal with our longer run problems on the supply side of this economy. Let me note some of them.

There's obviously nothing more important than energy. In terms of our Nation's productivity in the years ahead, in the most fundamental sense of the term, there is probably nothing more important than a program which adjusts us smoothly, efficiently, and as rapidly as possible to a world of scarcer energy resources and higher energy prices.

Similarly, such a program holds out the promise not of eliminating but of reducing our dependence on imported oil, and thereby reducing our vulnerability to outside inflationary shocks. Dealing with the longrun problem of inflation, Mr. Chairman, it is a question of possibly long-term demand restraint, of measures to improve our productivity and efficiency, and of measures to reduce our vulnerability to outside shocks.

Energy and an energy program dealing with both the conservation and supply side goes after both of those last two objectives: improving efficiency and reducing our vulnerability.

As an intermediate step in this energy process, let me also note that in chapter 3 of the Economic Report, we make a very rough estimate that the energy programs and changes in energy prices already underway would probably add—in additional investment in the energy area—something like 1 percent, probably a little bit more, of our GNP on top of our other requirements and other demands for investment goods.

I can't stress too much the interrelationship of that energy program with a long-term program dealing with our Nation's stability and economic growth, as I said, both on the productivity and on the vulnerability side.

As a second major set of efforts in this direction on which the administration and the Congress are working very closely together, I call your attention to a relatively large deregulation agenda. We have seen it in airlines. We saw it work. It is now underway in terms of administration proposals and congressional work in the area of trucking, rail, communications, and banking. In turn, the productivity and efficiency consequences of that can be quite substantial, again as we saw in the case of airlines; and as one who has looked at it can surely tell in the case of trucking, in the case of communications, and in the case of banking.

A third major area in terms of long run policies to improve our efficiency is improving the efficiency of our labor markets. To the extent that we, in effect, have imperfect labor markets which waste the potential skills or which in effect underutilize the skills, or which underprovide the skills for specific groups in our economy—and particularly the minority, particularly the poor and disadvantaged—to the extent that that happens, we literally are losing productivity as a nation. We are misusing one of our major resources.

Here again a longer term policy of targeted measures dealing with employment and training and skills and education for the disadvantaged is a major element in long-term economic progress. This year, despite a tight budget, the administration is launching an additional major initiative in the area of youth employment which combines both education and job opportunities as an initial step in this area. I might note that over the past 4 years, from fiscal 1977 to the fiscal 1981 budgets, budgets which in general have been relatively restrained, there is more than a twofold expansion in inflation-adjusted terms in these kind of programs for youth.

Let me talk about investment. I share your view, to a point at least, that a necessary condition—a necessary condition, not a sufficient condition, but a necessary condition—for improving the growth of productivity in the United States is an increase in investment. We devote a significant portion of our economic report to looking at investment requirements in the future.

Let me also note, however, that a program of tax reduction aimed at investment taken at the right time can be (a) supportive of the economy; and (b) anti-inflationary in the sense of beginning to move us toward increased productivity.

However, taken at the wrong time—taken at a time where it conflicts with the needs of demand restraint—it can, in fact, add to inflation.

Over time, as we continue to control expenditures, tax reduction will be possible, will be necessary, will be desirable. The President has indicated, we have indicated in our economic report that as that time comes, major emphasis has to be given to tax reduction devoted toward improving investments. It will work no miracles. The impact on productivity of relatively large increments of investment is positive, but it's not miraculously large. Nevertheless, it has to be done.

We agree with you it has to be done. We believe that the necessity of the immediate fight against inflation means it cannot be done right now.

Research and development is another element. There is no magic connection between research and development and productivity, but clearly it is an important relationship. Starting in 1976, a 10-year decline in inflation-adjusted support for R. & D. in the Federal budget began to be turned around. This administration picked that up and turned it around even further, with particular emphasis on basic research and development. And that support continues, and in real terms, has expanded in this relatively tight budget.

These are the major elements and perhaps—not the only elements, but the major elements—of a concerted program, a longrun program aimed at improving the efficiency of our economy and reducing our vulnerability to outside shocks.

In that latter respect, I did leave out one item which has kind of an unsung story. That is the farmer-owned grain reserves.

You may recall back in 1972–73 the massive impact on food prices, on inflation of a worldwide crop shortage. Starting several years ago, as part of our farm program, we began to build up this farmer-owned grain reserve. This year when the Soviet crop shortage hit, and imports into the Soviet Union increased rapidly, there only was a small and temporary run up in prices that quickly reversed itself. Conversely, when the suspension of the Soviet grain delivery was announced by the President, that same mechanism—putting grain into the reserve—is picking up that slack.

It is, as I say, an unsung addition to policy which I think holds some important promise for stability of prices and for anti-inflationary efforts in the future.

Mr. Chairman, while we do need demand restraint, it is absolutely critical in the period ahead that faces us, that we realize that it must be supported by a series of longer run measures aimed at improving our productivity, our efficiency, and to the extent we can, reducing our vunerability to outside inflation.

Thank you.

Senator BENTSEN. Mr. Schultze, in your joint prepared statement that I looked at, you reported some $80 billion worth of restraint that you are talking about, with the budget and oil prices. That is a very substantial amount of restraint. I think it could certainly take care of a $25 billion tax cut, properly targeted, without a contribution to inflation. I say, if it's properly targeted.

I 'certainly am not one who says that you do all that you have to do about productivity just by encouraging business investment. Obviously, that's just one of the things that you have to do.

One of the other things you have to do, obviously, is a better job of job training and targeted job training, particularly for blacks, Hispanics, for other minorities. They just aren't finding jobs, and they aren't finding a productive role in our society. That's one of the tragedies of what's happening to our economy.

I fully support the idea that we have followed now for the last 30 years a philosophy that's developed us into a bunch of demand junkies in this country. We have to try to turn that around.

One of the ways to br'ng about some of the restraint that you are talking about is through savings. I have a savings amendment over here that I got passed through the Senate. It squeaked through by a vote of 94 to 4. It does have some support. I looked at 30 different ways to encourage people to save. Take away regulation W; but that has to be done over the next 10 years, so the savings institutions can accommodate to it.

Others say, let's make it incremental savings because otherwise you are just rewarding people who are already saving. It's about time somebody rewarded people who are already saving. They are beginning to pull their savings out. Some of the institutions in the East are particularly having a difficult time today holding on to savings.

I have not been able to get support out of the administration for this savings measure. If you don't have one that's simple and easy to understand, people aren't going to utilize it. If they have to go down to their accounting firm to decide whether or not they qualify for it, they are not going to use it.

Insofar as deregulation is concerned, I have been a long supporter of deregulation. From the time I came to the Senate, I have supported it. The Pearson-Bentsen deregulation bill on gas was passed. In Texas, we call it Bentsen-Pearson. We don't have brownouts on gas. That thing is working. There were a lot of problems getting support on that one.

In 1975, I came out for putting a 35-cent tax on gasoline. We would utilize those funds for alternative sources of energy, all of that. We would be a long way down the road today if we had done that. It would have been a great thing to have done. I got bales of mail over that condemning me for it.

I remember when I went before the Democratic Policy Committee and recommended it. I remember Senator John Pastore saying: "Not me, Lloyd, not me." I said: "Why?" He said: "When I was Governor of Rhode Island, I passed a 1-cent tax and they named the darned thing after me." [Laughter.] Those are some of the problems. I think the mood is right to do some of these very major things.

When it comes to basic research, I am deeply disturbed—as I understand you are—by what is happening in this country. Part of that, a big part of it, I believe is management's fault. What we are seeing today is a change in management, different from what we have seen in the past. You are seeing professional managers who job-hop and who really are interested in this year's stock bonus or this year's cash bonus and this year's bottom line, and maybe next year's bottom line. They are not sure of the year after that because they might be working for somebody else.

They won't do the long-term R. & D. that is necessary in this country. Yet we are seeing our competitors in other places—the Japanese, in particular—doing a magnificent job on some of these things.

I really think that we must have some major substantive changes, and we are not going to be able to tiptoe into this. I get the feeling that's what we are doing. When you talk about demand restraint, if that's all we really do, then I don't see much on the supply side. Then I think we are playing the thing like they did in 1974. That obviously wasn't successful.

I want you to comment on this. I value your opinion. I am deeply disturbed over the fact that I don't think we are doing substantive, major changes. I have not been so concerned about this economy at any time I can remember in the past.

Mr. SCHULTZE. Let me back up a bit in terms of concern and say, of course, I share your concern. When you look back at the decade of the 1970's and see what you have that causes one concern, I think the problems are superable. They are superable only with patience, determination, and stick-to-itiveness.

Let me talk about demand restraint for a moment in another context. You noted that in the economic report and also in one of the charts in our exhibits we note a combined fiscal and oil restraint of some $80 billion on the economy by, in effect, between the fourth quarter of 1978 and the fourth quarter of 1980—over that 2-year period. That's a large amount. You note in that context, why not $20- or $25-billion worth of tax cut? Given that restraint, why would that be harmful on the demand side?

The first proposition is, if you look at those numbers, you find through the first quarter of 1979, we had $60 billion worth of restraint and the economy, while it did slow, was amazingly resilient in the face of that.

You look ahead to 1980. You do have to deal with the problem of what I guess maybe you could best describe as an imbalance of risks.

Suppose you forecast, as we have done, a recession. You say, well, what the heck, in that kind of situation, why not go ahead and have your tax cuts, accomplish a lot of good purposes with it, investment, whatever else you want. You are forecasting recession, so surely that should be no problem. Suppose then, you are wrong?

Virtually every forecaster has been wrong about the second half of 1979. We didn't have a recession. Everybody forecast we would. If you are wrong under the circumstances we face, if you are wrong under those circumstances, you have built in some additional inflation that may take 2, 3, 4, or 5 years to get rid of. If you hold your fire and wait until the timing is right, and maybe you even wait a little too long, it's easy—it's easier to reverse that kind of mistake than to reverse a mistake on the inflationary side. Once inflation gets in it's hard to wring out, as we are now finding out.

There is a reason, Mr. Chariman, why, in the face of that restraint, we still urge no tax cut—and I think there is very substantial support for this, although I haven't done a poll. Our primary objective is to provide the amount of restraint needed to get at this inflation. Obviously we are not going to bury our head in the sand. If economic conditions do deteriorate, we are prepared to come in and make recommendations. We surely can't take that kind of chance right now.

Senator BENTSEN. Congressman Brown.

Representative BROWN. Thank you, Mr. Chairman.

Mr. Schultze, first let me say that you are one of my favorite people in the administration because I respect you as a professional. I think that you are a pretty well-informed fellow and probably are stuck with some of the things that you have to do. I still want to make you a convert to some of the things that have been recommended by this committee.

Mr. SCHULTZE. We both have been trying.

Representative BROWN. Let me first just note for the record that this is not now a new administration. This is an administration that's been in power for 3 years. It is an administration that—as all administrations do—obviously inherited what went before it. It is an administration that clearly is seeking to continue itself, that is in the form of the reelection of the president for another 4 years, and for all we know, it may be successful in that regard.

Just one statistic, that has to impress you as it impresses me, is that this administration now enjoys, for fiscal year 1981, almost a 50-percent increase in tax receipts, from what it had when it came into power, or rather the year after it came into power in 1978. Those figures are \$615.8 billion for fiscal year 1981, and \$414.7 billion for fiscal year 1978.

That's, in effect, \$200 billion over that 3-year period, which is a fairly impressive increase in the amount of resources that the Government has to work with; and within that, certain adjustments, it seems to me, could have been made in both spending policy and also taxing policy. I have to reject the notion that we can't have changes in the tax structure within that amount of variation of income.

In your joint prepared statement, you state:

> The proportion of our national output devoted to increasing and modernizing our capital stock is well below that of most other major industrial countries. It is also below the amount required to assure long-run improvement in productivity and to meet increased needs for energy and the requirement of environmental, health, and safety regulations.

I am glad you recognize that, but we also recognize it, and this committee in its landmark report last year called for expanding the capacity of the economy to produce goods and services efficiently. This is the most effective policy to combat the major economic ill of our time—stagflation.

We went on to point out that much of the demand-oriented approach which became so fashionable in the Great Depression of the 1930's is now outdated by the economic evaluation of the past four decades. Modern economists have discovered the supply side of the economic model. The recommendations of the Joint Economic Committee reflect this by calling for increased capital formation, labor productivity, and output for the fight against inflation and unemployment.

We will repeat that message in the upcoming Joint Economic Committee report. Let me ask, since you recognized the problem, and you have our recommendation, a joint recommendation of a rather politically diverse and philosophically diverse group of Members of Congress, what do you intend to do about it, if you are not going to do what we suggest you do, in terms of the tax reductions and the direction of those tax reductions?

Mr. SCHULTZE. Let me again, at the risk of boring you, note that supply-side economics is not just investment-oriented tax cuts. We are talking about energy; almost all of that is supply-side economics. We are talking about regulation; that's a structure of the economy. We are talking about labor markets. We are talking about R. & D., and about agriculture.

What we disagree about—and we don't disagree in the longer pull—is the need for tax cuts. When the time is proper we both support tax cuts oriented toward investment. We are arguing about whether or not the economy is now in a situation that proposing a tax cut would make sense in the context of our inflationary problem. It's a matter of priorities. Clearly additional investment helps on the longer pull on productivity and therefore, most probably, on inflation.

In the short run a tax cut, we believe, would hurt.

Representative BROWN. I am lost. It's always tomorrow, tomorrow, tomorrow.

Mr. SCHULTZE. No; it isn't.

Representative BROWN. It's like the balanced budget. It's out there someplace. We aren't reaching——

Mr. SCHULTZE. Here is an administration that's been in power for 3 years. We had one tax cut. The administration recommended it, the Congress passed—in different form but with roughly the same magnitude—a tax reduction, a larger than historical proportion of which went to business.

Representative BROWN. And focused more than the administration originally recommended in the investment area.

Mr. SCHULTZE. That is not the case. Differently, but not more. What we recommended was in the same ballpark—I don't remember to the 0.1 or 0.2—was what in Congress was in a different form. You had capital gains heavily weighted in there.

In any event, my point is we have already done it. Our report spells out, the President's state of the Union message to the Congress spells out, the budget spells out the fact that as time is proper for a tax reduction, we believe a large part of it ought to go there.

Representative BROWN. With all due respect to that tax reduction, it was eaten up by inflation and social security tax increases.

Mr. SCHULTZE. Not the investment-oriented part of it.

Representative BROWN. The magnitude of it was, through underdepreciation. Let's look at where we are this year. You mentioned energy. You say in the report that last year's oil price increases acted like a $53 billion tax on the American economy. Last year inflation-induced taxes were about $17 billion. I think we can argue about $2 billion of that—$15 billion, $17 billion, $14 billion—additional taxes going to social security from the 1977 amendments were $7 billion. Underdepreciation and inventory evaluation adjustment caused an overpayment of taxes by $25 billion last year by American industry.

You know I am, in real life, in business—not the same business some of my colleagues apparently are in—in the newspaper business, where we have to replace presses from time to time. I face that probably within the next couple of years. Those presses are going to cost me three to four times what I was allowed to take in depreciation. I have got to get that money somewhere. The problem is that we pay taxes on profits that were not real because we are underdepreciated. At any rate, that's $25 billion.

If you add that all up, that's a total tax increase over 1978 of $102 billion. Yet we can't find room for a tax cut somewhere? I think there's got to be a tax cut available in that $102 billion of tax increases just to balance it out.

Mr. SCHULTZE. Look at it another way if you want, Congressman Brown. In 1977, or 1978, take your pick—they are the same numbers roughly—budget receipts were 21.8 or 21.9 percent of GNP. In 1981, we estimate they will be higher; they will be 22.3 percent. That's 0.4 percent higher. We are asking that that be devoted, in effect, toward reducing the deficit rather than toward a tax cut.

It is higher; you are quite right. Inflation has pushed people into higher brackets, offsetting—in this period—more than all of the tax cut we had in 1979. Nevertheless, we are talking about a 0.4 percentage point of GNP. While I think it's important, and we want to get that down—and we will—it is a matter of timing.

Representative BROWN. Can I translate that for you into a simple term? That is that we are going to balance the budget by increasing taxes, in other words, increasing receipts to the Federal Government. That means we are going to take it out of the pockets of people, give it to the Government, and balance the budget. That's not going to improve the circumstances.

If I may say so, that falls into a trap that I think some of my Republican colleagues and even I in the past thought was a meritorious policy. As long as you balanced the budget, everything would be right with the world. It is not. That's simplistic. We can't just do that.

I hope somebody is keeping time. I don't want to overrun my time and be rude to my colleagues.

Your prediction is for unemployment at 7.5 percent in the fourth quarter of 1980. That would be a higher rate than President Carter had when he came into office. Not quite?

Mr. SCHULTZE. No. I think 7.9 percent in November or December of 1976; 7.7 for the quarter before he came in. It's close.

Representative BROWN. It's about the same rate. I am sure you haven't overstated unemployment. I do not think you would do that.

The upshot of it is that we are back to unemployment as a means of solving the problem of inflation.

In effect, what we are doing is taking care of the inflation situation by balancing it with unemployment. In the past, we have seen the cycles over the last few years every time we have unemployment, it hits a higher peak in order to take the inflation out of the economy, but it doesn't take out as much of the inflation as inflation hits a higher peak as it previously did; and our inflation trough, that is the best rate of inflation we can get, is always higher than the last one.

I must say that that is as a result of the exercise of demand control or demand management in the economy, and it is leading us straight to disaster. I'm not trying to make this a partisan issue, because I don't think it has been partisan over the last few years. I think the previous administration to President Carter's followed some of that demand management approach and it didn't work. Isn't that so? Higher unemployment? Higher inflation?

Mr. SCHULTZE. Compared to what?

Representative BROWN. At the best of times. We have been through what are supposed to be good times with reference to growth of the economy and jobs, and yet the best unemployment rate we got was still higher than the last unemployment trough.

Mr. SCHULTZE. Congressman Brown, let me point out the fact that we had an economy which, looked at in late 1978, needed to slow its growth but could have continued to grow without additional inflationary pressure of some moderate amount.

Representative BROWN. Growth I won't accept—slowing inflation, yes. I can't accept slowing growth.

Mr. SCHULTZE. You have to accept slowing growth. You couldn't have continued to run at 5 percent growth as we did in 1977–78.

Representative BROWN. It seems to me, Mr. Schultze—and I don't want to get off of this, because my time is up—but growth is a function of the expansion of the economy to provide jobs for people. If you look at that minority unemployment thing, it is just a disaster. At the best of times, it is horrible; at the worst of times, it is a social time bomb for us.

Mr. SCHULTZE. I won't argue with you. Let me withdraw my preface. I want to make another point.

That is that this economy was hit by a massive OPEC oil tax. That has two effects. It poses a dilemma for every government in the world. We are not the only government facing this problem. Every government is facing it. Some with better productivity growth to start with than ours. Some not so good. Every government is facing this dilemma.

That oil price impact drives up, necessarily, any kind of price impact. It drives up the cost of living; sometimes it gets overstated, but basically it drives it up. It sets in motion the problem of a new double-digit wage-price spiral as people try to catch up with it.

Similarly, because it's a tax and withdraws purchasing power, it depresses the economy. That's what's mainly depressing this economy, Query: Given those two facts of life, should we walk in with tax cuts or cheap money or both or some combination of the two and stimulate the economy to prevent that temporary reduction? Either stabilization or reduction in output? I say if you do you risk very strongly the danger of having, outside of energy, instead of 8 percent inflation, maybe

8½ percent, having 10, 11, or even 12. You will never get out of it, or at least it will take years. This is the dilemma. It's not Democratic, Republican. It's not even American. It's a problem every government in the world is faced with.

What we are arguing about is the proper timing for what we all agree is going to be needed: is more emphasis on investment through tax reduction. I am saying the oil thing puts us in the situation where it makes it very difficult to do right now.

Representative BROWN. I will come back. My time is up. I will address precisely that point.

Senator BENTSEN. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Welcome, Chairman Schultze.

I have a lot of problems with the administration's anti-inflation policy. I think most members of this committee believe that the Federal Reserve is doing its part, and has the monetary aggregates at last under control. But when you look at the other gamut of policies, those which the administration controls, I really don't see an anti-inflation policy in place adequate to deal with the 13 percent inflation that now plagues us.

The budget is not in balance. There's still a deficit at this late stage; and indeed, military expenditures hint that the deficit will be increased.

The wage-price incomes policy is weakened. The description of that ends up with the statement from your joint prepared statement that "As this report went to press, the Pay Committee has just recommended a basic pay standard that would establish a range of allowable pay increases." Those allowable pay increases are, of course, greater in many instances than what we had. So that's weaker.

No attempt, by gasoline rationing or by a sharp increase in the excise tax, to limit the discretionary nonessential element in American transportation, and thus cut down on the cost of our imports and strengthen the dollar and fight inflation by enabling us to cut down on the real cost of our imports.

Finally, I find that the section on the structure of the economy, quoting again, "Improving the structural performance of the economy," has just two very short paragraphs in it. Nothing, as far as I can see, is said about the problems of steel, of automobiles, of semiconductors, of railroads, of mass transit, and the half hundred other American industries which, in my judgment, really need a sectoral approach such as the Germans and Japanese have been giving their problems.

So I am disappointed with the anti-inflationary program; but if I am unnecessarily dour, I wish you would cheer me up.

Mr. SCHULTZE. I will try. Let me start with a brief note, that improving the structural performance of the economy, which as you note has two paragraphs, was meant to be a two-paragraph introduction to a 51-page exercise. You may disagree with the subjects we picked out that are important. We didn't think we were smart enough to pick out exactly which industries ought to be pushed but we did talk importantly about investment, labor markets, agriculture, and energy—the key big sectors of the economy.

Representative REUSS. If I may, let's stop there. Who is smart enough? There really ought to be somebody in the Government who is putting his mind on avoiding future Rock Island-Milwaukee roads, avoiding future Chryslers and Fords, avoiding the disappearance of our steel industry.

Mr. SCHULTZE. I thought we had something called the market. That doesn't mean the Government should never intervene. My own judgment is that we are probably better off intervening very occasionally and on an ad hoc basis with some very tough hurdles to cross just because if we tried to do it on some systematic basis, quite frankly, I don't think this is a major area in which the Federal Government can do anything but harm when it mucks around.

Again, like any statement of a generalization, it has exceptions. I realize that. You may have to exercise it by exceptions.

Representative REUSS. At least you, with your characteristic honesty, have stated the issue. There is surely an issue between me and you in that I think that the Germans and Japanese have made the market work by the specific sectoral approach that tries to remove market rigidities and tries to give industry, the private sector, a matrix in which it can make its plans.

Mr. SCHULTZE. Removing market rigidities, I must say I agree with you. We are engaged in that. I must say—maybe this shows my ignorance of the subject—while I do realize the Japanese have administrative guidance of various kinds, on the other hand, the German "success" has been pretty much in letting it go. Letting the market do it; with exceptions.

Let me note what you might be able to do in this area. Just as a very quickie exercise, I asked someone to take a look at the 20 fastest growing industries in the United States for 1967 to 1977 to ask myself "Gee, could I have picked those out 10 years ago?"

I had tufted carpets, wines and brandy, poultry raising, utility vehicles; yes, microprocessing was on there. I am exaggerating in the sense of maybe I am overdoing this; but I am not sure I think our solution is a kind of a policy whereby the Federal Government picks the industries that are going to be the winners and subsidizes them.

We need to do a lot of things in labor markets, in energy; we have to worry about our whole trade policy. All of that I realize. I am sure you and I agree on most of it. I do have a little difficulty in trying to focus on doing this by industry.

Representative REUSS. Let's take a minute to do that. Suppose in 1975, a Government labor-management team, with people like Messrs. Greenspan, Rostow, or Thurow on it—just to talk about present company—or yourself, had gone out to Detroit in 1975. You would have observed that not only were we not doing anything much about the then fivefold increase in OPEC prices, but we were seeing our gas-saving compact automobile industry spirited away—before we ever got it—to Germany, France, Italy, and, notably, Japan.

I would have though that such a team, without interfering with the market, would have put on its thinking cap and decided what financial, what regulatory, what labor market devices were needed to bring Detroit to its senses.

Had it done that, we wouldn't now have a Chrysler; we wouldn't even now have a Ford, which is losing about $1 billion a year on its domestic business; and we wouldn't be in the thrall of OPEC to anywhere near the extent we are.

I think we should come down off our psychological high horses and concede that maybe the Germans and the Japanese have been doing something right. Germany has 4-percent inflation. They don't produce any oil at home. They must be doing something sensible.

Mr. SCHULTZE. It's not subsidizing individual industries or having teams go in to decide for them.

Representative REUSS. Who said anything about subsidies? Let me disabuse you of any neo-RFC. Not at all. All I favor is somebody putting his best thought on it, which I would think would not involve a Chrysler bailout or a New York rescue——

Mr. SCHULTZE. I guess what you are suggesting——

Representative REUSS [continuing]. But preventive measures.

Mr. SCHULTZE. I guess what you are suggesting is that all these industries need help from Government people in terms of thinking what their future ought to be. It's hard for me to say advice isn't always helpful, but I doubt that that would change much. Advice is always good, useful.

Representative REUSS. Well, we didn't do it. Such a Presidential Tripartite Commission did not visit Detroit in 1975, nor did it visit Gary and Youngstown in 1978, nor the Midwest railroads in 1979. When I besought them to do that, somebody always got lost in the macroeconomics.

Mr. SCHULTZE. We have had the Government in the railroad business one way or the other for years. That has not produced very much.

Representative REUSS. Because it's been fundamentally faulty, because the ICC resists attempts of the railroads, including the—breathing its last—Milwaukee road, to nationalize themselves.

Mr. SCHULTZE. Maybe it's this way, Congressman Reuss: If you and I were the ones always on that tripartite team, with our wisdom at this, maybe it would work. As a general proposition. I don't believe that it's going to give you very much. From hindsight, one can always go back and pick up things you should have seen. There are always things we should have seen. That's true. I am not sure we would have seen them.

Representative REUSS [presiding]. I have a list of foresight things I think we should attend to now. I have taken my 5 minutes.

Congressman Rousselot.

Representative ROUSSELOT. Thank you, Congressman.

Mr. Schultze, we appreciate your being here to share some of your thoughts about the budget and so forth. I would like to know how you came, in the administration, to the views you have on tax reduction as only appropriate as a countercyclical tool in the face of a very serious downturn.

We heard many testimonies last week before the Ways and Means Committee to the effect that to increase incentives in the private sector, we need all kinds of tax reductions in various areas, especially to improve productivity and investment, and so forth.

Why do you feel we have to wait for a heavy downturn before we consider a tax reduction? I do realize that, despite your struggle with trying to put a cap on them, expenditures are very high. I am not sure your effort is a good one or that the majority of Congress will be any better, though I would like to see it better. However, assuming we can resist some of the expenditure increases that are listed in the budget, why can't we have some kind of tax reductions?

Mr. SCHULTZE. Several points, Congressman Rousselot. In the first place, I do not believe, and the administration does not believe, that the only time for tax reduction is a downturn. You may recall, we proposed and the Congress acted in a different form in having a tax reduction in 1978–79, not in the middle of a recession. That isn't the point.

The point is, as I engaged in an earlier colloquy with Congressman Brown, we and every other nation in the world are faced with a situation in which, on the one hand, a very large increase in OPEC prices in 1979 drove up consumer prices. It wasn't the only thing.

Representative ROUSSELOT. It clearly wasn't the only thing.

Mr. SCHULTZE. That price increase, under normal circumstances, could very well lead, not to 8½ percent wage increases, which is what we had in 1979, but—to the extent people try fully to keep up with it on wages, salaries, and profits, try to catch up with it—it could lead you to a double-digit inflation in areas outside of energy which would be hard as heck to get rid of.

We do need a period of demand restraint. We need a period in which we have to have a tight budget in order to make sure that that inflation of 1979 isn't translated in the longer term to double-digit inflation. It means tax cuts which might otherwise have been appropriate are not, at the moment.

The administration is forecasting a relatively mild recession. We are about in the middle of the pack in forecasts. However, that's a very uncertain forecast. Six months ago everybody was forecasting a recession, but it didn't occur. Output flattened mainly because of the downturn in the second quarter. Output in the second half of this year continued to rise, not by any huge leap, but fairly steadily.

Suppose we are wrong again? Suppose we are wrong again? It seems to me, given the fact that once you build inflation into the system it's hard to get it out, that you have to play it relatively cautiously. You have no option but to play the balance of risks on the cautious side. That's essentially what we are saying.

Representative ROUSSELOT. All the testimony we got in the Ways and Means Committee last week in favor of tax cuts aimed to supply side incentives was backed up not only historically, but by other substantial verification. Past tax cuts have led to improvements in the economy. Take the reduction in the capital gains tax, which actually generated an improvement in the economy, investments, savings, as well as an improvement in capital effort. Why don't we ever look at that side of the equation instead of always believing tax reductions will create a huge deficit? In actuality, case histories show that this has not occurred.

Mr. SCHULTZE. Again, I have to disagree to some extent. If you are saying that when you cut taxes, you get the revenues all back, you don't.

Representative ROUSSELOT. I didn't say you got them all back immediately. You get some back immediately. You also generate real economic growth that has meaning. It creates jobs.

Mr. SCHULTZE. To some extent, you do, that's quite right. The question is the timing.

Representative ROUSSELOT. I could take a lot of your writings to show that's what happened.

Mr. SCHULTZE. If you do that——

Representative ROUSSELOT. I did last year before this committee.

Mr. SCHULTZE. You have to distinguish between two impacts of a tax cut.

Representative ROUSSELOT. I understand that. It isn't all negative on the revenue side.

Mr. SCHULTZE. Of course it isn't.

Representative ROUSSELOT. I am sure we could find the areas to resist the increase in expenditure. That's a pretty huge increase in the expenditure level. Percentagewise, it is very great on the Federal level, which in many cases discourages investment.

Mr. SCHULTZE. Let me address myself for a moment to that. Adjusted for inflation, total spending—Federal spending during the 1960's—rose 4 percent a year. From 1970 to 1977, the first 7 years of the 1970's, it rose 3 percent a year. Despite the increase in Defense budgets in the last 4 years, 1977 to 1981, it's 1.3 percent.

It's a major flattening out of that curve.

Representative ROUSSELOT. The Government expenditure curve?

Mr. SCHULTZE. That's correct. Inflation is such that with indexed programs, with keeping the Defense Department up with and a little ahead of inflation, you do have very large numbers. What I am suggesting, however, is in terms of the real claim——

Representative ROUSSELOT. As you know, the Defense part of the budget is 24 percent. We never talk about the other part.

Mr. SCHULTZE. I am saying, with the indexing of programs, with the impact of inflation on them. I call your attention, at your convenience, to I think the table on page 613 of the budget, which provides these in inflation—adjusted terms. There really was a massive momentum going through the 1960's and the early 1970's. That has not been fully stopped, but substantially turned around.

Representative ROUSSELOT. Anyway, I hope you will look again at tax cuts.

Mr. SCHULTZE. We continue to look.

Representative ROUSSELOT. Tax cuts in areas where they really will stimulate incentive and encourage, rather than discourage, investment. Our steel industry alone will tell you that this lack of incentive is one of the reasons they have not invested in new equipment here. We can't keep up with our competitors overseas. The chairman and I had a chance to meet with American friends overseas who are trying to sell their products and services. We can't compete with Germany, Japan, and Korea. These countries have better tax policies relative to investment and we are hamstrung in our ability to compete with them, for this very reason.

Mr. SCHULTZE. Congressman Rousselot, we don't disagree.

Representative ROUSSELOT. Let's get at it and start recommending some good tax cuts.

Mr. SCHULTZE. We don't disagree in our evaluation of tax cuts directed toward investment incentives. We disagree on the timing. Right now, we have to concentrate on reducing that deficit.

In 1978 we proposed and you enacted substantial investment incentives.

Representative ROUSSELOT. OK.

Representative REUSS. Thank you very much, Mr. Schultze. We appreciate your helpfulness today, as always. We wish you luck.

Representative REUSS. Mr. Thurow, please proceed.

STATEMENT OF LESTER C. THUROW, PROFESSOR OF ECONOMICS AND MANAGEMENT, MASSACHUSETTS INSTITUTE OF TECHNOLOGY, CAMBRIDGE, MASS., AND VISITING PROFESSOR OF ECONOMICS, UNIVERSITY OF ARIZONA, TUCSON, ARIZ.

Mr. THUROW. Thank you, Congressman.

However you rate the performance of the economy during the first half of the 1970's, the performance during the first half of the 1980's is apt to be worse. Inflation, high unemployment, slow productivity growth, exploding energy prices, and erratic supplies, a falling dollar—in each case the probability of a worse performance is higher than that of a better performance.

Part of the cause is found in the subject matter of these hearings. At no point in the past decade has any administration, Republican or Democratic, had a long-run strategy for curing the Nation's economic ills. Each administration has been preoccupied with short-run fire fighting.

Our economic problems have been with us for the past decade and will be with us for the next decade because none of them has a short-run cure. Some of them cannot even begin to be solved unless others are first solved. The 1980's are going ro require a national bipartisan long-run startegy and the patience to stick with it.

Our most basic problem is slow productivity growth. Productivity determines the increase in our real standard of living and the ease with which the country can shoulder a larger defense burden. If productivity is growing at an acceptable rate the country can survive its other problems. Without productivity growth the country will inevitably slip into economic oblivion even if the other problems are solved. While our per capita GNP is not a perfect measure of economic performance, the United States has already slipped to fifth among industrial nations. And whatever America's current absolute position, its growth of productivity is far below that of most other industrial countries.

With manufacturing productivity growing at a rate one-half that of Germany and one-third that of Japan, the value of the dollar can only fall. Monetary policies, such as those adopted in October, can only provide a shortrun respite, but they cannot prevent the inevitable. The dollar will fall as long as ou productivity is growing much more slowly than that of our major trading partners and competitors.

Faster productivity growth will require fundamental changes in the way that we operate our economy. There are a number of current practices that we are going to have to stop. The Japanese have a conscious national economic policy of getting out of sunset industries and into sunrise industries. If you look at American economic policies over the past decade, this country has adopted exactly the opposite strategy.

Our recent history is one of using tariffs, quotas, informal marketing agreements, subsidies, and a host of other policies to protect our sunset industries. But in doing so we imprison ourselves in low productivity. Protection is a policy that has got to be reversed. But this means much better policies for directing workers and capital into the new sunrise industries. Without the promise of new industries and new jobs, no country is able to close down its old obsolete industries.

Higher productivity growth will also require a different anti-inflationary strategy. A case can be made for fighting inflation with recession, if inflation can be easily and quickly conquered; but it makes no sense if the anti-inflationary fight is going to be difficult and slow. No one is going to increase investment if they have large amounts of idle capital capacity and the prospects of little or no economic growth. To spend the next decade fighting inflation with recession is to guarantee a decade of bad productivity performance. Most studies indicate 25 to 30 percent of our current productivity decline stems from these policies.

The country needs economic policies that guarantee a period of sustained real economic growth. Only then will people be willing to make the longrun plans and investments necessary to cure the productivity problem. While more savings and investment will not cure the productivity problem by themselves, they are certainly necessary ingredients of any solution. If you believe that Germans, Japanese, and Americans are equally smart, then the economy that invests 20 percent of its GNP in plant and equipment, the Japanese, is going to do better than the economy that invests 15 percent, the German; and both are going to do better than the economy that invests 10 percent, ourselves.

But before policies can be designed to stimulate saving and investment, a decision has to be made about an issue that now stands implicitly in the background. Does America want to increase savings and investment with policies that will make the distribution of income more unequal, or does it want to achieve this result with policies that preserve the current distribution of income and wealth? Savings and investment can be increased either way. But to follow the first course seems guaranteed to generate so much controversy that the issue of more investment will get lost in the argument as to whether Government should have conscious policies to make the distribution of income more unequal.

If we want more savings and investment it is not necessary to have a more unequal distribution of income. On the investment side the correct solution is to abolish the corporate income tax and to completely integrate corporate and personal income taxation. The corporate income tax would be abolished, but each year the corporation would send every stockholder the equivalent of a W–2 form telling him how much had been earned on his behalf. The income would be added into the shareholder's other sources of personal income to determine how much personal tax he or she should pay. This improves the progressivity of the personal income tax, since each shareholder is now paying taxes at a rate commensurate with their own personal situation and not at some common corporate rate; but it is also a powerful incentive for more investment since the after-tax rate of return on corporate investment almost doubles.

But the major difficulty is not found in the precise incentives for more investment. If investment goes up as a fraction of the GNP by a major amount, then something else must come down. Given the in-increases that are likely to occur in the defense budget, it is not going to be possible to simply cut taxes and Government expenditures to stimulate investment. There is going to have to be a conscious national policy of reducing consumption.

Cutting consumption is the essence of increasing investment. How is this to be done? Unless you are prepared to answer that question you are not really an advocate of more investment.

The answer, if there is one, is to be found in a progressive value added tax. In a progressive value added tax the tax is imposed at some rate, let's say 10 percent, but there is also an offsetting income tax credit, let's say $1,000. Thus the family with $10,000 in expenditures pays an extra $1,000 in value added tax, but gets $1,000 back in the form of an income tax credit. The family spending $15,000 pays $1,500 in value added taxes, gets $1,000 back in income tax credits, and is a net taxpayer of $500. Such a tax can be used to reduce consumption in accordance with whatever your judgments are as to how the economic burdens of increasing investment should be shared across the population.

But let me return to the strategy for fighting inflation. While many factors have contributed to our current inflation problem, inflation is now being driven by the price of energy. Each energy shock has driven the inflation rate to higher levels in the 1970's and there is every reason to believe that each shock during the 1980's will drive it to yet higher levels. As long as these shocks continue to occur, no one is going to cure the inflation problem.

To control inflation we must control the price of energy. This means energy independence and developing alternative domestic sources of energy.

Since Germany and Switzerland are often held up as countries that have cured their inflation problems without curing the energy problem, let me examine the price that they have been willing to pay; or more accurately, let me examine the price that they have been willing to force others to pay.

There is no doubt that a major recession will reduce the rate of inflation even in the face of an energy shock. And there is also no doubt that Germany has been willing to engineer a major recession. In the third quarter of 1979, Germany industrial employment was 12 percent lower than what it was in 1973. If American employment had fallen 12 percent from 1973 to 1979, we would now have a 28 percent unemployment rate. Germany and Switzerland do not have high unemployment rates because they have been willing to send hundreds of thousands of guest workers back to their homes in Italy, Spain, Turkey, and Yugoslavia. Between 1972 and 1978 the Swiss deported 10 percent of their labor force. To do the same we would have to deport over 10 million workers.

Inflation can be controlled with recession, but only if you are willing to pay an enormous cost. Short recessions are not going to do the job. And every new oil shock requires a new recession.

Energy is the key to inflation. But the United States does not now have an energy policy. It has not agreed on what fuels will be used to provide alternative sources of energy and it does not have a realistic timetable for achieving energy independence. Moving to world energy prices is at best the removal of a bad policy. It eliminates the subsidy to consume energy and increases the incentive to produce domestic energy; but America is going to have to be willing to take the hard steps that most other industrial countries have already taken.

Most countries levy a large tax on gasoline to increase its selling price far beyond that of world petroleum prices. Many of these taxes are between $1 and $2 per gallon. To solve the energy problem we will have to do the same. To prevent the tax from making inflation worse it should be refunded to the States on a dollar for dollar basis, to the extent that they reduce sales or property taxes. This also has the advantage or making it clear to voters that a gasoline tax is not a net increase in taxation. It is simply a device to drastically discourage gasoline consumption until alternative sources of liquid energy can be found.

Energy also ties back into the productivity problem. The U.S. savings rate has fallen dramatically in the last half of the 1970's. Some of this is due to inflation and low interest rates on the savings accounts of small savers, but some of it is also due to the energy tax that has been levied by OPEC. At current oil prices OPEC will take almost 4 percent of the GNP during 1980. This is beginning to approach our defense spending. At 1972 prices current oil imports would be absorbing less than 0.3 percent of our GNP. When someones levies a tax on a necessity that ends up taking almost 4 percent of the GNP, it would be very surprising if the average American family did not pay part of this tax out of its savings. To some extent our savings are down because we are giving them to OPEC.

To solve the inflation, falling dollar, and unemployment problems we are first going to have to solve the energy and productivity problems. Inflation cannot be controlled without controlling energy prices. The dollar cannot be rescued without a better productivity performance. With a more rapidly growing GNP and more investment, the unemployment problem will gradually shrink. But both energy and productivity are going to confront us with a difficult problem. Both energy and productivity require that we devote a much larger fraction of the GNP to investment. And this is going to have to occur in an environment where a much larger fraction of the GNP will also have to be devoted to defense. This is only possible if we consume less.

In the long run, increasing the proportion of our GNP devoted to investment will increase our consumption standards, but in the short run it is necessary to cut consumption to raise investment. Reaching agreement on cutting consumption is going to be the key policy question of the 1980's. If we cannot agree on how to cut consumption, we are not going to be solving any of our problems.

Representative REUSS. Thank you very much, Mr. Thurow.

Senator JAVITS. Congressman, may I say before Mr. Greenspan starts, that I beg the witnesses to excuse me? I came to hear them especially, but I just had word I have to go back to the Senate floor for an amendment.

Thank you. I will read everything with great interest.

Representative REUSS. Mr. Greenspan, please.

STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC., NEW YORK, N.Y.

Mr. GREENSPAN. Thank you, sir.

I would like to address myself somewhat to the shortrun issues, but I will, by implication and explicit expression, confront some of what I think are the critical longer term policies of this Nation.

Despite the rising unemployment rate of 6.2 percent for January, there is still no compelling evidence that the economy has as yet moved off the remarkably stable plateau which began in March 1979. Since April, industrial production has ranged within less than 1 percent of the March peak. Moreover, January 1980 output does not appear to have shown a significant change from December, either plus or minus.

Payroll employment continued to move higher in January in the most recent data, and there is little change shown for the month of February. The uptick in the unemployment rate occurred as a consequence of declines in agricultural employment and number of domestic service workers. Both declines appear suspiciously like sample aberrations. The growth in employment in the context of stagnant production, of course, reflects the continuing poor productivity picture.

Although admittedly unimpressive during the past year, economic activity has been better than the economic forecasting profession as a whole had anticipated. A recession has been expected to begin almost momentarily, by at least some forecasters, since late 1978. The economy has, in fact, hung in there, owing to far stronger consumer spending than forecasters in general suspected could be the case.

Over the past quarter century the personal savings rate has rarely ventured outside a narrow 5-to-8-percent range. Hence, once the savings rate slipped below 5 percent late in 1978, an upturn became a reasonable expectation. Granted the general sluggishness of capital goods, inventory, and construction markets, a flattening in the savings rate would have been enough to tilt the economy downward; but this did not happen. Instead, the savings rate fell to 3.3 percent during the fourth quarter of 1979 and to a low 2.6 percent in December. There was little change evident for the month of January.

This is the arithmetic source of the failure of the economy to turn down. The question of course is, Why is the savings rate declining? That can be inferred by disaggregating the consumer balance sheet. The results are, in fact, quite revealing.

Prior to 1970, net increases in home mortgages on single-family homes rarely exceeded $15 billion annually. Most of the time it was significantly less. During the past 3 years, however, increases have approached $100 billion annually. Moreover, when we disaggregate the mortgage debt increases, it becomes clear that virtually all of the increase in net additions resulted from realized capital gains on existing homes rather than any quickening in new single-family home sales. The reason is fairly straightforward: with the rapid escalation of home prices, the average capital gain per house sale has been approximately $25,000. We estimate that prior to turning down late last year, realized capital gains on homes reached the $100 million annual rate level, reflecting an average gain of $25,000 per sale on an annual sales turnover of approximately 4 million homes.

It turns out, as best we can judge, that the new mortgage taken out by the home buyer tended to exceed the mortgage canceled by the home seller by approximately the realized capital gain on the home. The seller therefore received a large block of cash representing not only the increase in the mortgage debt on the home that he had just sold, but also his original downpayment plus any amortization of the mortgage which he had held during his ownership. After the downpayment on a new home, there was still substantial cash available on average for savings or purchases of goods and services, and the significant part of this cash apparently went into the purchase of goods and services.

This means that in recent years there have evolved two sources of purchasing power: The usual disposable personal income and, secondly, the cash raised through mortgage debt extensions as a consequence of the turnover and capital gain realizations on existing homes.

While consumption expenditures financed out of the latter are reflected in total consumer outlays, the purchasing power source is not. By convention, realized capital gains are excluded from personal income and, of course, the debt used to finance them is not considered income. Thus, the calculation of savings as disposable personal income minus consumer outlays is artificially low and could even turn out to be negative sometime in the future.

This, however, is not to say that the average household perceives itself as having a low savings rate. To the extent that there are realized capital gains available, savings behavior can be perceived as quite normal by the average household even though the Department of Commerce official statistics report an unusually low savings rate.

While realized capital gains have bolstered consumer outlays and the economy, they are unlikely to continue to do so in the months ahead. Indeed, in the case of higher mortgage interest rates, home sales are already declining. So is mortgage debt financing. Accordingly, I would expect consumer outlays and business activity generally to ease off in the months ahead. In this context, a policy of fiscal stimulus would be most ill advised. Past policies have been too stimulative, generating a substantial acceleration in inflation. Unless far greater problems are to exist in the future, substantial reining in of Federal credit creation is necessary.

Inflation-based capital gains are acting as the basis of massive acceleration in debt creation and spending. They are creating the type of economic stimulus with which large Federal deficits used to be associated. In fact, the stimulus coming from the financial sector—that is from the monetarization of a good part of the residential capital gains—is aggregated with deficit spending of fiscal policy; the economy has clearly been exposed to excessive stimulus.

This is even more the case if the impact of fiscal policy is broadened from the full-employment or high-employment concept to the wider concept which embodies all credit creating and preempting activities of the Federal Government when initiated through deficit spending, credit guarantees, or—as a consequence—a Federal regulatory initiative.

Although the borrowing associated with Federal on-budget activities is projected in the current budget to fall to only $16 billion in fiscal 1981, off-budget credit requirements, especially through the Federal Financing Bank, add another $18 billion which, after minor adjustments, brings official Federal borrowing from the public for fiscal 1981 to $33 billion. There is, furthermore, $41 billion scheduled for net Government-guaranteed borrowing and an additional $12 billion for net Government-sponsored borrowing, bringing aggregate Federal and federally assisted borrowing budgeted for fiscal 1981 to $86 billion.

This compares with $81 billion for fiscal 1979 and a scheduled $92 billion for fiscal 1980. However, before heralding the decline in fiscal 1981, let us remember that a year ago fiscal 1980 was projected at $81 billion. In fact, there is every reasonable expectation that total

Federal and federally assisted borrowing in fiscal 1981 will far exceed the budgeted $86 billion and could easily approach the record fiscal 1976 levels of $98 billion.

Thus, although the Federal budget deficit has fallen sharply from its historic peak of $66 billion in fiscal 1976 to $28 billion in fiscal 1979, total Federal and federally assisted borrowing has come down only marginally This suggests that the degree of fiscal stimulus coming from Federal activities is far greater than that implied by on-budget borrowing alone. I not am saying that Federal credit guarantees stimulate the economy dollar for dollar as much as direct Treasury borrowing does. Nonetheless, even if we significantly discount the impact of credit guarantees, the conclusion cannot be avoided that aggregate stimulus from the Federal sector, when combined with large credit infusion resulting from high levels of realized capital gains on homes, has been excessive.[1]

Moreover, there is every reason to believe that the current budget put together prior to the Soviet incursion into Afghanistan is largely obsolete and significant increases in Defense Department total obligational authority will be forthcoming, either through congressionally initiated add-ons or through a formal supplemental appropriation initiated by the administration.

However, the major short-term threat to the Defense Department's programed outlays is not increasing budget authority, which is unlikely to have significant impact in most areas right away, but rather the evident reversal of the mysterious shortfalls in Federal spending of a few years ago. Budget authority for procurement items for fiscal years 1979 and 1980 as reported in the just released budget document is close to the authority programed a year ago.

Outlays, however, have shown a significant upward revision; and for fiscal 1979, as I recall, a year ago, outlays were programed at $22.5 billion. That was last January. They actually ended up at $25.4 billion; and so far, scheduled fiscal 1980 outlays are exhibiting the same pattern. This is without any change in obligational authority or any apparent change in the structure of the underlying defense programs.

A couple of years ago DOD couldn't seemingly spend its obligations. Now they seem to be running ahead of schedule. If one compares the quarterly pattern of total defense expenditures as programed a year ago with what actually occurred, it's apparent that they began to accelerate relative to early schedules last fall and have since shown even wider gaps. This suggests that even without additional budget authorities, defense outlays could very well run several billion dollars higher than currently anticipated.

I might add, parenthetically, with the budget authorities that I expect to occur, we could find ourselves moving into the type of budget-chasing-budget expenditures calculations that we unfortunately were exposed to in the midsixties as the Vietnam war began to accelerate.

Thus, although I do believe that a modest recession will probably start sometime in the early spring and last through at least the rest of this year, I would be most hesitant to engage in policies whose basic purpose was restimulation of the economy. On the contrary, a major attempt at restraint of nondefense expenditures is going to have to be

[1] There is some double counting of stimulus since mortgage credit guarantees have probably accelerated home price increases and associated capital gains.

initiated, and although I would not rule out tax cuts currently aimed at longer term productivity improvements, any revenue losses need to be offset by further reductions of nondefense Federal outlays. We cannot—I might add—look at the budget as we usually have in recent years.

Finally, it is clear from the foregoing analysis that a renewed focus on constraining the growth in Federal guarantee programs will have to be initiated. In short, Mr. Chairman, while I do favor your basic program of tax cuts to enhance productivity—as I always have—I think that we are in a different context. We have to recognize that we are in a new defense budget environment, and that we do not have the choice to do both. We must, in fact, increase the defense budget; and we must engage in the type of program toward enhancing capital investment which this committee has proposed.

In order to do that, however, we must reset our priorities and recognize that domestic social program expansion as usual is no longer feasible.

Representative REUSS. Senator Bentsen.

Senator BENTSEN [presiding]. Yes.

Representative REUSS. At the request of Senator Javits, who had to leave, I would like to ask unanimous consent that the Senator's written opening statement be included in the record at this point.

Senator BENTSEN. Without objection, so ordered.

[The written opening statement of Senator Javits follows:]

WRITTEN OPENING STATEMENT OF HON. JACOB K. JAVITS

The administration has offered an exceedingly grim economic forecast for the near term and really for much of the decade. A recession with unemployment reaching 7½ percent is expected—indeed counted upon to deal with the worst annual inflation rate (13.3 percent) since 1944—and severe inflation is projected to continue unabated. Meanwhile the key to price stability, to wit: Productivity, which was negative in 1979 for only the second time in the postwar era, is expected to remain stagnant for some time. We are confronting today the economic "triple threat" of double digit inflation; double digit unemployment; and stagnant productivity.

Indeed, the Humphrey Hawkins Act medium term goals of 4 percent unemployment and 3 percent inflation, which were to have been reached in 1983 have now been postponed until 1985 and 1988, respectively.

The difficulty with this Economic Report is not what it tells us; it is what it fails to tell us. I do not take issue because it contains bad news; candor is a necessary virtue in times like these, even if it hurts to hear it. The real shortcoming is that we are not given the blueprint for dealing satisfactorily with the anticipated gloomy prospect. The Economic Report is bereft of the elementary contingency planning that is needed right now more than ever!

I want to remind the administration that the key element of the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978 was its provision for indicative planning, which had its genesis in the Humphrey-Javits Balanced Growth and Economic Planning Act of 1975. The full employment, price stability and other numerical goals were intended to keep us pointed in the right directions; they were to help us chart our course for balanced economic growth for the 1980's. It was then to be the responsibility of the President to develop the *program* necessary to achieve those goals.

Preamble of Public Law 95–523 reads as follow:

> "An Act * * * to assert the responsibility of the Federal Government to *use all practicable programs and policies* to promote full employment, production and real income, balanced growth, adequate productivity growth, proper attention to national priorities, and reasonable price stability" [Emphasis added.]

What so deeply disturbs me about this Economic Report, therefore, is that there is no planning for anticipated stresses and crises—the prescription is not equal to the illness.

We're going to have productivity stagnation for some time; other than increased R. & D. spending where is the President's program: what are we going to do about it?

Price stability is not expected until 1988; 8 years from now—so what are we going to do about it other than hope for a recession—a discouraging idea, indeed.

Unemployment is expected to rise to 7½ percent next year and could hit 8½ percent in 1981 according to CBO, amid a very severe recession—so what are we going to do about it other than continue to hope that the recession will be shallow?

In short, therefore, we have a Report that is very grim, perhaps the gloomiest such Economic Report in history. But where is the remedy? All we are told is that we must go through the wringer of recession—with all that entails—and that we must be bled dry perhaps, until we are purged of the illness. This is a very high risk policy and could easily turn out to be only a prescription for continued stagnation—for letting the illness run its course.

The Humphrey-Hawkins Act and the Employment Act of 1946 gives this administration not one but two responsibilities: (*1*), to tell us the facts as accurately as they can be foreseen; and (*2*), to recommend a program equal to that contingency. The latter has not been done and this represents a serious abdication of responsibility.

I urge the administration to go back to the drawing board and return with a better articulated plan before too long for meeting the emergency in which we could find ourselves. Congress could treat this plan solely as standby authority, if you will, and we need not implement the plan until the situation warrants it. But the Congress and the American people should at least know in greater detail today the administration's intentions with respect to capital investment stimulus; or savings incentives; or public service jobs; or public works; or countercyclical revenue sharing.

We need to brace ourselves for the worst this year and in 1981, but everything in the Economic Report is tentative and very qualified. It does not, in my judgment, measure up to the perilous condition this administration fully expects for our country for the foreseeable future.

Senator BENTSEN. Congressman Reuss, my understanding is that questions are going to be asked of all the witnesses.

Representative REUSS. Yes, Senator.

Senator BENTSEN. Professor Rostow.

STATEMENT OF WALT W. ROSTOW, PROFESSOR OF ECONOMICS, UNIVERSITY OF TEXAS AT AUSTIN

Mr. ROSTOW. Mr. Chairman, I believe our economy—and our national life—is caught in a trap. The purpose of my testimony is to describe the trap, to explain why current policies will not extricate us from it, and outline a route of escape. At the end, I shall pull back and try to explain in broad terms the historical reasons for our difficulty and for the necessary remedy.

I have a prepared statement for the record, and the first part describes the trap as stemming from the rise in the international oil price, its effects on inflation, and the rate of growth of real income, and the slowing down of the increase in productivity. It is a chain of causation quite familiar to you.

If present policies continue, the 1980's could be a decade of progressively slower growth, progressively higher unemployment, continued high inflation and stagnant productivity, accompanied by progressive erosion of public services and progressive weakening of our stratagic position on the world scene, which an increase in military hardware alone cannot correct.

How, then, do we break out of the trap?

The answer lies in elaborating and acting on the concept which the Joint Economic Committee has helped to pioneer. I refer to the theme enunciated in your report of March 19, 1979, reinforced in the midyear report and staff study of August; namely that "* * * the basic economic problems * * * for the foreseeable future are not on the demand but rather on the supply side of the economy."

Within this broad concept, the place to start is with the task of reducing the Nation's paralyzing reliance on oil imports. This will require not only redoubtable efforts to conserve energy but also an all-out energy production effort, including a massive effort in what can broadly be defined as synthetics. The first table in my prepared statement, comparing quite similar projections down to 1990 made by the Energy Information Administration—RIA—and the Bureau of Economic Geology of the University of Texas at Austin, exhibits the basis for this conclusion. I shall not elaborate the assumptions underlying these estimates now, but would be pleased to answer any questions they may raise. I would only say that, on the basis of recent U.S. performance, the assumptions are optimistic.

The first point I wish to drive home is that the required investment in U.S. production and conservation needed to reduce oil imports is so large that it would, in itself, bring the economy back to sustained full employment. This is the key linkage between macro and microeconomics.

The technical basis for this judgment is published in a piece of mine entitled "Energy and Full Employment" which appears in Charles Hitch is "Energy Conservation and Economic Growth." Taking into account infrastructure as well as plant and equipment requirements, I would estimate that we require during the 1980's something like an extra 3 percent of GNP allocated to investment in energy production, conservation, and conversion of utilities to coal. This linkage of investment requirements on the supply side to a return to sustained full employment is the missing element in the Joint Economic Committee's 1979 report. And it is a critical element, because, once the linkage is perceived, it should be possible to unite business and labor in support of a supply-side program, including the minority groups which have suffered such disproportionately high unemployment rates.

The second necessary elaboration of supply-side economics relates to productivity. As we all know, the slowdown in productivity has multiple causes. But, as I argued on July 25, 1979, before a hearing of your "Special Study on Economic Change," the most important is the slowdown in the investment rate. The working force has been increasing quite rapidly, but the capital/labor ratio has fallen. The low investment rate, in turn, is the result of the stop-and-go policies we have experienced since 1973, plus the deceleration or decline in consumer outlays.

We may well need special tax incentives to stimulate investment, notably in the modernization of industrial plant; but the experience of France and other countries indicates that private investment only expands substantially in an environment of sustained high growth and expected high growth. Only then are business firms prepared to make the long-term commitments to new plant and new, more efficient technologies.

In this context, the sessions you are now holding are of particular importance. They should design the national strategy for the next sustained period of economic expansion. The recession now underway is releasing labor and increasing idle industrial capacity. That labor and capacity should be set to work in the next boom not in response to enlarged consumers outlays, induced by an income tax cut or otherwise enlarged Federal deficits; but by enlarged investment outlays for energy production and conservation, for the modernization of industrial plant, and for other necessary supply-side purposes.

As for inflation, the dollar will begin to strengthen from the day the world's financial centers conclude the United States has adopted an energy policy capable, in time, of substantially reducing oil imports. And that will damp some of the inflationary pressure arising from an undervalued dollar. But in the end, we shall require a much more redoubtable effort than any yet attempted to negotiate arrangements—equitable for business and labor alike—to link money wage increases to the average rate of productivity increase. Such arrangements should be easier to negotiate if labor is convinced that energy-related investment is underway on a scale which promises sustained full employment in the short run and a removal of the international oil constraint on our economy when the energy investment program is completed.

How long will that take? The lead times for various types of energy investment, conventionally measured, vary, of course, as the second chart in my prepared statement indicates. But those lead times could be cut radically if the energy production and conservation effort were to be undertaken on essentially a wartime basis.

The 1975 modifications in the Defense Production Act of 1950 provide to the President some of the tools to do the job. Congress might extend its provisions, if necessary. I would guess that if we rolled up our sleeves and decided to recapture control over our destiny, our energy situation could be significantly improved in 2 years and radically transformed for the better within 5 years. But we would have to mean it as much as we did when Franklin Roosevelt set the target of producing 50,000 planes a year and the Nation delivered. In fact, I have reluctantly concluded that the strategic, economic, and social consequences of our excessive dependence on oil imports are so grave that, with the agreement of the Congress, the President should institute a state of emergency.

But, more generally, I am arguing that the route out of the trap—and the heart of supply-side economics—is a massive investment program to reduce oil imports; that such a program would strengthen the dollar and our balance of payments; supplemented by tax incentives for the modernization of industrial plant, it would accelerate the increase in productivity; and it would provide a setting—a political, social, psychological setting—in which we ought to be able to get control of the 8 percent or so element of wage-push inflation which bedevils us all, including labor.

I should like to conclude, however, not with these operational recommendations but by suggesting as an economic historian why we face this extraordinary challenge.

The reason is that we enjoyed but did not understand the great boom of the 1950's and 1960's. That boom was made possible by a 25-percent improvement in our terms of trade; that is, import prices fell relative to export prices by that amount. The rise in real income we therefore enjoyed permitted us to expand consumers purchases of goods and services; to expand public services, notably in education and health; and also to enlarge transfers to the less advantaged. Our economists and the politicians they advised came to regard this state of affairs as permanent, perhaps even the result of the magic of Keynesian revolution.

But the underpinnings of this majestic boom were eroding in the 1960's: world grain stocks in relation to consumption declined; U.S. oil and gas reserves relative to consumption declined and production peaked out in 1970–71. There was degeneration also in the other supply-side sectors. We discovered that large allocations of resources were required to maintain reasonably clean air and water; we failed to maintain a minimally viable rail transport system; we failed to recognize and act to redress a decline in water reserves in certain regions of the country.

Then, starting at the close of 1972 with the leap in grain prices, the terms of trade radically reversed. They have since shifted about 25 percent against us and other advanced industrial countries. The disproportionate rise in import prices accelerated inflation, cut into real wages, and, in effect, turned off the the great boom of the 1950's and 1960's. Although I shall not burden you today with the evidence, this was the fifth time in the past two centuries that something like this had happened.

It is the unfavorable shift in the terms of trade which signals the coming of a supply- rather than demand-oriented phase in our national life and, indeed, in the world economy as a whole.

I would note, Mr. Chairman, although I haven't had a chance to study it, the first thing I looked for was to see whether the Economic Report of the President to the Congress, this year at least, contains terms of trade figures. I regret to report that this absolutely critical index appears not to be included in the data.

In the past, such phases of favorable and unfavorable relative prices have lasted 20 years or so. They were periods when the direction of investment shifted to expand supply in the sectors where relative prices had risen and the profitability of investment thereby increased. For example, the price of wheat increased by 2.5 times between 1844 and 1855. The response of the world economy was to pour capital, from Britain as well as the Northeast, into the opening up of the American Middle West by building a railway net beyond the Appalachians and encouraging a massive flow of immigrants from Northwest Europe. The process continued out to the Pacific after the Civil War. Although business cycles continued, the years of railway building across the continent were, by and large, prosperous. There was a rise in the overall investment rate and some pressure, in the 1850's, on urban real wages.

I cite this case because it suggests in a rough-and-ready way what is likely to happen if we face up to our supply-side tasks. To free ourselves from dependence on oil imports is, relative to the size of our economy, quite as big an enterprise as building the transcontinental railroads 130 years ago. It will require the mobilization of capital and technology on a grand scale. It will provide jobs. We may still face, for a while, pressure on real earnings; but that should lift as the price of energy is brought under control and productivity resumes a decent rate of increase. The spirit of common purpose and unity such a great national enterprise would generate should ease many problems which now seem unmanageable, notably the problem of controlling wage-push inflation.

Thus, the stakes are high for all of us in the success or failure of this committee in translating supply-side economics into a viable set of operating policies.

Thank you.

Senator BENTSEN. Thank you, Mr. Rostow.

[The prepared statement of Mr. Rostow follows:]

PREPARED STATEMENT OF WALT W. ROSTOW

I

I believe our economy—and our national life—is caught in a trap. Current policies in no way promise to get us out of that trap. The purpose of my testimony is briefly to describe the trap; to explain why current policies will not extricate us from it; and to outline a route of escape. In the end I shall pull back and try to explain in broad terms the historical reasons for our difficulty and for the necessary remedy.

II

Although it has deeper causes I shall come to, the trap was sprung by the rise in oil prices in the autumn of 1973 and the failure of the Executive Branch under three presidents and the failure of the Congress to generate a policy capable of reducing oil imports. This extraordinary failure over 6 years produced not only successive balance of payments deficits, but also a dollar undervalued by about 30 percent relative to the other major currencies; that is, the exchange rate is about that much lower than the dollar's relative purchasing power would suggest. The weakness of the dollar, in turn, threatened the barely viable system of international trade and payments which emerged after the collapse of the Bretton Woods arrangements in 1971. In 1979 we were forced to cope with the crisis by bringing about a recession which is now under way. Output is declining and unemployment may well rise above 8 percent in 1980. Average gross real weekly earnings in the nonagricultural sector, which increased at an annual average rate of 1.8 percent between 1952 and 1972, declined at an annual rate of 1.4 percent between 1972 and the third quarter of 1979. There was, in fact, a decline of 4 percent between September 1978 and September 1979. The recession will worsen this situation. It will also lower investment and prevent the rise in the capital/labor ratio necessary to restore momentum to our lagging rate of productivity increase. The recession, in addition, will increase the federal budget deficit by simultaneously reducing revenues and increasing social welfare outlays.

Meanwhile, the failure to deal with energy combined with a gap of about 8 percent between the rate of increase in productivity and the rate of increase in money wages appears to guarantee an inflation rate of over 10 percent during the recession year 1980. The recession will have only a minor effect on the rate of price increase due to the nature of the inflationary forces we confront. A reduction in aggregate demand will not greatly abate the wage-push and raw material-push inflation which now grips the country. So far as energy is concerned, we have not faced up to the requirements for increasing coal, nuclear, synthetics, and solar energy production sufficiently to permit us to cut oil imports substantially. Nor have we increased the incentives for oil and natural gas drilling enough to slow down the inevitable decline in production as much as we could. We have done rather well in energy conservation, cutting the marginal energy/GNP ratio from almost 1 to 0.6 percent. There is more to do; but it is evident that conservation cannot do the job on its own. Indeed, it will take heroic efforts to hold the marginal energy/GNP ratio at 0.6.

In the very short run, economies induced by high energy prices and recession may yield a temporary oil glut; but the prospects for global oil demand and production do not appear compatible with high or even modest growth rates in the United States, Western Europe, and Japan over the years ahead. This is the somber conclusion of the CIA assessment of last August. We face the prospect, therefore, of being plunged promptly into another and perhaps deeper recession after a brief and incomplete recovery from the present recession.

If present policies continue, the 1980's could, then, be a decade of progressively slower growth, progressively higher unemployment, continued high inflation and stagnant productivity, accompanied by progressive erosion of public services and progressive weakening of our strategic position on the world scene, which an increase in military hardware alone cannot correct.

III

How, then, do we break out of the trap?

The answer lies in elaborating and acting on the concept which the Joint Economic Committee has helped to pioneer. I refer to the theme enunciated in your report of March 19, 1979, reinforced in the Midyear Report and Staff Study of August; namely, that ". . . the basic economic problems . . . for the foreseeable future are not the demand but rather on the supply side of the economy."

Within this broad concept, the place to start is with the task of reducing the nation's paralyzing reliance on oil imports. This will require not only redoubtable efforts to conserve energy but also an all-out energy production effort, including a massive effort in what can broadly be defined as synthetics. The accompanying table, comparing quite similar projections down to 1990 made by the Energy Information Administration (EIA) and the Bureau of Economic Geology of the University of Texas at Austin, exhibits the basis for this conclusion. I shall not elaborate the assumptions underlying these estimates now, but would be pleased to answer any questions they may raise. I would only say that, on the basis of recent U.S. performance, the assumptions are optimistic.

U.S. ENERGY PERFORMANCE, PROSPECTS AND POSSIBILITIES, 1978–90

[In mmboed]

	1978	1990	EIA–C 1990	Recent performance	Assumptions, 1978–90
Total energy consumption.	36.9	46.8	51.2	1975–78, 3.5 percent, 1977–78, 2.4 percent.	Increase at 2 percent per annum
Oil and NGL production	9.8	7.7	9.4	1972-76, −3.7 percent. Decline resumed after North Slope oil came on stream (last quarter, 1978).	Decrease at 2 percent per annum.
Natural gas	9.1	8.1	7.9	1973–78, −2.7 percent. Reduced to −1 percent. 1975–78, due to intrastate market incentives.	Decrease at 1 percent per annum.
Coal	7.1	11.4	13.0	1973–77, 2.7 percent with decline in 1978 due to strike.	Increase at 4 percent per annum.
Nuclear	1.4	4.4	4.9	Rapid increase 1972–77 (from 0.3 to 1.3 mboed) with new starts now virtually halted.	Assumes present impasse will be overcome and current plans are consummated.
Other	1.4	2.0	2.4		
Total production	28.6	33.6	37.6	1973–78, −0.72 percent but stagnant 1975–78.	Comes to 1.3 percent increase per annum as opposed to net decline between 1973 and 1978.
Exports	.9	.9	1.0		
Net imports	8.9	13.2	13.8	1973–77, 8.4 percent with temporary decline in 1978 due to coming on stream of North Slope.	Comes to 3.3 percent increase per annum.
Synthetics program required for 4.5 mmboed imports.		8.7	9.3		

Source: 1990 estimates from Bureau of Economic Geology, University of Texas at Austin.

IV

The first point I wish to drive home is that the required investment in U.S. production and conservation needed to reduce oil imports is so large that it would, in itself, bring the economy back to sustained full employment. (The technical basis for this judgment is published in a piece of mine entitled "Energy and Full Employment" which appears in Charles Hitch [ed.]. Energy Conservation and

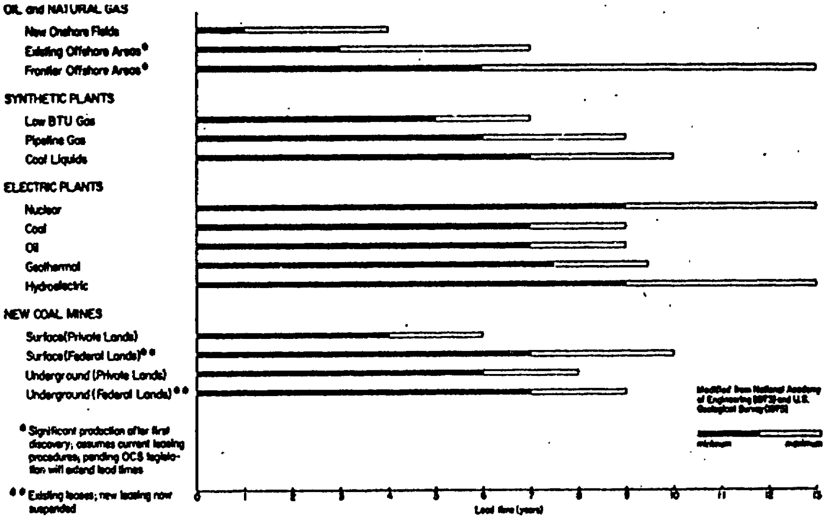
Economic Growth.) Taking into account infrastructure as well as plant and equipment requirements, I would estimate that we require during the 1980's something like an extra 3 percent of GNP allocated to investment in energy production, conservation, and conversion of utilities to coal. This linkage of investment requirements on the supply side to a return to sustained full employment is the missing elements in the Joint Economic Committee's 1979 report. And it is a critical element, because, once the linkage is perceived, it should be possible to unite business and labor in support of a supply side program, including the minority groups which have suffered such disproportionately high unemployment rates.

The second necessary elaboration of supply side economics relates to productivity. As we all know, the slowdown in productivity has multiple causes. But, as I argued on July 25, 1979, before your special study committee on economic change, the most important is the slowdown in the investment rate. The working force has been increasing quite rapidly, but the capital/labor ratio has fallen. The low investment rate, in turn, is the result of the stop and go policies we have experienced since 1973 plus the deceleration or decline in consumer outlays. We may well need special tax incentives to stimulate investment, notably in the modernization of industrial plant; but the experience of France and other countries indicates that private investment only expands substantially in an environment of sustained high growth and expected high growth. Only then are business firms prepared to make the long-term commitments to new plant and new, more efficient technologies.

In this context, the sessions you are now holding are of particular importance. They should design the national strategy for the next sustained period of economic expansion. The recession now under way is releasing labor and increasing idle industrial capacity. That labor and capacity should be set to work in the next boom not in response to enlarged consumers outlays, induced by an income tax cut or otherwise enlarged federal deficits; but by enlarged investment outlays for energy production and conservation, for the modernization of industrial plant, and for other necessary supply-side purposes.

As for inflation, the dollar will begin to strengthen from the day the world's financial centers conclude the United States has adopted an energy policy capable, in time, of substantially reducing oil imports. And that will damp some of the inflationary pressure arising from an undervalued dollar. But in the end, we shall require a much more redoubtable effort than any yet attempted to negotiate arrangements—equitable for business and labor alike—to link money wage increases to the average rate of productivity increase. Such arrangements should be easier to negotiate if labor is convinced that energy-related investment is under way on a scale which promises sustained full employment in the short run and a removal of the international oil constraint on our economy when the energy investment program is completed.

How long will that take? The lead times for various types of energy investment, conventionally measured, vary, of course, as the accompanying chart indicates. But those lead times could be cut radically if the energy production and conservation effort were to be undertaken on, essentially, a wartime basis. The 1975 modifications in the Defense Production Act of 1950 provide to the President some of the tools to do the job. Congress might extend its provisions, if necessary. I would guess that, if we rolled up our sleeves and decided to recapture control over our destiny, our energy situation could be significantly improved in 2 years and radically transformed for the better within 5 years. But we would have to mean it as much as we did when Franklin Roosevelt set the target of producing 50,000 planes a year and the nation delivered. In fact, I have reluctantly concluded that the strategic, economic, and social consequences of our excessive dependence on oil imports are so grave that, with the agreement of the Congress, the President should institute a state of emergency.



Lead times in domestic energy development.

V

But, more generally, I am arguing that the route out of the trap—and the heart of supply-side economics—is a massive investment program to reduce oil imports; that such a program would strengthen the dollar and our balance of payments; supplemented by tax incentives for the modernization of industrial plant, it would accelerate the increase in productivity; and it would provide a setting in which we ought to be able to get control of the 8 percent or so element of wage-push inflation which bedevils us all, including labor.

I should like to conclude, however, not with these operational recommendations but by suggesting as an economic historian why we face this extraordinary challenge.

The reason is that we enjoyed but did not understand the great boom of the 1950's and 1960's. That boom was made possible by a 25 percent improvement in our terms of trade; that is, import prices fell relative to export prices by that amount. The rise in real incomes we therefore enjoyed permitted us to expand consumers purchases of goods and services; to expand public services, notably in education and health; and also to enlarge transfers to the less advantaged. Our economists and the politicians they advised came to regard this state of affairs as permanent, perhaps even the result of the magic of the Keynesian revolution.

But the underpinnings of this majestic boom were eroding in the 1960's: world grain stocks in relation to consumption declined; U.S. oil and gas reserves relative to consumption declined and production peaked out in 1970–71. There was degeneration also in other supply-side sectors. We discovered that large allocations of resources where required to maintain reasonably clean air and water; we failed to maintain a minimally viable rail transport system; we failed to recognize and act to redress a decline in water reserves in certain regions of the country.

Then, starting at the close of 1972 with the leap in grain prices, the terms of trade radically reversed. They have since shifted about 25 percent against us and other advanced industrial countries. The disproportionate rise in import prices accelerated inflation, cut into real wages, and, in effect, turned off the great boom of the 1950's and 1960's. Although I shall not burden you today with the evidence, this was the fifth time in the past two centuries that something like this had happened.[1]

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[1] The evidence for this view is contained in my *The World Economy: History and Prospect*, Austin: University of Texas Press, 1978, Part three.

It is the unfavorable shift in the terms of trade which signals the coming of a supply- rather than demand-oriented phase in our national life and, indeed, in the World economy as a whole.

Such phases in the past have lasted 20 years or so. They were periods when the direction of investment shifted to expand supply in the sectors where relative prices had risen and the profitability of investment thereby increased. For example, the price of wheat increased by 2½ times between 1844 and 1855. The response of the world economy was to pour capital (from Britain as well as the northeast) into the opening up of the American middle west by building a railway net beyond the Appalachians and encouraging a massive flow of immigrants from northwest Europe. The process continued out to the Pacific after the Civil War. Although business cycles continued, the years of railway building across the continent were, by and large, prosperous. There was a rise in the over-all investment rate and some pressure, in the 1850's, on urban real wages.

I cite this case because it suggest in a rough-and-ready way what is likely to happen if we face up to our supply-side tasks. To free ourselves from dependence on oil imports is, relative to the size of our economy, quite as big an enterprise as building the transcontinental railroads 130 years ago. It will require the mobilization of capital and technology on a grand scale. It will provide jobs. We may still face, for a while, pressure on real earnings; but that should lift as the price of energy is brought under control and productivity resumes a decent rate of increase. The spirit of common purpose and unity such a great national enterprise would generate should ease many problems which now seem unmanageable, notably the problem of controlling wage-push inflation.

Thus, the stakes are high for all of us in the success or failure of this committee in translating supply-side economics into a viable set of operating policies.

Senator BENTSEN. Professor Rostow, your comments on the massive expenditure needed on the supply side for energy are very interesting.

I'm on the "Tax Conference." We agreed to a tax of $227 billion, but we all know it's going to be a lot more than that. We know our assumptions are out of date insofar as the price of oil and the way it will probably be rising. We are talking about a massive amount of money to be expended for developing alternative sources of energy.

I don't know of anyone who has really made an evaluation that's up to date on what that means to the economy and what it means to employment in this country. Do you have anything on that?

Mr. ROSTOW. Yes, sir, the estimates that I made, I have not brought up to date. I hope that I can induce some of my colleagues to work with me on it. We made estimates by using all manner of sources, from the private sector and the public sector. We tried to estimate the amount of investment required over a 9-year period down to 1985 to achieve President Carter's initial target of cutting oil imports down to 6 million barrels a day or so by 1985.

The estimates, on a plant and equipment basis, in 1976 dollars indicated on extra 2.5 percent of GNP would have to be invested in energy production and conservation.

Then two other colleagues of mine, Dean George Kozmetsky of our business school and Eugene Konecci, made estimates which included some, but not all of the infrastructure required. Their figures indicated something like an extra 3 percent of GNP would be required.

That was for, as I say, a 9-year period, 1977–85 inclusive. It's on the basis of these figures, which checked out tolerably well with some Bechtel did out in San Francisco, that provided a feel at least, for the order of magnitude of the problem.

Without having updated the calculations for the 1980's and the 4 million barrel per day target for 1990. I would guess the figure is likely to be higher for this reason: It now seems clear that we will have to go on a large scale for synthetics from coal and shale, as substitutes for gasoline. That's a very capital-intensive business.

One of the things that emerge, Mr. Chairman, that I think we all ought to remember, is that energy conservation is also capital intensive. We tend to think of energy conservation as keeping the car home, getting the children to close the icebox door, setting the thermostat lower; but seriously to alter industrial processes takes a lot of capital. We are doing it.

In fact our best performance has been on the conservation side, where we brought the marginal energy GNP ratio down to 0.6 percent. Conservation investment accounted for something like 20 to 30 percent of our total.

Incidentally, the original title of my talk was "Energy, Full Employment, and Regional Development." We broke our figures down by regions. It turned out that all of the capital would not go to the Mountain States and the Southwest; that the extra amount required in the Northeast, for example, would be, on a plant and equipment basis, about $100 billion, and about the same for the industrial Middle West. This fits rather well the estimate made by the Northeast Governors' Conference in support of their submission to the Congress of the plan for the Northeast Energy Corporation. They figured that an extra $120 billion of energy investment would be necessary for the Northeast. They included some infrastructure.

As we go for synthetics including, hopefully, the Middle Western shale, the regional direction of energy investment is quite good. I think it is the missing dynamic element for the revival of the Northeast and industrial Middle West.

You were talking earlier, Congressman Reuss, about the steel industry. I have looked at the Bechtel detailed requirements for energy-related investment. They break down to specific requirements for materials and types of labor. I have a hunch that if we ever take energy seriously as a nation we are going to find an interesting transition. If you will forgive my speaking for a moment as an economic historian, in the 1880's there was a bad patch for the steel industry when railroad building stopped. Railroad steel was initially 80 to 90 percent of total production. The producers formed an international cartel because they had idle capacity. In 10 years it was gone. They found new markets for steel in steel ships, buildings, and bridges. I believe we are also going to find new markets for steel. Automobile steel requirements are declining as cars get smaller. But we will have enormous requirements for steel for the supply-side tasks that I am talking about: energy production and conservation and, I would add, for the making of a minimally viable railroad system, for slurry pipelines, and so forth. If we get on with energy, I think that idle steel plant will find uses.

Senator BENTSEN. Well, I am very deeply concerned about the steel industry. It's not that major a part of the economy in my State, but for the Nation it's terribly important. I see some of the steel industry in the process of liquidation; and using what capital they have for diversification. I have a deep concern over that.

Let me ask Mr. Greenspan, in 1974 and 1975 in the recession, as I recall we had other major countries in the world also in recession. Each contributed to the others. What do you see this time? Most of you gentlemen are talking about some modest recession this year. For the other countries is it going to be a plus or a minus? How will they influence our situation, the major countries?

Mr. GREENSPAN. Mr. Chairman, it looked for a while as though if the United States dipped into a recession and got it over with sometime late this year, that we would be out of phase with any difficulties that could conceivably occur either in Germany or Japan which would, in a sense, be the major forces in the rest of the world.

It's no longer clear. We do not as yet fully understand the extent to which the shift in the Defense budget will impact upon the timing of the cycle and its degree of depth here in the United States. If we run into troubles here we will, in a sense, create problems for those abroad. In part, the weakness in the United States can be transmitted rather quickly to the major European and Japanese markets.

At this particular stage, if the recession is as modest as it appears in the United States, then we are not looking at any significant interaction; but I hesitate to make that forecast without qualification, largely because the dynamics of international finance—especially as it's been working its way through the Eurocurrency system—is at this stage largely unknown to us; and many things, I might add, happened in 1974 which seemed very peculiar.

Let me give you one very interesting example. I remember when Helmut Schmidt came over here to discuss the economic outlook with President Ford—we compared notes. What was remarkable was that the German economy fell apart the same week that the United States economy fell apart. There is no way for international flows of goods and services to create that.

Senator BENTSEN. You mean you think you can be that precise, when you say "that week they fell apart?"

Mr. GREENSPAN. We know it. You could see it in the insured unemployment system in the United States. It was some week in October where all of a sudden we jumped very sharply, and the whole economy began to fade very rapidly. It's one of those very rare events in which when the economy falls apart in any severe recession it apparently does it very rapidly. That was the case both here and in Germany. What I am saying is we never did find out why that happened. It could not be explained in terms of the normal flows of goods and services. It largely occurred, as best I can judge, as a consequence of the international financial system operating in a manner which does things we do not as yet understand.

So I merely offer a large element of questioning with respect to the answer I have given you, because our beliefs, our understandings of the interaction of international events in the short run, is less than it should be.

Senator BENTSEN. Congressman Reuss.

Representative REUSS. Thank you, Mr. Chairman.

Let me ask each member of the panel a question which I hope can be answered yes or no. The question: Mr. Rostow, do you find the anti-inflationary economic program of the administration adequate?

Mr. ROSTOW. No.

Representative REUSS. Mr. Greenspan, do you?

Mr. GREENSPAN. No.

Representative REUSS. And you, Mr. Thurow?

Mr. THUROW. No. [Laughter.]

Representative REUSS. A very interesting point you made, Mr. Greenspan, which you have made before about all of the capital gains people have realized when they sell their homes at today's inflated prices and you set forth some numbers about the stimulative effect of Federal direct borrowing—when you throw in all of the off-budget, the Federal Financing Bank, assisted borrowing, it comes to something like $86 billion for the next fiscal year, to use your figure.

Can you give us a figure for the monetarization which occurs in the private "sell your home and realize a handsome capital gain" or "don't sell your home, but up the mortgage" and use that?

What are we dealing with here? Who has what share of the total monetization?

Mr. GREENSPAN. First, let me say that these two processes are not unduplicated totals. A very substantial part of the guaranteeing by the Federal Government, needless to say, is in the mortgage market. The mortgage market has been unquestionably the most explosive element in the financial structure of the United States in the last 5 years.

Representative REUSS. With that caveat against double-counting—which is always a good one—what is your mortgage market guess?

Mr. GREENSPAN. The mortgage market increase at this stage is running, for one- to four-family homes, at an annual rate in excess of $100 billion.

Representative REUSS. For what kind of homes?

Mr. GREENSPAN. One- to four-family homes.

I might add that is true up to the third quarter. In the fourth quarter, on the basis of fragmentary data, it's somewhat less. That is not true monetization, I might add. That is merely the aggregative borrowing on homes. It is a very large number; and unquestionably, to the extent that it has put pressure on the financial systems, and put pressure indirectly on the commercial banks, part of it has been monetized; and that unquestionably has been a factor of critical significance in pressuring money supply growth and, in turn, obviously has been a factor in the inflation base of the country.

Representative REUSS. When you say "monetized," exactly what do you mean? I have a house that I bought for $35,000; it's got a $30,000 mortgage on it. It's now worth $100,000 at fair market value.

Case No. 1, I sell it. Is that monetization?

Mr. GREENSPAN. No. Not technically.

Representative REUSS. That's direct cash in hand, isn't it?

Mr. GREENSPAN. True enough. I merely tend to use the term "monetization" as it's technically used by most economists, in the sense of debt creation working its way through the financial system to create money, that is either M–1 or M–2 or some specific form.

Representative REUSS. That you would get—please check me if I am wrong—when I, the owner of a house for which I paid $35,000, which has a $30,000 mortgage on it, but which is now worth $100,000, that monetization would occur when I either enlarge or switch my existing $30,000 mortgage for a $70,000 mortgage? Isn't that the process you are talking about?

Mr. GREENSPAN. It most certainly is the process. My quibble is only a minor definitional question. There is no question that the mere turnover of existing homes, running at about a 4 million annual rate now, in and of itself creates a huge increase in debt on existing homes. That particular phenomenon has been so extensive that it has dominated the domestic financial structure of this country for the last 3 years.

Representative REUSS. You said with respect to 1979 and its rate that the increase in value of existing one- to four-family dwellings was on the order of $100 billion. Are you talking about the increase in mortgage debt on one- to four-family homes?

Mr. GREENSPAN. I was talking about two things. One, realized capital gains from the sale of a home; and mortgage debt. It turns out that one is running very close to the other.

Representative REUSS. Together they make $100 billion?

Mr. GREENSPAN. Both. Realized capital gains on the one hand are $100 billion and the mortgage debt increase because of those realized gains is $100 billion.

Representative REUSS. Well, I will say wow. You are telling me that monetization, this dreadful thing which I have been beaten around the head with for 20 years, is twice as bad in the private sector, one- to four-family homes, as it is in the Federal Government even with all its monstrous, swollen, semifraudulent, off-budget monetization?

Mr. GREENSPAN. The problem, however, is that a substantial part of that capital gain and the credit associated with it probably occurs as a consequence of the various types of mortgage expansion programs that are part of the Federal system; so that while there is no doubt that if you wish to look at the balance sheet of the U.S. economy and ask, where are the sources of demand for funds coming from, in a strictly numerical sense, it is certainly true that if you look at the size of Federal borrowing for Treasury securities, on the one hand, and the increase in mortgage debt on the other, the latter is a multiple of the first.

I would not, however, conclude that inflation is caused by the private sector, because one must then ask what's causing the mortgage debt system to increase. To get into that, Representative Reuss, I suspect you would find that it in itself reflected substantial expansionary policies of the Federal Government in the mortgage area.

Representative REUSS. Let us suppose what is an absurd supposition that the Government stood up to the homebuilders, the mortgage bankers, the savings and loans, and, I might add, to at least half the people in the United States—and stopped further mortgage stimulation. We will would have one hell of a problem, wouldn't we? Because if your figures are right, we've got a source of mad money in place that is grotesquely larger than all the monetization that zany public finance has produced?

Mr. GREENSPAN. Congressman Reuss, if we initiated the particular program you have in mind, I would venture to say that a substantial part of the aggregative mortgage market would disappear; and I fear, a large segment of the constituents of both Houses of the Congress——

Representative REUSS. No doubt. No doubt of that.

This is a cheery thought. We are lashed to the log and heading for the sawmill. I will yield back the balance of my time and clear out.

Senator BENTSEN. Thank you very much, Congressman. You gentlemen have really posed some interesting questions. I'm not going to add to them, but I do hope that we can find some way of evaluating what we have wrought when we get through this tax bill on oil and the amount of money that would be raised there. When you speak of a target of limitations on imports that's one thing. But we are legislating here without any real analysis, when we get the whole thing put together, of what we are going to end up with in terms of bringing on alternative sources and the stimulation of jobs

I hope there is some way we can get a handle on that, get a better understanding by the time we get the package finally passed.

Gentlemen, thank you very much. We appreciate it.

The committee is recessed.

[Whereupon, at 12:15 p.m., the committee recessed, to reconvene at at 10 a.m., Wednesday, February 6, 1980.]

THE 1980 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 6, 1980

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

The committee met, pursuant to recess, at 10 a.m., in room 2212, Rayburn House Office Building, Hon. Clarence J. Brown (member of the committee) presiding.

Present: Representatives Brown and Rousselot.

Also present: Mayanne Karmin and Paul B. Manchester, professional staff members; Betty Maddox, administrative assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

OPENING STATEMENT OF REPRESENTATIVE BROWN, PRESIDING

Representative BROWN. The committee will please come to order.

We have as our first witness today Hon. James T. McIntyre, Director of the Office of Management and Budget.

Senator Bentsen, the chairman of the Joint Economic Committee, is unable to be with us this morning, and in his place I have been asked to chair this morning's hearing.

Senator Bentsen in his announcement of the meeting today said that we would assess the impact of the President's budget on the economy, and further went on to say:

> The committee also wants to know administration plans to increase productivity, including government productivity. In addition, we will ask for and examine the administration's view of the need for a regulatory budget.

On my own behalf I would like to make the following statement:

As we begin the fourth day of Joint Economic Committee annual hearings, an ominous theme and message is coming through loud and clear. The message is the administration is either insensitive or doesn't understand what is needed to promote long run economic growth and increase living standards in the United States.

I was stunned yesterday when the Chairman of the Council of Economic Advisers, Charles Schultze, for whom I have a good deal of respect as a professional, said that we need to slow down economic growth in order to curb inflation.

I wonder if the administration is aware of studies and the widespread agreement that even a severe recession will only make a dent in the inflation rate.

I wonder if the administration has read the 1979 JEC consensus report that said:

> Much of the demand-oriented approach, which became so fashionable in the great depression of the 1930's, is now outdated by the economic evolution of the

past four decades. Modern economists have rediscovered the supply side of the economic model. The recommendations in the Joint Economic Committee report reflect this by calling for increased capital formation, labor productivity, and output for the fight against both inflation and unemployment.

Expanding the capacity of the economy to produce goods and services efficiently is the most effective policy to combat the major economic ill of our time—stagflation.

Mr. McIntyre, I hope you appreciate that tax policy is a cornerstone to savings and investment in the United States. I hope you will be responsive to the fact that last year's oil price increases acted like a $53 billion tax on the American economy. Last year inflation-induced taxes were about $17 billion. Additional taxes going to social security from the 1977 amendments to the social security law were about $7 billion. Underdepreciation and inventory valuation adjustment caused an overpayment of taxes by about $25 billion last year. That is a total of $102 billion in tax increases that the Federal Government has received and taken out of the pockets of Americans over 1978. And yet the administration can't find room for a tax cut. Why not?

The administration has for the past 3 years been telling us that real tax reductions and reforms will have to be put off 1 more year. The administration promised us a balanced budget this fiscal year, but instead the deficit will be $40 billion, which is larger than last year's deficit.

The administration has promised a budget this year that is reasonable and responsible. But the bottom line on this budget is that 1 year from now the best this administration can give us is 10.5-percent inflation and 7.5-percent unemployment under your own estimates.

I hope the administration will shed itself of its economic myopia and will get with the longrun needs of the 1980's—the need to expand savings, expand investment, increase productivity, and solve some of our most pressing economic problems by aggressive real economic growth.

I'm glad to welcome here today Frank Lindsay, chairman of Itek Corp., and trustee of the Committee for Economic Development. The CED has just released a study on research and development, technological innovation, and how to get new technology into our factories. The study concludes that inflation has reduced the rate of return to R. & D. and investment, and that some form of accelerated or replacement-cost depreciation must be adopted. The committee also recommends significant changes in Government support for R. & D. tax treatment of R. & D. and patent law.

Mr. McIntyre, this is just an example of the sort of things that Government should be looking at and putting into practice without further delay.

If we had saved and invested a bit more; if we had grown only 1½ percent faster each year since 1950 than has been the case historically, we would now have a $3½ trillion economy instead of just over $2¼ trillion. Incomes would be 50 percent higher than they are now. Jobs would be plentiful. We would have $250 billion more in Federal revenues, balanced budgets would be possible, stable prices would be part of our environment, income and payroll tax cuts would be included in the budget, and national health insurance and some of the other social programs that this administration has indicated it favors would be within our grasp. There would be a 50-percent higher living standard, millions more jobs, and a solvent social security system. We would have an ultramodern productive economy three times the size of the Soviet Union's instead of twice, and unquestioned military superiority because we'd have the resources for that. The Russian economy simply could not have kept up with us.

Faster growth, higher incomes, and plentiful jobs are exactly what the unemployed, underprivileged, and the minorities of this country have been seeking for many years. It is no accident that the greatest gains in income, jobs, and dignity for minority workers have come during periods of rapid expansion.

Growth is critical, and saving is critical to growth. We have thrown away 30 years. The hour is very late. It is high time we got started if we are to accomplish the objectives of not only this administration but all previous and perhaps all future administrations in our society.

I don't need to lay that on you as too heavy an admonition for your testimony this morning, and I don't want to throw you completely off your testimony, but we might as well know where the focus of our concern will be expressed this morning as we get started.

STATEMENT OF HON. JAMES T. McINTYRE, JR., DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY VAN DOORN OOMS, ASSISTANT DIRECTOR, ECONOMIC POLICY; DALE R. McOMBER, ASSISTANT DIRECTOR, BUDGET REVIEW; AND W. BOWMAN CUTTER, EXECUTIVE ASSOCIATE DIRECTOR, BUDGET

Mr. McIntyre. I will review the President's budget briefly this morning but I want to reserve most of the time for questions and answers, and for a discussion of the issues Representative Brown has raised.

Let me say I am concerned about the hypothetical examples that are being used. If we had assumed an even higher level of growth than you had assumed in your hypothetical statement, we'd be even better off. I think we have to deal with what has actually happened in the world and in this country, and particularly how we can deal with our own economy without exacerbating inflation. This is a concern that you share with the President and me. We have to deal with inflation rapidly in this country.

Representative Brown. I will try not to interrupt you except to say that this committee has recently toured another part of the world, the markets in the Far East, and in every one of those markets—the Philippines, the Hong Kong community—they are vastly different in terms of their approaches to government; the Governments of free China, Taiwan, and Seoul, Korea—in every one of those communities the economy has been growing much more rapidly than ours, as they have been in other industrial parts of the world, notably Germany and Japan. So while we are fully concerned and conscious about the rest of the world, you'd think there would be some things we could learn from the rest of the world about how to conduct our economic situation.

Mr. McIntyre. I don't think we have the universal font of knowledge here in this country, and we look at what others are doing and constantly consult with others outside the Federal Government to try to bring in new ideas.

I think many of the points you have made are very appropriate points, and my comment about the hypothetical situations with respect to growth was not in any way to your points. I simply wanted to emphasize that if things had been better than in your hypothetical example, we would be even better off than you stated. I think we have to deal with things that are actually before us.

Let me briefly go over the budget for you, Congressmen Brown, and give you some of the highlights and try to relate some of the aspects of the budget to particular things such as research and development and how we have treated them, and then I'd be glad to go into some of the questions you have raised and answer them.

It is a pleasure to appear before you today to testify on the President's budget for the following year. As you know, we have taken the unusual step this year of preparing a joint prepared statement representing my views and those of Secretary Miller and Mr. Schultze. And with your permission, Congressman, I'd like to submit that joint prepared statement for the record.[1]

Representative BROWN. It will be included in the record.

Mr. McINTYRE. You have already received testimony from Mr. Schultze and Secretary Miller on the outlook for the 1980's and the administration's economic policy for reducing inflation.

My own brief oral testimony will summarize some of the highlights of the President's 1981 budget and its relation to fiscal and economic policy.

I would like to refer to some of the exhibits that have been passed out. I would like to start at exhibit 12 for my presentation.

The figures on exhibit 12 give you the budget totals, the actual totals for 1979, the estimated totals for 1980 and 1981, as well as future projections for 1982 and 1983.

I'd like to focus for just a moment on 1980 and 1981.

The economic assumptions incorporate a mild recession in 1980, and thus our estimates for outlays for 1980 are increased to reflect the effects of some of those economic assumptions. The deficit increases to about $40 billion for 1980.

In 1981 we see an increase of $52 billion in expenditures over 1980. The resulting deficit is approximately $16 billion. Actually, it's $15.8 billion. Of that $52 billion increase, $37 billion goes to fund the noncontrollable items in the budget—the entitlement programs, interest on the debt, and prior year contractual obligations, and so forth.

The remaining $15 billion is reflected in increases in the defense budget.

Now, obviously the budget has other increases in other programs, but we have tried to offset those increases with reductions in other programs throughout the budget.

To look at the real growth in the 1981 budget as one illustration of whether or not the budget is restrained or expansionary, you will see that there is virtually no real growth. In fact, according to our estimates, it is about 0.2 of 1 percent real growth in the 1981 budget, even though real growth in defense will be 3.3 percent.

So I think that if you look at the 1981 budget in that sense, it reflects the administration's determination that we should continue on a course of fiscal restraint.

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[1] See the joint prepared statement, together with exhibits 1 to 26, beginning on p. 141.

And obviously that is one of the most important ways in which we feel we have to deal with inflation.

If you look at the next chart, it contains the current budget estimates for 1980 and 1981 by department and agency. Let me highlight two or three of those changes.

In 1980 there is a large increase in the budget for the Department of Agriculture. That increase reflects the cost of the President's decision to embargo the shipment of grain to the Soviet Union and his further commitment to purchase grain contracts from the dealers and to expand the foreign-owned reserve program. The total amount we expect that program to cost is about $2 billion. That is reflected in our 1980 budget.

The cost of that same program in 1981 is about $800 million and that amount is also reflected in the Department of Agriculture's budget.

If you look at the Department of Defense, you see that the total obligation authority or the budget authority for that agency increases by about $20 billion. That is over 5 percent real growth in total obligational authority. The reason for that is important. We fully fund major acquisitions such as ships and weapon systems in the Defense Department, and therefore that budget authority constitutes the true planned program level for the Department of Defense.

Outlays are increased by over 3 percent in real terms going from $127.4 billion to $142.7 billion.

There are major increases in the Department of Health and Human Services. Those increases are primarily increases in the entitlement programs such as social security, medicare, medicaid, and black lung benefits, and other similar programs.

There appears to be a large decrease in budget authority for the Treasury Department in 1981 over 1980. That results because there will be a large nonrecurring 1980 increase in budget authority for the Energy Security Corporation. There is no bulge in ongoing Treasury programs.

In the foreign assistance budget, I would point out that a number of the activities that are included in the foreign assistance function are spread over the State Department and other agencies.

The apparent decrease in foreign assistance basically reflects technical changes in the treatment of the foreign military sales trust fund and in the multilateral development banks.

Let me next turn to various ways in which we can measure the stringency or the relationship of this budget to such things as the gross national product or to outlook.

If you look at exhibit 14, you will see that we have been on a track of getting the budget deficit down as a percentage of GNP. In 1981 the budget deficit as a percentage of the gross national product will be 0.6 of 1 percent, in contrast to the deficit in fiscal year 1976, which was 4.1 percent of the GNP. We are continuing to make progress in getting the deficit down; I personally think that is very important. Eventually we have the goal of balancing the budget.

The next exhibit shows another way to look at the relative tightness of the budget. Exhibit 15 displays current services estimates for 1981.

There have been increases and decreases throughout the budget in various programs. The net effect of those increases and decreases is to increase the budget by about $3.8 billion over what would otherwise be the current services level; that is what it would require merely to carry out those services that are authorized by existing law. I think the fact that we were able to increase the defense program by $5.4 billion and still keep the total increase in current services down to $3.8 billion is a remarkable accomplishment.

Last year we began to look at the multiyear budget effects of current policy. We have tried to display what will happen to the budget over a 3-year period. If you look at exhibit 16 you will see that between now and 1982 the budget could be expected to increase by $211 billion. That is a lot of money. And in the current economic environment we find ourselves, it raises a lot of questions about whether we should reexamine certain Federal programs.

We are all committed to improving our national defense, and the $55 billion increase as reflected in this chart for an increase in national defense is consistent with the President's defense plan.

The uncontrollable programs grow by almost $100 billion. Other nondefense programs grow by about $36 billion, and the President's national health proposal will cost about $24 billion.

The point I want to make from this exhibit is that we must start looking at the effects of the budget over a longer period of time than just 1 year. And I think that is important from this committee's perspective if we are going to have a rational economic policy to deal with some of the problems of the economy.

Exhibit 17 reflects what has happened to budget outlays in constant 1981 dollars from 1950 to 1981.

The most striking thing to me about this exhibit is the tremendous growth in payments for individuals and grants. That particular program area has grown by 592 percent since 1955, whereas other programs such as national defense have actually declined in constant dollars. This gives you some idea of what is really driving the Federal budget increases that we are experiencing.

The next exhibit shows what has happened to military programs from 1950 through 1983 in current and constant dollars.

The next exhibit shows what is happening in the area of Federal expenditures for basic research. This administration is committed to increase real spending for basic research. The total amount estimated in 1981 for basic research is $5.1 billion, an increase of almost $600 million over 1980, and an increase of $1 billion over 1979. The total research and development expenditures increase by about 14 percent in 1981. Our expenditures on basic research increase by about 12 percent in 1981.

Exhibit 19 illustrates where these research dollars are flowing: to the National Institutes of Health, the National Science Foundation, the National Aeronautics and Space Administration, the Department of Energy, the Department of Defense, and other agencies.

The final point I would like to make about the budget is that we have limited the number of new initiatives recommended in the budget. There is only one major new initiative: a program for youth training and employment. One of the most difficult problems we have had to deal with is trying to reduce youth unemployment, particularly of minority youth. While we have made much progress in reducing unemployment and in creating new jobs over the past 3 years, we still face unaccepatably high rates of minority youth unemployment.

The President has recommended a youth initiative that will both provide young people with jobs and require that they continue their education and obtain certain basic skills that are absolutely crucial if, as adults, they are to attain permanent positions in the workplace. We think this is an important initiative. We worked hard to squeeze it in the budget in what is otherwise a tight fiscal policy.

Mr. Chairman, I know you have some questions about taxes. We have stated in our budget that we believe that over the period of 1982–85 there will have to be reductions in taxes. The tax burdens cannot be allowed to continue to increase, and we will have to take major steps. We did not think, in putting this budget together, that the time was appropriate to recommend tax reductions, particularly in a time when very high inflation requires that we hold down Federal spending and Federal deficits and continue a tight fiscal policy.

With that, Congressman Brown, I will conclude my statement, but I will be glad to answer questions of the committee.

[The joint prepared statement of Mr. McIntyre, Mr. Miller, and Mr. Schultze, together with exhibits 1 to 26, follows:]

Joint Prepared Statement of Hon. James T. McIntyre, Jr., Hon. G. William Miller, and Hon. Charles L. Schultze

I. Economic Program and the Outlook

The 1970's were a decade of economic turmoil. The price of oil rose more than tenfold. The world's cost of importing oil swelled from less than $25 billion at the beginning of the decade to almost $300 billion at the end. In the middle of the decade the world experienced the largest recession of the past forty years. Inflation averaged much higher than in the prior two decades; inflationary expectations became embedded in the consciousness of consumers and businesses; and the decade closed with inflation running in double-digit figures. Finally, the pace of productivity, upon which the advance of our real income and living standards ultimately depends, slowed sharply.

As we enter the 1980's, economic policy has to concentrate on three major priorities: controlling and then reducing inflation; adjusting to a world of higher energy prices, and reducing our dangerous dependence on foreign oil; improving the structure and functioning of the American economy so as to restore a healthy growth in productivity and real incomes.

While the problems and challenges that confront economic policy are difficult ones, it is reassuring to recall that the American economy has made substantial progress on many fronts during the past several years.

Output and employment during the expansion

Three years ago our economy was suffering from very high unemployment and idle plant capacity. Recovery from the severe recession of 1974–75 was still far from complete. Major progress has been made during the past three years in bringing the Nation's human and capital resources back into production.

Real output is almost 12 percent above its level 3 years earlier. Adjusted for inflation, after-tax income per capita has increased 7½ percent. Increased use of plant capacity was accompanied by a heartening rise of business investment in the new plant and equipment we need for future growth of output and better productivity performance.

Gains in employment over these past 3 years—4.1 million new jobs in 1977; 3 million in 1978, and 2.1 million more in 1979—have been phenomenal. Employment growth in recent years has no parallel in the postwar period.

Two particular features of the employment expansion have been particularly encouraging. First, job creation has been concentrated in the private sector. Employment at private nonfarm establishments climbed 14 percent over the past three years, while state and local government employment increased 4 percent and Federal employment was essentially level.

Second, employment gains have been largest for those groups most in need of jobs. For every 100 black adults holding a job in late 1976, there are now 115 gainfully employed. For every 100 black teenagers at work then, 115 are at work now. For every 100 Hispanics with jobs three years ago, there are now 120.

As idle resources were increasingly put to work, it became necessary to shift policy towards restraint in order to moderate economic growth. We reached that point over a year ago, when accelerating inflation also required greater fiscal and monetary discipline. The pace of economic expansion in 1979 slowed more than expected, however, largely because of the heavy blow to the economy from rising OPEC oil prices.

The economic effect of higher oil prices on the economy is similar to that of an excise tax. Because prices are increased, real purchasing power of consumers is drained away. The higher revenues of OPEC oil producers and domestic oil companies are only gradually spent on additional imports and investment projects. The economy suffers a net reduction in demand and output. The Council of Economic Advisers estimates that the net drag on the economy imposed by last year's rising oil prices was equivalent, by the fourth quarter, to a tax increase of $53 billion, far larger than the tax relief provided by the Revenue Act of 1978. Of course the increase in the price of imported oil was unlike an excise tax in one crucial respect: it extracted real wealth from our economy, an effect not reversible by domestic tax reductions or spending.

TABLE 1.—GROWTH OF MAJOR COMPONENTS OF REAL GNP

[4th quarter to 4th quarter]

	Percent change	
	1978	1979
Real GNP	4.8	-0.8
Personal consumption expenditures	4.5	1.6
Business fixed investment	10.5	1.7
Residential construction	(1)	-8.3
Government purchases of goods and services	1.7	.1
Domestic final sales	4.3	.9
	Change as a percent of Real GNP	
Inventory accumulation	(1)	-0.6
Net exports	0.5	.5

[1] Less than 0.05.

The drain of purchasing power was so large that the total after-tax income of consumers, adjusted for inflation, remained unchanged over the four quarters of last year. Since consumers were willing to reduce their rate of saving substantially, however, consumption expenditures in real terms continued to increase, but more slowly than in 1978. Other major categories of demand also weakened in 1979. The rise of business capital spending also slowed, and residential construction declined. Businesses curtailed their orders and production to keep inventories in balance with slowing sales; consequently, the rate of inventory accumulation at the end of 1979 was below the year-earlier level. Net exports of goods and services rose in 1979, however, as the volume of exports rose substantially more than the volume of imports.

Although, as shown in Table 1, real output rose less than 1 percent during 1979, employment continued to increase strongly. Demand for labor was sustained by a sharp decline in productivity that aggravated inflation and put a squeeze on the profit margins of most American businesses outside of oil companies. The profit share of total output originating in nonfinancial corporate businesses other than petroleum and coal companies fell 15 percent during the first 3 quarters of last year.

Declining profit margins, a gradual increase in excess capacity, and concerns about the possibility of recession contributed to the substantial slowdown in the pace of business capital formation last year. Business purchases of cars and trucks declined sharply. Since the growth of real GNP slowed even more than the rise in business fixed investment, the share of total real output devoted to business outlays for new plant and equipment was a little higher last year than in 1978. But the proportion of our national output devoted to increasing and modernizing our capital stock is well below that of most other major industrial countries. It is also below the amount required to assure long-run improvement in productivity and to meet increased needs for energy and the requirements of environmental, health, and safety regulations.

Inflation

Developments on the inflation front were the most significant disappointment in the 1979 economic performance. At the beginning of the year, it was widely expected that inflation would moderate. Those hopes were destroyed, however, by skyrocketing energy prices.

Last year, the consumer price index rose by over 13 percent. Within the index, energy prices rose by 37.4 percent. Had energy prices risen at the previous year's rate of 8 percent, the CPI would have increased by 2½ percentage points less, considering only the direct effects of energy prices on the index.

Sharply rising costs of home purchase and finance also added a large element to CPI inflation. The way the CPI treats the cost of purchasing a home, and the associated costs of home financing, tends to overstate the rise in the cost of living to the average consumer when home prices and mortgage interest rates increase rapidly. Beginning with the December CPI, the Bureau of Labor Statistics has begun to release data that provide additional perspective on changes in consumer prices. For example, the Department has calculated the cost of home ownership in a way that makes it roughly equivalent to rent. If this rent index is substituted for the homeownership and finance component of the CPI, the rise in consumer prices last year is found to be 10.8 percent. And when energy is removed, the alternative index rises only about 8 percentage points in 1979, the same as in 1978.

The President's program of voluntary standards for pay and price increases could not prevent the rise in OPEC oil prices or the increases in housing and home finance costs. But they were instrumental in keeping the rising inflation in those areas from setting off a major acceleration of price and wage increases elsewhere. Compliance with the program was widespread. Although the overall rate of inflation rose to 13 percent, increases in wages and fringe benefits were no higher than in 1978. The rise in prices of goods and services outside of energy, housing and home finance was less than the rise in the unit costs of production, and as pointed out earlier, very little greater than in 1978. Had the huge increase in energy prices spilled over into the broad structure of industrial wages and prices, our basic inflation problem would have worsened for many years to come.

Why the economy avoided recession in 1979

The economy's resilience in the face of dramatic increases in oil prices and the attendant worsening of inflation was one of the more surprising features of economic developments in 1979. Forecasts of impending recession were becoming frequent by late 1978, long before the magnitude of the 1979 rise in OPEC oil prices was perceived. By the middle of 1979, they were common. Yet, the characteristics of cumulating recession are still not in evidence at the present time.

The reasons why the economy was able to absorb the shocks of rising oil prices, a substantial acceleration of inflation and sharply rising interest rates without going into a steep decline are only partially understood. Three factors, however, have played a role.

First, individuals as consumers and homebuyers appear to be more strongly affected by inflationary expectations now than in the past. Such expectations help account for the further decline in the personal saving rate during 1979, and for the continued strength of housing sales until late last year, despite a rise of mortgage interest rates to unprecedented heights.

Second, monetary restraint no longer produces the abrupt changes in availability of credit to borrowers that used to bring an end to economic expansion. A number of changes have taken place in financial markets during recent years that have removed or reduced the constraints which used to limit access to credit by some borrowers during periods of general credit restraint. The most recent of these—the introduction in mid-1978 of money market certificates of deposit sold by banks and thrift institutions—has been a major factor sustaining credit flows to housing. Because of these developments in financial markets, monetary policy now works more through changes in interest rates that affect a borrower's willingness to incur debt, and less through changes in his ability to obtain credit. For this reason, monetary restraint now tends to affect aggregate demand less abruptly and with a less uneven impact across major economic sectors. As events in financial markets late last year attest, however, significant changes in monetary policy may still lead to constraints on the availability of credit, particularly for housing.

Third, the continued growth of the economy last year reflects the relative absence of cyclical imbalances characteristic of earlier periods of economic expansion. Most notable in this regard is the fact that inventories have remained in good balance with sales throughout the expansion. When consumer spending declined in the second quarter of last year, therefore, businesses did not find themselves seriously overstocked. To be sure, auto inventories, particularly for large cars, increased substantially, and major auto producers are still trying to redress the balance between stocks and sales. In other industries, however, production cutbacks to reduce excess stocks remained modest in 1979.

Economic outlook

The unsettled state of world oil markets and the unexpected resilience of the economy last year make forecasting in 1980 an unusually hazardous exercise. The factors that sustained growth in 1979 will continue to affect economic performance in 1980. But it is unlikely that they will cushion the economy's response to shocks to the same extent that they did in 1979.

Key elements of the economic forecast underlying the fiscal year 1981 Budget are shown in Table 2 below.

TABLE 2.—KEY ELEMENTS OF THE ADMINISTRATION'S ECONOMIC FORCE

	1980	1981
Real GNP growth (Q4/Q4, percent)	−1.0	2.8
Unemployment rate (Q4, percent)	7.5	7.3
Increase in the CPI (December/December, percent)	10.4	8.6

Over the four quarters of 1980, real GNP is forecast to decline by 1 percent; in 1981, an increase of 2.8 percent is expected, as indicated in the table. This forecast is broadly in line with many others, including that of the Congressional Budget Office. The decline in real GNP this year is expected to be accompanied by an increase in the unemployment rate to about 7½ percent in late 1980. Resumption of economic expansion next year, however, is expected to bring unemployment down to 7½ percent by the end of 1981.

The forecast assumes that the economy will head into a mild recession in the first half of this year. Housing starts turned down in the fourth quarter of last year and may decline somewhat further. New car sales also fell, and auto companies have curtailed their production schedules for the first quarter of 1980 to reduce abnormally large inventories, especially of large, fuel-inefficient models. The downward pressure on consumers' real incomes, resulting from rising oil prices and increasing marginal tax rates caused by inflation, is continuing. With the personal saving rate already at exceptionally low levels, slow growth of real income is likely to mean sluggish consumer markets. Current indicators suggest, moreover, that real business fixed capital spending will turn down moderately in 1980. As final demand weakens, the rate of inventory accumulation may also fall somewhat further.

If a recession does occur early this year, it is likely to be brief, mild and largely over by midyear. A large cutback in production to reduce inventories has often magnified recessionary forces in the past. Such a development is unlikely this year because the cautious inventory policies followed by most business firms have prevented a large buildup of undesired stocks. Interest rates are likely to decline because of the abatement of credit demands in a weakening economy. This would permit housing starts to turn up in response to strong underlying demands.

The rise in consumer prices is expected to slow somewhat this year to about 10½ percent. This moderation of inflation during the course of 1980 will contribute to strengthening consumer purchasing power. Early this year, we will continue to face the shock effects of the latest round of OPEC oil price increases. Once those effects wear off, the rise in energy prices is expected to moderate. Moreover, in a weak economy, cost increases will be more difficult to pass through to product prices. Mortgage interest rates may also come down from their very high present levels. Next year, a further reduction of inflation to around 8½ percent is forecast. By any historical yardstick, however, inflation next year will still be extraordinarily high.

The progress against inflation we expect, and which we sorely need, would not be achieved if last year's sharp increase in energy prices and the costs of home purchase and finance were to spill over into wages, costs, and the broad range of industrial and service prices. Preventing that from happening is the first priority for economic policy in our country in 1980. The problem is not ours alone. Every oil importing country around the world is facing starkly higher energy prices and a potentially dangerous acceleration of inflation.

No one can be satisfied with an economic outlook for this year that implies declining real output, rising unemployment, and continuing very high inflation. Appropriate economic policies can help the economy adjust to the impact of recent OPEC oil price increases. But no policies can change the realities which those increases impose.

Economic policy at the present time must hold firm against inflation, despite the prospect of a weakening economy. The Administration recognizes, however, that fiscal policies cannot be set on an unswerving course regardless of how economic developments unfold. We will monitor developments closely this year. If economic conditions and prospects deteriorate significantly, we will be prepared to take corrective action in ways and under circumstances that do not aggravate inflation.

II. THE 1981 BUDGET AND FISCAL POLICY

The fiscal policy in the 1981 budget recognizes that inflation remains our paramount economic problem. If we do not deal effectively with inflation, the very substantial economic progress achieved under this Administration will be reversed, and our long-term goals of balanced growth with full employment and price stability will be even more difficult to achieve. The 1981 budget is, therefore, a restrictive budget. The growth of budget outlays is held to the lowest rate consistent with our national security and energy security objectives and the most urgent domestic requirements. Budget increases for less critical needs have been rejected. There are no major tax reductions. This austere budgetary policy is a necessary condition for controlling inflation.

Reasons for fiscal restraint

A restrained budget is necessary to lower inflationary expectations. There have recently been disquieting signs that consumers expect high inflation to continue indefinitely, as a permanent fixture of economic life. Workers and businesses increasingly appear to make their wage and price decisions on the basis of that expectation. Such expectations could become self-fulfilling, leading to a dangerous wage-price spiral which would do permanent damage to the economy. The public must be convinced that this will not happen, and make their price, wage, borrowing and expenditure decisions accordingly.

Budget restraint is also necessary because forecasts are highly uncertain, and there are risks to any policy. Under present circumstances, the risks of a restrained fiscal policy are far less than the risks of fiscal stimulus. Expansive policies are difficult to reverse, and the long-term inflationary damage resulting from a mistakenly expansive policy would be severe. On the other hand, if economic conditions should significantly worsen, changing to a policy of less restraint would be less difficult.

A restrained budget is also necessary to preserve the international confidence in the dollar required to prevent destabilizing and inflationary exchange rate changes. A bloated 1981 budget would be a signal to the world that the United States has accepted double-digit inflation and is unwilling to make the sacrifices needed to restore price stability. This could be damaging not only for the United States, but for the world trading and financial system as well.

For the longer-term, budgetary restraint is required to generate the savings and capital formation required for higher productivity growth, lower inflation, and rising employment and living standards. Federal spending must be held down to make resources available for additional capital formation, and this will be especially difficult at a time when demands on the budget from energy and national security requirements are growing. Because of the difficulties in controlling expenditures in the short-term, this long-term problem must be addressed now, in the 1981 budget.

Restraint in the 1981 budget

This budget recommends outlays for 1981 of $615.8 billion. This is effectively a zero-growth budget; after allowing for inflation, 1981 outlays are at virtually the same level as 1980. Receipts are estimated at $600 billion, and the recommended deficit is $15.8 billion, the lowest in 7 years. Because of the urgent necessity for fiscal restraint, tax reductions are not proposed. The only major tax proposal included in the budget is the windfall profit tax.

TABLE 3.—BUDGET TOTALS

[In billions of dollars]

	1979 actual	Estimated 1980	1981	1982	1983
Budget receipts	465.9	523.8	600.0	691.1	798.8
Budget outlays	493.7	563.6	615.8	686.3	774.3
Surplus or deficit (−)	−27.7	−39.8	−15.8	+4.8	+24.5
Budget authority	556.7	654.0	696.1	775.1	868.5

It is regrettable that present difficult economic conditions do not permit a balanced 1981 budget. However, the proposed 1981 deficit marks substantial progress toward that goal. The deficit proposed for 1981 is $50 billion lower than when President Carter ran for President. As a percentage of the budget and of the GNP, the proposed deficit is the second lowest of the preceding decade, and less than a third of the average for the 1970's. If, contrary to our expectation, the economy were to expand rapidly enough to keep the unemployment rate at its current level, the 1981 budget would be in surplus by about $15 billion.

A common measure of fiscal stimulus or restraint is the change in the high-employment budget surplus or deficit, a measure which excludes the budgetary effects of changes in the degree of resource utilization. This measure of fiscal restraint increases from a $12 billion deficit during fiscal year 1979 to a surplus of $5 billion in 1980 and a surplus of $57 billion in 1981. The 1981 budget thus continues—and intensifies—the policy of fiscal restraint begun earlier. The increase in the high employment surplus from 1979 to 1981 is over 1¾ percent of GNP—a very substantial degree of restraint.

Budgetary stringency can also be measured by examining proposed budget outlays in comparison with current services, the level of spending required to maintain existing program levels. The level of outlays in fiscal year 1981 is only 0.6 percent above the level needed to maintain the current level of services. The $3.7 billion difference is more than accounted for by $6.3 billion of increased spending on defense and energy, which are critical to our national security. The rest of the budget shows a reduction of $2.5 billion below current services.

Because the 1981 budget is restrictive, the pressures to expand it will be strong. Unemployment later in 1980 and in 1981 is expected to be higher than it is today. Businesses will need greater incentives to invest in plant and equipment. Worthwhile social programs will seem to require additional funding. Many of these needs are legitimate, and under other circumstances they might deserve room in the budget. But the harsh reality of inflation makes it critical for the Congress to resist those pressures, as the Administration has done.

Major budget priorities

The budget is more than an instrument of macroeconomic policy. It is also a means of addressing the needs of our society and the ordering of national priorities. Although spending growth has been held to a minimum in this budget, the President has recommended program increases in a few critical areas. The most important of these in 1981 are defense, energy, basic research, and the development of our young people.

Defense.—When the Administration assumed office, real defense spending had declined for almost a decade. Even in 1978, outlays for defense largely reflected decisions of the previous Administration. In real terms, those outlays were lower than they had been 4 years earlier. In the 1979 budget, the President proposed a long term policy of substantial and sustained growth in real defense spending. Developments in Iran and Afghanistan during recent months attest to this need. Therefore, this budget proposes a defense program in 1981 of $158.2 billion in budget authority, an increase of over 5 percent in real terms. Outlays for defense will be $142.7 billion, a real increase of over 3 percent. With this budget, spending on defense will have increased by 9.4 percent in real terms since 1978. This Administration is committed as a matter of fundamental policy to continued large real increases in defense spending beyond 1981.

Energy.—Solutions to our energy problem are essential for both economic progress and national security. This budget reflects the important progress being made by this Administration, in cooperation with the Congress, through a broad and practical program addressing the energy problems the Nation is facing in this new decade. The 1981 budget assumes that, early in the 1980 session, the Congress will pass the crucial measures proposed last year: the windfall profit tax, the Energy Security Corporation, the conservation measures and the Energy Mobilization Board.

The energy program supported in the 1981 Budget is comprehensive and balanced, addressing both production and conservation. To stimulate production, it recommends resources for the Energy Security Corporation that would help to create a synthetic fuels industry, and it supports major increases for solar, fossil, and fusion energy. It provides for an ambitious gasohol program and emphasizes safety and the solving of current problems in nuclear fission programs. Overall, spending on energy programs will increase to $8.1 billion in 1981, an increase of over 90 percent during the first four years of this Administration.

As the Nation adjusts to energy scarcity, we must protect those who are most vulnerable. Much of this protection is achieved automatically, through programs such as social security and retirement which are indexed to the cost of living. The 1981 budget expands this protection, providing funds for the poor for weatherization of their homes, and for energy cash and crisis assistance. In all, the 1981 budget proposes $2.4 billion in energy assistance for the disadvantaged, an increase of 50 percent over the 1980 level.

Youth Employment.—Despite the economic gains that have been made over the past 3 years, youth unemployment, especially for minorities, remains distressingly high. When youth have significant employment problems upon leaving school, their employment and earnings may be adversely affected for a lifetime. To eliminate this waste of national resources, this budget proposes a major new education and employment initiative designed to prepare today's youth for the labor market of the 1980's. This program will help schools to provide disadvantaged youth with the basic skills needed to get and keep jobs, and to reinforce those skills with job experience in the private sector. Disadvantaged youth out of school would acquire these basic skills in improved training and employment programs. By 1982 this program will add $2 billion to the over $4 billion currently being spent on education and employment programs for 14 to 21 year old disadvantaged youth.

Basic Research.—Between 1968 and 1975, Federal spending for basic research, measured in constant dollars, declined substantially. In order to maintain our Nation's position as a leader in the development of new technology, the budgets of this Administration have increased real spending on basic research each year. The 1981 budget continues this policy and provides for major and sustained increases above the rate of inflation for all research and development programs. Obligations for research and development will increase by 13 percent; for basic research by 12 percent. Since 1978, obligations for basic research will have increased by 40 percent, or 9 percent in real terms.

Agriculture.—Because of the aggression of the Soviet Union against Afghanistan, the President has significantly limited Soviet grain purchases from the United States, while at the same time taking steps to ensure that the burden of the export limitation does not fall disproportionately on farmers. Specifically, the Secretary of Agriculture will:

Purchase from shippers contracts entered into with the Soviet Union and sell the contracts back into export markets only at prices above those prevailing on January 4.

If necessary, take title to the grain intended for export to the Soviet Union and isolate it from the market.

Purchase up to 4 million metric tons of wheat for an international food aid reserve.

Increase the loan level for feed grains and wheat by 10 and 15 cents per bushel respectively.

Expand CCC export credit guarantee coverage to include full commercial risk.

Modify the farmer-owned grain reserve to encourage farmers to place additional grain in their reserve.

Purchase grain in local markets to stabilize markets and relieve the congestion of grain in transit to major ports.

It is estimated that these measures will increase outlays by $2.0 billion in 1980 and $0.8 billion in 1981. In addition, the President will propose additional funding for Public Law 480 for fiscal year 1980 and fiscal year 1981 of $100 million per year. The administration stands ready to take further steps if these actions prove insufficient, taking care, however, to avoid long-term distortions in our basic farm policies.

Initiatives to reduce federal spending

These initiatives of high national priority have been proposed in the context of overall budgetary restraint. The required restraint has made it essential to propose a number of reductions in Federal programs. Restraint has been applied carefully. For the third consecutive year, zero-base budgeting has been used to establish priorities that put taxpayers' dollars to best use. Desirable new programs have been deferred. Increases in existing programs have been limited. Past efforts to achieve program efficiencies and improve management are beginning to pay off, and further efforts in this direction are undertaken in this budget. Reductions in lower priority programs have been proposed, and this budget contains specific outlay reductions of $9.7 billion from current service levels.

A substantial portion of these reductions take the form of legislative proposals that would reduce Federal spending. Together, these legislative proposals will reduce Federal spending by $5.6 billion in 1981 and by significantly larger amounts in subsequent years. Savings would be achieved through several health-related proposals, modification of entitlement programs to relate benefits more closely to need or to earned rights, increased administrative efficiencies, and reduction of waste, fraud, and abuse. In addition, this budget contains proposals to reform Federal compensation practices and procedures, place the railroad retirement system on a solid financial footing, and dispose of excess materials in the national stockpile of strategic materials.

Large spending reductions are extraordinarily difficult to achieve in the immediate budget year, because so much of the budget is relatively uncontrollable in the near-term. In the 1981 budget, fully 77 percent of outlays are classified as relatively uncontrollable, and these will account for $37 billion of the $52 billion increase in total outlays between 1980 and 1981, The remaining $15 billion will be due entirely to increased spending for national defense. The rest of the budget, in total, has been held at the 1980 level. For every increase in spending for controllable, non-defense programs an offsetting reduction within other programs has been made.

As inflation gradually comes down, its severe impact on the growth of budget outlays will be mitigated. But future spending levels can only be held down by efforts begun now—in 1981—to hold the lid on spending initiatives.

Receipts

Total receipts for 1981 are estimated to be $600 billion, $76.2 billion more than in 1980.

TABLE 4.—ESTIMATED UNIFIED BUDGET RECEIPTS

[Fiscal years; in billions of dollars]

	1979	1980	1981
Individual income tax	217.8	238.7	274.4
Corporation income tax	65.7	72.3	71.6
Contributions for social insurance	141.6	162.2	187.4
Other receipts	40.8	50.6	66.6
Total	465.9	523.8	600.0

These estimates assume a windfall profit tax which, on a net basis, produces excise tax receipts of $5.5 billion in 1980 and $13.9 billion in 1981. The windfall profit tax will ensure that the burden of higher energy costs is equitably shared and will provide additional receipts to finance energy programs essential to our economic well-being and national security.

Because the windfall profit tax is deductible, it will reduce the corporation income tax liabilities of oil firms. This, combined with lower growth in corporate profits due to a sluggish 1980 economy, results in a slight reduction in corporation income tax receipts in 1981.

Control of Federal credit activities

In recent years, direct loans and loan guarantees have come to play an increasingly important role in economic policy. Unfortunately, too much of this activity has escaped the normal discipline of the budget process. In the 1980 budget, we announced our intention to institute a system to control the use of Federal credit. This system, which is now in place, recommends specific credit limitations for most credit programs. It also provides estimates of the new direct loan obligations and new loan guarantee commitments to be made in the coming fiscal year.

TABLE 5.—CREDIT BUDGET TOTALS

[In billions of dollars]

	1979	1980	1981
New direct loan obligations	51.4	59.7	60.7
New loan guarantee commitments	74.7	75.2	81.4
Total	126.1	134.9	142.1

In 1981, new direct loan obligations increase by 1.7 percent over 1980 compared with a 16.1 percent increase in the previous year. Loan guarantee commitments, on the other hand, increase 8.3 percent in 1981 after increasing only a small amount in 1980. The total increase for direct loans and loan guarantees together is 5.3 percent in 1981.

The credit control system is an important improvement of Federal budgeting practices. The new system has three long-run goals:

To ensure that credit programs meet the purposes for which they were intended, that they do so effectively, and that the level of resources is justified.

To provide a closer examination of the allocation of credit and real resources across broad sectors of the economy.

To encourage more careful consideration of the impact of total Federal credit activity on the private economy as a whole—on the borrowing needs of the private sector, and on economic growth, inflation and unemployment.

This new system of credit control, in conjunction with zero based budgeting and multiyear planning, will help ensure that the government runs more intelligently and efficiently.

III. OTHER MEASURES TO FIGHT INFLATION

Budgetary restraint, of course, is not the only anti-inflationary policy at our disposal. But it is a necessary condition for the success of other policies. Fiscal discipline must be combined with responsible monetary policy to provide the economic environment necessary to reduce inflation. But more is required. Inflation has been building in our country for 15 years, and its momentum is very strong. Reducing inflation cannot be accomplished by traditional macroeconomic policies alone without enormous losses of output and jobs. Maintenance of effective standards for pay and price restraint is essential. We must also attack other structural causes of inflation, especially those related to energy and low productivity growth.

Monetary policy

Policies of monetary restraint are never popular. They hit some sectors harder than others. They are associated with shortages of credit and high interest rates, even though those developments stem principally from the forces of inflation that dictate monetary restraint, rather than from those policies themselves. However, inflation will not come down unless the growth of money and credit is gradually reduced to a rate consistent with lower inflation.

The Federal Reserve has been pursuing a responsible course. Growth of the major monetary aggregates was within the established target ranges last year. When an excessive pace of monetary growth did emerge in mid-1979 the Federal Reserve took steps to deal with the situation.

In the first few weeks following the Federal Reserve's October 6 actions, there was considerable turmoil in financial markets. Interest rates rose sharply, and uncertainties were created in the minds of lenders and borrowers regarding the outlook for the cost and availability of credit. Mortgage markets were most severely affected.

Subsequently, however, interest rates on market securities began to decline. Credit has now begun to flow more freely to mortgage borrowers, and mortgage interest rates have declined somewhat in some regions of the country. While housing starts have been adversely affected, the decline has been much less substantial than in previous cycles. Moreover, mortgage credit flows and housing construction will be sustained early this year by the temporary Federal preemption of State usury ceilings.

These painful effects of monetary restraint are a price that has to be paid to prevent the excess growth in money and credit which would aggravate inflation.

By placing greater emphasis on the supply of bank reserves, the Federal Reserve's present operating strategy will allow more effective control over the growth of money and credit. Growth in virtually all of the monetary aggregates fell back to a moderate pace during the closing months of last year, and interest rates have shown remarkable stability recently.

If the pace of economic activity slackens next year, a modest decline in interest rates should accompany reduced demand for credit. However, a significant and lasting decline in interest rates cannot be achieved without progress in reducing inflation.

The relatively small deficit that will result from the Administration's 1981 budget will help to relieve pressures in financial markets. Net Federal borrowing from the public will be an estimated $33 billion in fiscal year 1981, compared with $34 billion in fiscal year 1979, and $44 billion in fiscal year 1980. Private credit demands in 1980, however, are expected to decline by more than the increase in net Federal borrowing.

Pay and price policies

Dealing effectively with inflation requires policies aimed directly at promoting restraint in wage and price increases in the private sector. The cooperation of business and labor in adhering to voluntary wage and price standards is essential in this endeavor. Standards for wages and prices are not only a means of reducing inflation; to the extent that they succeed, they reduce the burden on monetary and fiscal policies in fighting inflation, and thus make increased employment and output possible.

The standards have a critical role to play in 1980. Our most immediate problem this year is to prevent last year's large price increases in energy and housing from spilling over into wages, costs, and the broad range of industrial and service prices. Should that happen, inflation could worsen for many years to come.

To promote continued cooperation with the standards, the Administration and organized labor arrived at a National Accord announced on September 28, 1979. The Accord called for the creation of two advisory committees, one on pay and one on prices. The Pay Advisory Committee consists of representatives from labor, business and the public and has already recommended a number of modifications in the pay standard. For the basic pay standard, the recommendation contemplates that pay increases in normal circumstances would average 8½ percent, with possible variation within a range of 7½ to 9½ percent. The Council on Wage and Price Stability is now reviewing this recommendation.

Energy

All of our efforts to defeat inflation will be severely compromised if we experience continued shocks from sharp increases in oil prices.

Price controls on domestic energy supplies were a significant factor behind our excess reliance on imported oil. Price controls encouraged the wasteful use of energy and discouraged the development of domestic energy sources. As a result, oil imports increased from about 2.2 million barrels a day in 1967 to a peak of 8.5 million barrels a day in 1977.

In order to reverse this trend, to encourage conservation and stimulate domestic production, the Administration has begun phased decontrol of domestic oil and gas prices.

Higher energy prices have already begun to reduce energy consumption dramatically. Since 1973, the rise in per capita use of energy has slowed substantially. Had the trend of the 6 years prior to 1973 continued, oil imports in 1978 would have been nearly 6 million barrels a day higher than they were. In 1979, efforts by Americans to conserve energy accelerated. Consumption of gasoline in the fourth quarter of last year, for example, was 10 percent below a year earlier.

Decontrol is an essential part, but only one part, of our program to stimulate conservation and encourage domestic production of energy. Other conservation efforts, as well as programs to develop conventional energy sources, renewable energy resources and synthetic fuels, are also urgently needed.

We have proposed two important pieces of legislation that would promote domestic energy production. The first of these, the Energy Security Corporation, would facilitate private sector development of synthetic fuels to substitute for imported oil. The second, the Energy Mobilization Board, would help to reduce the regulatory delay involved in building new energy facilities. It is essential that Congress complete action expeditiously on both of these proposals.

Legislation will soon be sent to the Congress setting targets for reduced oil use by electric utilities. To enable utilities to meet these goals, financial assistance will be proposed to facilitate their conversion to coal. There will also be submitted to Congress a standby gasoline rationing plan which could be put into place quickly in case of a severe energy shortage.

The United States is working with other oil importing nations, through the International Energy Agreement, to coordinate import policies to avert a costly scramble for oil when supplies are short. In 1977, the United States used 8.5 mmb/d of imported oil. President Carter set a limit of 8.2 mmb/d for U.S. oil imports during 1979 and this goal has been continued for 1980. If discussions in the IEA produce a fair and equitable agreement for sharing import reductions, the President is prepared to lower the 1980 target.

Agricultural policy

Periodic scarcities of food have often occasioned an acceleration of inflation. The history of the past 15 years indicates clearly that price shocks stemming from temporary scarcities of food or energy can have a lasting effect on inflation, because they tend to become built into the structure of wages and other costs and thus into the underlying inflation rate.

Prior to 1972, agricultural policy had concentrated on supporting prices and controlling excess supply through production adjustments. The Food and Agricultural Act of 1977 established a system of farmer-owned reserves designed to protect both producers and consumers against volatile food prices, while promoting intensive use of U.S. agricultural productive capacity.

The reserve system has been successful during its short existence. Grain prices began to rise during the spring of 1979 when export demand was projected to rise sharply. This increase was moderated, and an inflationary spurt in food prices avoided, by a substantial release of stocks from the reserve. When grain shipments to the Soviet Union were suspended in response to that country's invasion of Afghanistan, increased incentives to place grain in reserve served as an important line of defense to protect farmers against a precipitous decline in prices.

Hospital cost containment

Inflation must also be attacked directly in the health care sector. The costs of medical care have been rising faster than prices of all other consumer goods and services for a number of years. The costs of hospital care have risen even faster than the rise in costs of other health care services. These costs affect consumers both directly and through the higher taxes needed to pay for public health services.

Aggregate demand policies have very little effect in this sector of the economy. Furthermore, we cannot expect market forces to work effectively in this sector. Often buyers or sellers of medical services lack the incentive or information necessary to take actions that would limit the rise in medical costs to the levels that would exist in a competitive market.

The Administration therefore, will continue to urge enactment of its important initiatives to restrain unnecessary spending and help contain hospital costs. Passage of the Administration's hospital cost containment legislation is one of the most important steps Congress can take now to fight inflation.

Improving productivity

The disappointing performance of productivity has been an important factor behind the inflation of the last few years. In the early 1960's, productivity gains averaged more than 3 percent per year. In recent years, productivity increases have dwindled to about 1 percent, and a sizable decline occurred in 1979.

Improvement in productivity growth would obviously have highly beneficial effects. Besides reducing the rise of costs and prices, increased productivity would mean higher real output and improved living standards for Americans. However, bettering our productivity performance cannot be achieved quickly or at low cost.

Indeed, since we do not fully understand the causes of the slowdown in productivity, we are hampered in our efforts to deal with it. We do know, however, that basic research and development and a stronger pace of business investment in new plant and equipment are indispensable ingredients for increased economic efficiency.

Increased investment will enhance the productivity of workers in two ways: first, by giving them more capital to work with; second, and perhaps more importantly, by putting the latest technological advances into practice.

The budget for 1981, as noted earlier, contains additional funds for basic research and development, continuing the strong Federal backing for basic research that began in fiscal 1978. The budget does not contain new tax incentives for investment. Reductions of significant magnitude in business taxation would have been inconsistent with the basic policy of fiscal restraint that characterizes this budget. Tax incentives will not result in increased investment unless investors can be confident that we will have a strong and stable economy. A lean budget geared to reducing inflation is the most important step we can take now to stimulate investment. Furthermore, as explained in the Economic Report, higher national savings and capital formation will not be compatible with large budgetary deficits over the longer term.

In the years immediately ahead, tax reduction will become possible if the Administration and the Congress work together to hold the line on growth in Federal spending. When that time comes, the Administration will give very high priority to tax changes that will stimulate investment and direct a larger fraction of our national resources to capital formation.

Dealing with structural unemployment

Investment in human capital is as important to enhancement of productivity as investment in physical assets. At the present time, our nation is wasting a significant part of our human resources. Unemployment among blacks and minorities is still unacceptably high. By improving employment opportunities for these groups, the supply of goods and services will be increased and, efficiency in resource use will be improved.

Reducing unemployment and increasing the earnings of these groups cannot be accomplished merely by stimulating the economy. Attempting to do so would add to inflation while yielding, at best, minimal benefits to those suffering special employment problems. Instead we must have targeted programs to enable these groups to expand their skills and give them the opportunity to work.

This Administration has already increased expenditures on employment and training programs for the disadvantaged by 73 percent and spending on special programs for youth threefold. The most significant new domestic initiative the President is sending the Congress this year deals with the problem of teenage unemployment. As discussed earlier, this program will emphasize improved classroom provision of basic skills and useful work experience for low achieving youth still in school; disadvantaged out-of-school youth will be given such skills through redesigned and improved training and employment programs.

The Administration's welfare reform proposals also contain important initiatives for improving the employment and wages of principal wage earners in low-income families with children.

In the years ahead, efforts to promote productive employment for the structurally unemployed must continue. We are learning from experience which programs provide lasting benefits to workers while avoiding waste and unnecessary expenditures of public funds. We will strongly emphasize, as we have with several of the new programs developed recently, the active involvement of the private sector in hiring and training the disadvantaged.

Regulatory reform

Unnecessary and sometimes counterproductive government regulation has added to inflation. Recognizing this, the President, working with the Congress, has started to dismantle economic regulations that contribute to inflation. The first step was the deregulation of the airline industry. The Administration is now working with the Congress to eliminate costly and inefficient aspects of regulation in the trucking, railroad, and communications industries. We are also proposing the reform of regulations over financial institutions to promote equity for small savers, maintain the viability of our thrift institutions, and enhance competition and efficiency in financial markets.

In fulfilling environmental, health, safety, and other social objectives, governmental regulations serve a function that cannot be performed by the market place. In these areas, important cost savings are possible by improving the design of individual regulations, setting standards that will meet objectives without being unnecessarily stringent, and encouraging the most cost-effective approach to meeting those standards.

The Administration has taken steps of fundamental importance to the long-run impact of social regulations on costs, productivity, and inflation. Executive Order 12044 established a regulatory analysis review procedure that requires policymakers in regulatory agencies to give greater attention to the cost of regulations. A regulatory council has also been established to help achieve better coordination of important regulations issued by the various executive branch and independent agencies, and to develop a calendar of important regulations that will provide a broad overview of the potential impact of regulations on the economy. Moreover, the regulatory analysis procedure undertaken under Executive Order 12044 would be made permanent, and extended to the independent regulatory agencies, by the regulatory reform legislation that the Administration has sent to the Congress. Prompt passage of that legislation is a high priority in the Administration's legislative agenda for 1980.

IV. U.S. INTERNATIONAL ECONOMIC POLICY

Our fight against inflation must include international as well as domestic policy initiatives. A stable dollar is essential to avoid additional inflationary pressures. A fair and open system of international trade and investment promotes competition within our own economy. Food and commodity prices can be stabilized through international action. Intensive cooperation with both industrialized and developing countries can help to promote our economic objectives in today's interdependent world economy.

The U.S. economy is inextricably linked to the other industrial economies, and is increasingly affected by the developing nations as well. We depend on the world economy:

To purchase the production from 1 in 7 U.S. manufacturing jobs and 1 in 3 acres of U.S. farmland;

To provide almost 1 in 3 dollars of U.S. corporate profits;

To provide one-fifth of our total energy requirements;

To assure a wide variety of consumer choice, promote efficient production at home, and stimulate competition in our markets;

To supply essential inputs for U.S. industries, including more than one-fourth of U.S. consumption of 12 of the 15 key industrial raw materials.

U.S. economic policy must therefore be developed in full recognition of the linkages between our own economy and the rest of the world.

A strong, stable dollar is fundamental to the stability of both our own economy and the international financial system. Changes in the value of the dollar have an important effect on jobs, investment, inflation and growth at home. Maintaining a stable dollar is particularly important in our fight against inflation, because a strong dollar holds down the price of imports and promotes domestic competition.

During the period of exchange market instability in the autumn of 1978 the United States took strong measures, including monetary actions and the mobilization of adequate resources for forceful intervention in exchange markets. The effectiveness of those measures has been enhanced recently by continued monetary discipline and strengthened cooperation between U.S. monetary authorities and those in other major nations. The emphasis of our economic policy on eliminating inflation and reducing our dependence on imported oil will make an essential contribution toward maintaining a sound and stable dollar.

A sound dollar is aided by a stable international monetary system, the goal of the International Monetary Fund. The IMF promotes the adoption and maintenance of appropriate economic policies by member countries, both those in balance of payments surplus and deficit. The IMF also maintains multilateral surveillance over the world financial system as a whole. In addition, the United States has itself borrowed from the Fund during the past year to augment the resources available for exchange market intervention. The Fund thus provides direct support for fundamental U.S. interests, and is an integral part of our overall economic policy strategy.

A stable monetary system is important not only in its own right, but because it helps to preserve and strengthen the prospects for open and fair international trade and investment, which are vital for our economic interests. American industry and agriculture must expand their exports aggressively if we are to have a stable dollar, and American consumers must have access to competitive foreign products if we are to check inflation.

To foster open and fair trade, U.S. policy must continue to seek the freest possible international market. The Multilateral Trade Agreements signed in December 1979 sets the stage for significant reduction or elimination of both tariff and nontariff trade barriers in all key trading nations. More than ever before, U.S. business must look to export market as a means of increasing production, providing jobs, and paying for essential U.S. imports.

As both a major producer and consumer of raw materials. the United States also has an important interest in international commodity markets. We seek to mitigate the effects of commodity price instability through international commodity agreements. Properly constructed arrangements can provide benefits to both producers and consumers by reducing inflationary pressures, promoting greater stability of commodity export earnings, and increasing incentives for primary commodity production. The recently negotiated Natural Rubber Agreement provides an excellent example of an international commodity arrangement which balances producer and consumer interests to their mutual benefit.

Finally, our national dependence on the world economy requires us to cooperate closely with both industrialized and developing nations across a whole range of international economic issues. Economic summit meetings, the IMP, GATT, and OECD are simply a few of the institutions through which we carry out such cooperation.

The multilateral development banks—the World Bank and the similar regional institutions—are the centerpiece of international efforts to mobilize resources to aid developing countries. Our fundamental national interests require a reasonable program of foreign assistance, and participation in the multilateral development banks is a particularly cost-effective approach to development cooperation. For example, the World Bank has lent $50 for every $1 which we have paid into it.

The development banks are efficient instruments of development cooperation. During their 35-year history, developing country growth has considerably exceeded their historical experience or reasonable expectation. Part of the credit for this growth must go to the catalytic effect of external assistance flows, including those from the banks. Positive support for these institutions enhances the likelihood of constructive LDC cooperation in other global institutions which are addressing problems of key importance to the United States.

Each of these individual initiatives forms part of a comprehensive and cohesive U.S. international economic strategy, which supports stable prices and increased employment at home. We can ensure that other countries respond to our vital concerns only if we also respond to their interests. Our own domestic economy can prosper at home only if we maintain, and indeed intensify, our joint efforts with other countries to improve the collective management of the world economy.

V. CONCLUSION

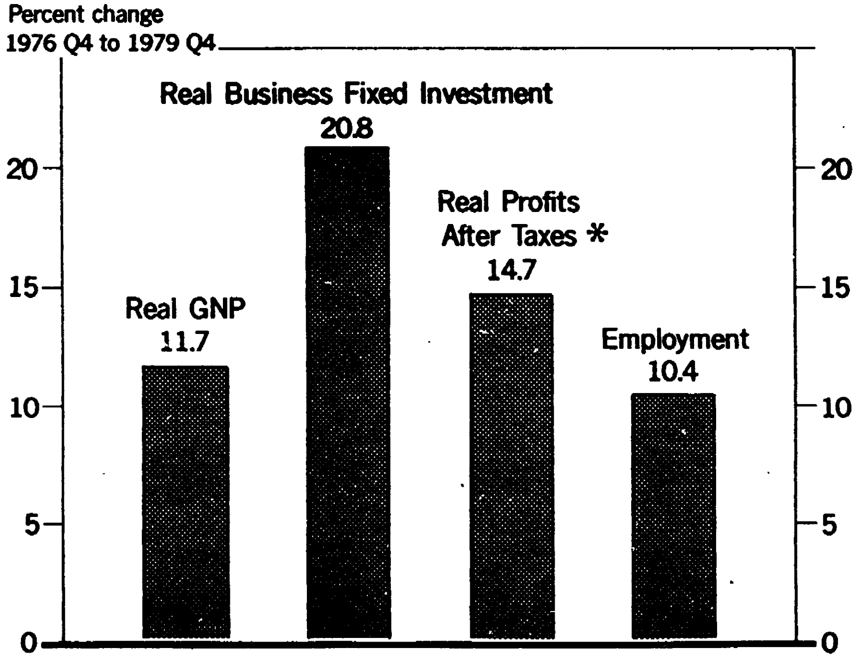
In sum, the 1981 budget is a key element of the Administration's comprehensive program for containing and reducing inflation. This budget attacks inflation in two ways: first, through overall fiscal discipline; second by emphasizing programs which ensure our national security and lay the foundation for a more efficient and productive economy.

THE ADMINISTRATION'S 1981 BUDGET AND ECONOMIC PROGRAM

Department of the Treasury
Office of Management and Budget
Council of Economic Advisers

Exhibit 1

Economic Gains, 1977—1979



* Percent Change from 1976 Q4 to 1979 Q3.

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Exhibit 2

Employment and Unemployment

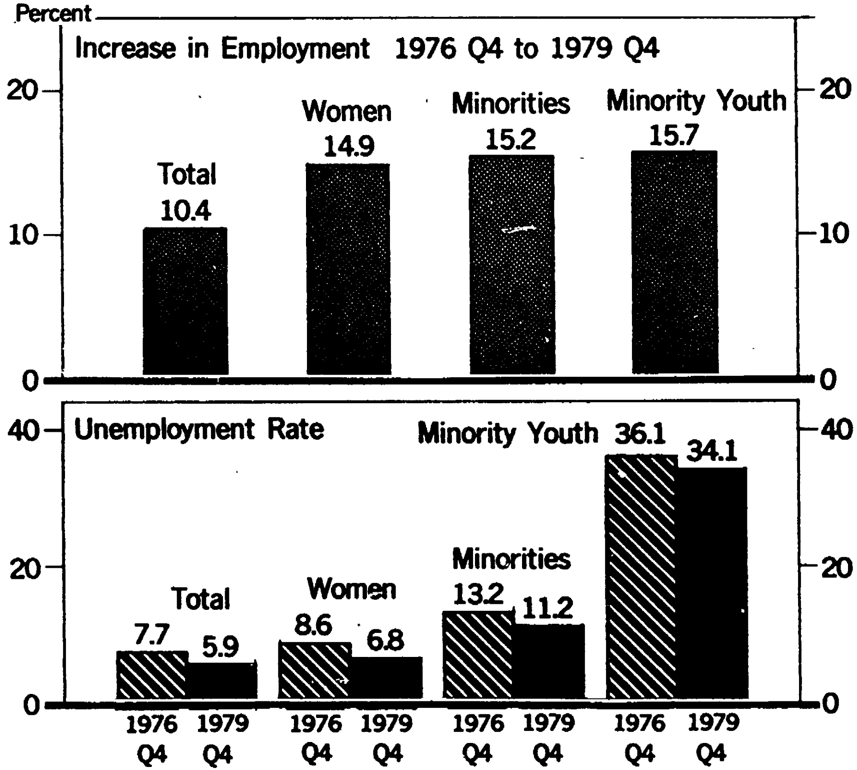
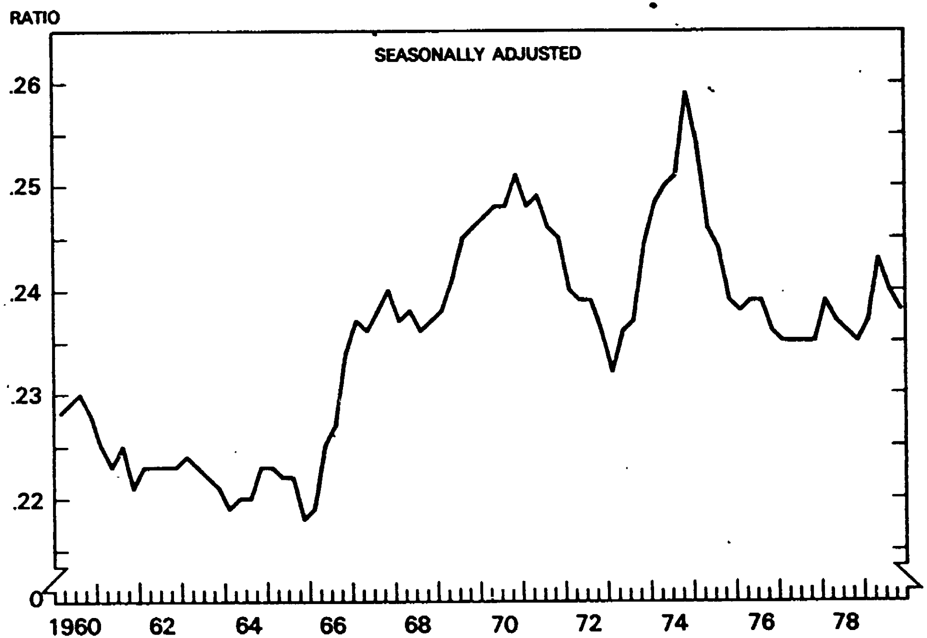


Exhibit 3

Real Inventory/Sales Ratio, Nonfarm Business

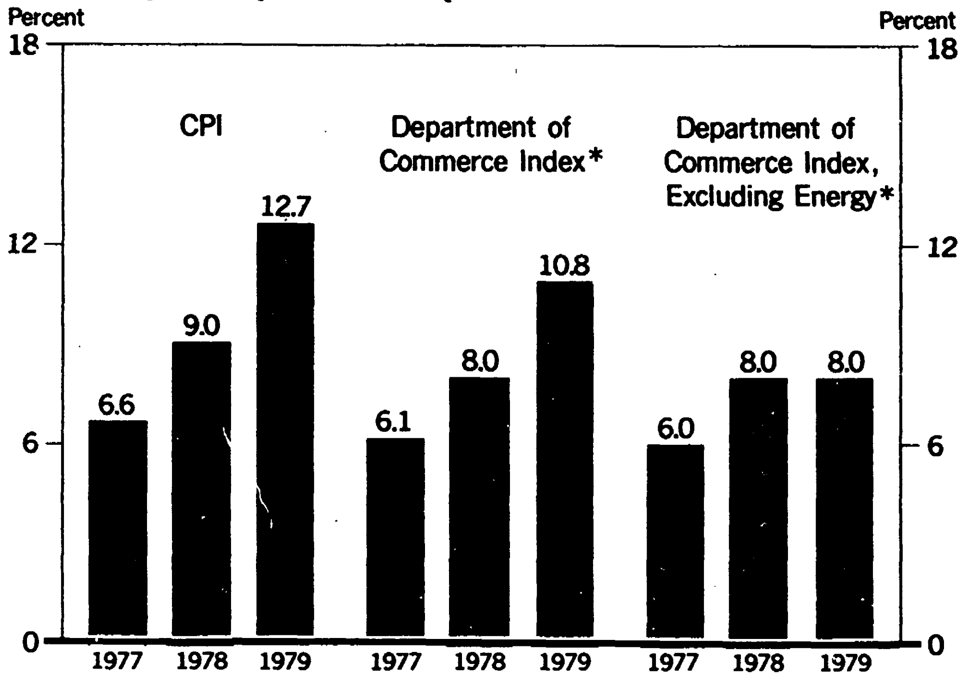


NOTE: RATIO OF REAL INVENTORIES AT END OF QUARTER TO ANNUAL RATE OF REAL FINAL SALES FOR QUARTER.
SOURCE: DEPARTMENT OF COMMERCE.

Exhibit 4

Measures of Inflation 1977—79

Percent Change Fourth Quarter to Fourth Quarter

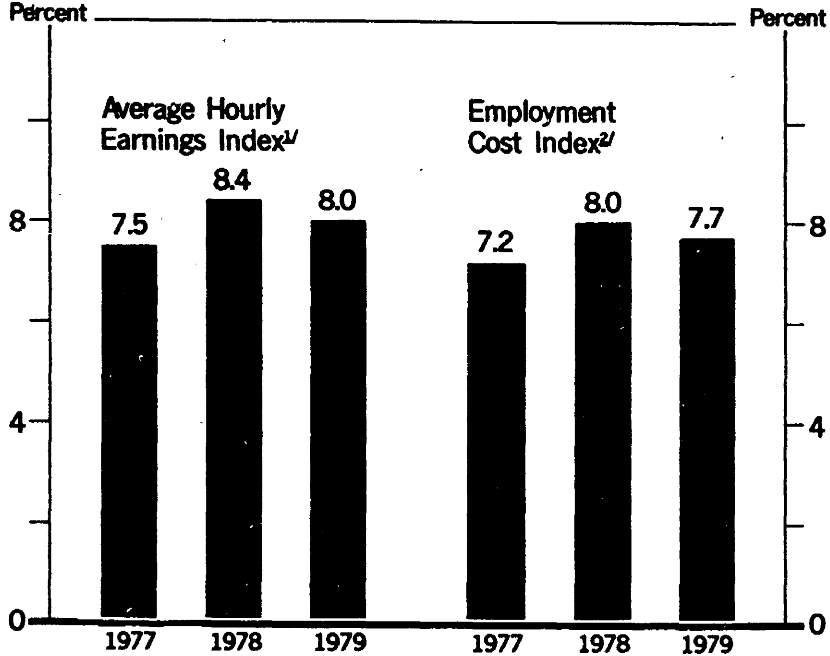


* Fixed-weight price index for personal consumption expenditures.

Exhibit 5

Wage Increases, 1977—79

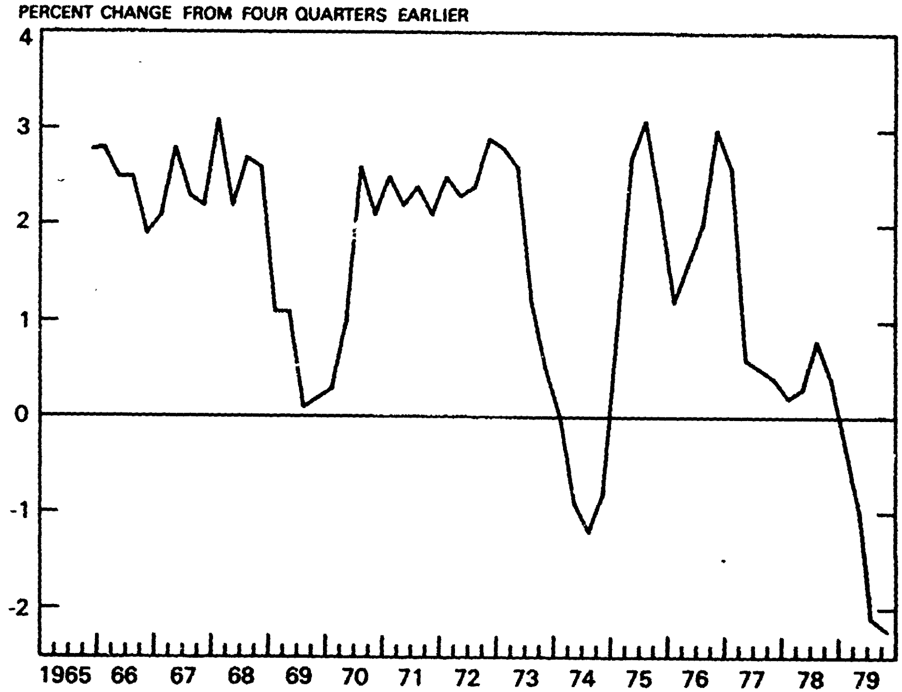
Percent Change



1/ Measured Q4 to Q4
2/ Measured Q3 to Q3

Exhibit 6

Productivity Adjusted for Cyclical Variation



NOTE: DATA ARE FOR PRIVATE NONFARM BUSINESS SECTOR, ALL PERSONS.
SOURCE: COUNCIL OF ECONOMIC ADVISERS.

Exhibit 7

Fiscal and Oil Price Restraint

Billions of Dollars

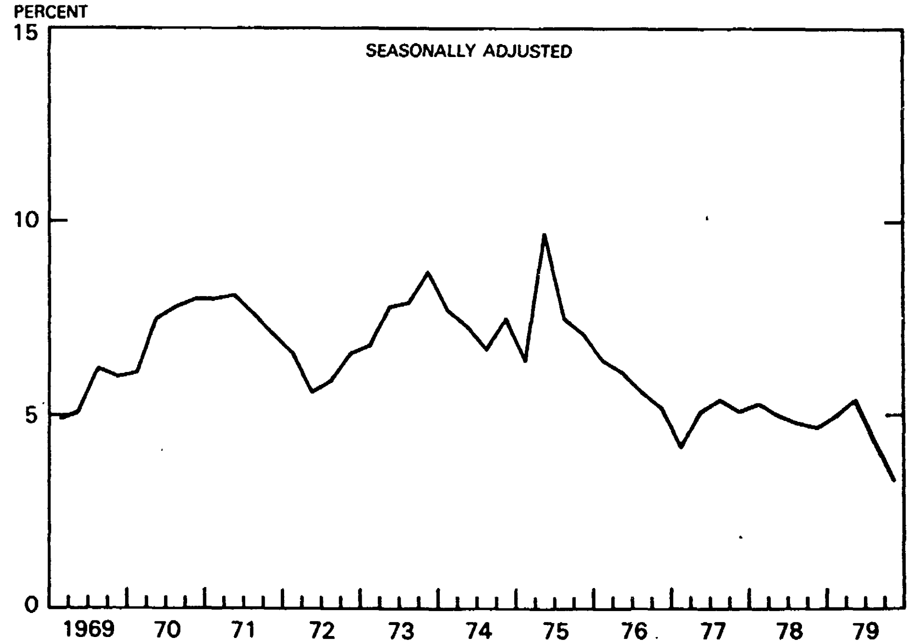
	Change from 1978 Q4:		
	To 1979 Q4	To 1980 Q4	To 1981 Q4
Fiscal Restraint[1/]	20	34	74
Oil Price Restraint[2/]	42	45	42
Total	62	79	116

1/ Changes in the high employment surplus.

2/ Net of respending by OPEC countries and by domestic oil companies out of the additional revenues from higher oil prices. Excludes windfall profits tax and corporate taxes due to higher oil prices; they are included in fiscal restraint.

Exhibit 8

Personal Saving Rate



SOURCE: DEPARTMENT OF COMMERCE.

Exhibit 9

Key Elements of the Economic Forecast

	1979[1]	1980	1981
Change in Real GNP (Percent, Q4/Q4)	0.8	–1.0	2.8
Unemployment Rate (Percent, Q4)	5.9	7.5	7.3
Change in Consumer Prices, (Percent, December/December)	13.3	10.4	8.6

[1] Actual

Exhibit 10

High Employment Budget Surplus (+) or Deficit (—)

Unified Budget Basis

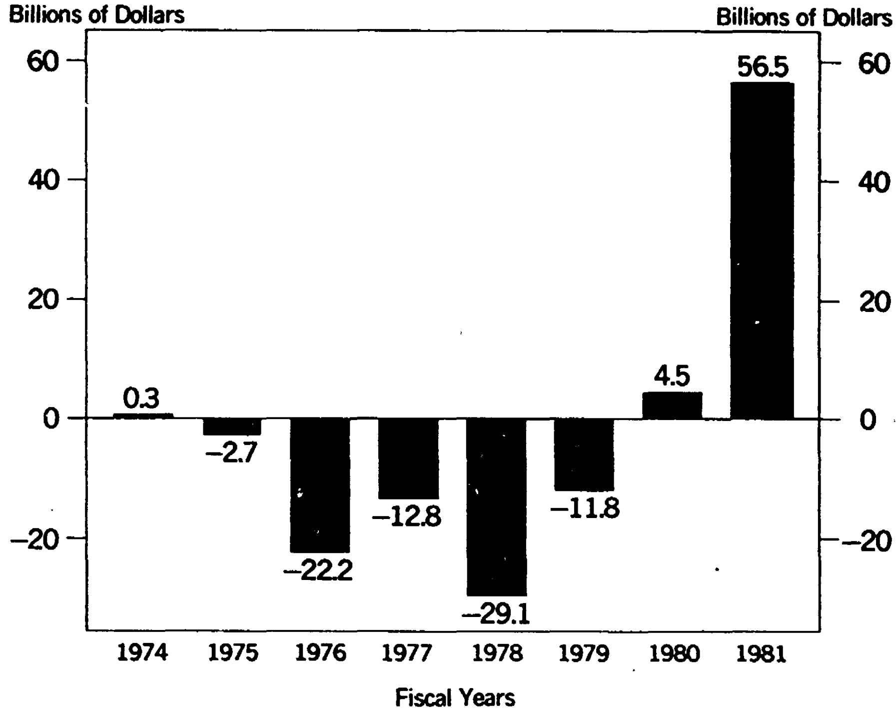


Exhibit 11

High Employment Budget Surplus (+) or Deficit (–) as a Percent of High Employment GNP

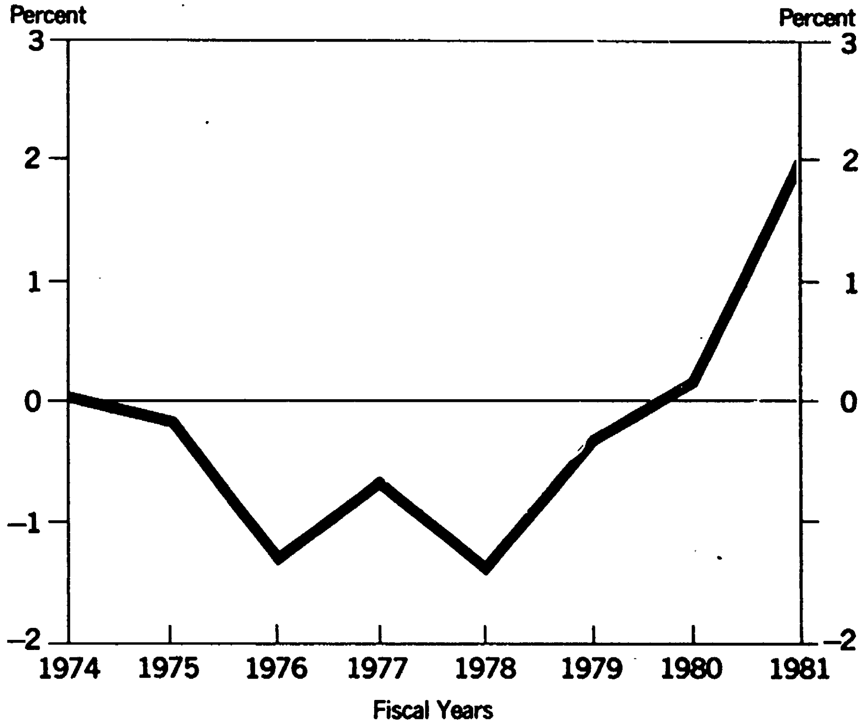


Exhibit 12

The Budget at a Glance

(In Billions of Dollars)

Item	1979 Actual	1980 Estimate	1981 Estimate	1982 Estimate	1983 Estimate
Receipts	**466**	**524**	**600**	**691**	**799**
Outlays	**494**	**564**	**616**	**686**	**774**
Surplus or Deficit (—)	**—28**	**—40**	**—16**	**5**	**25**

Exhibit 13

Current Budget Estimates

(In Billions of Dollars)

Department/Agency	1980 BA	1980 Outlays	1981 BA	1981 Outlays
Agriculture	24.7	23.6	24.6	20.1
Commerce	3.7	3.6	3.4	3.4
Defense—Military	138.6	127.4	158.2	142.7
Education	13.9	12.9	15.5	13.5
Energy	10.5	7.7	10.2	8.7
Health and Human Services	195.4	193.7	222.9	219.3
Housing and Urban Development	35.7	11.6	40.4	11.8
Interior	4.6	4.2	4.7	4.2
Justice	2.5	2.6	2.7	2.7
Labor	28.1	27.5	33.0	31.8
State	2.1	2.0	2.3	2.2
Transportation	17.8	17.3	20.5	17.9
Treasury	94.1	75.8	80.9	80.3
Environmental Protection Agency	4.7	5.0	5.3	5.2
National Aeronautics and Space Administration	5.3	5.0	5.7	5.4
Veterans Administration	21.2	20.7	22.7	21.7
Foreign Assistance	8.2	6.0	5.8	4.7
All Other	42.8	16.9	37.2	20.2
Total	654.0	563.6	696.1	615.8

Exhibit 14

Budget Deficits as a Percent of GNP

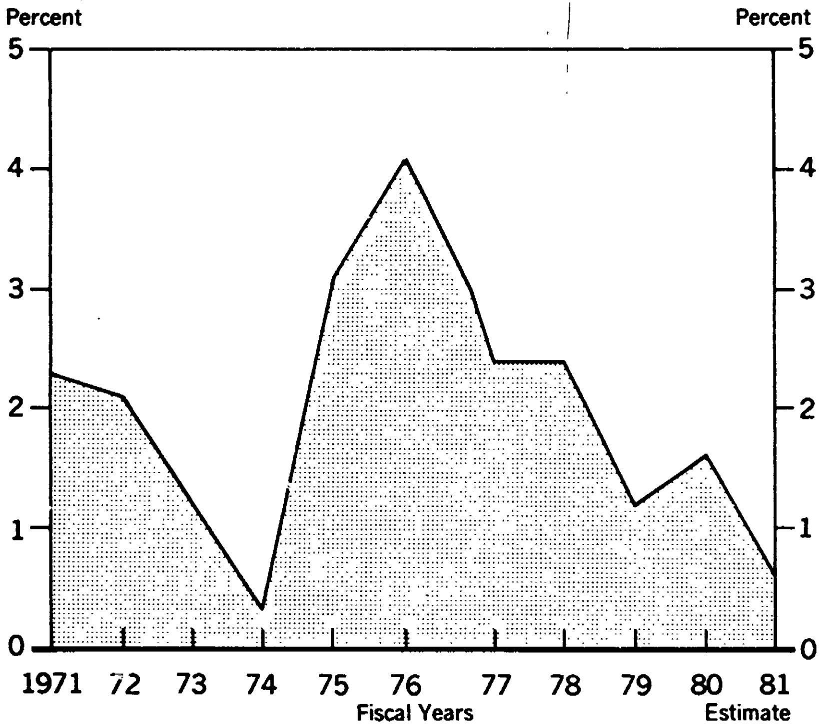


Exhibit 15

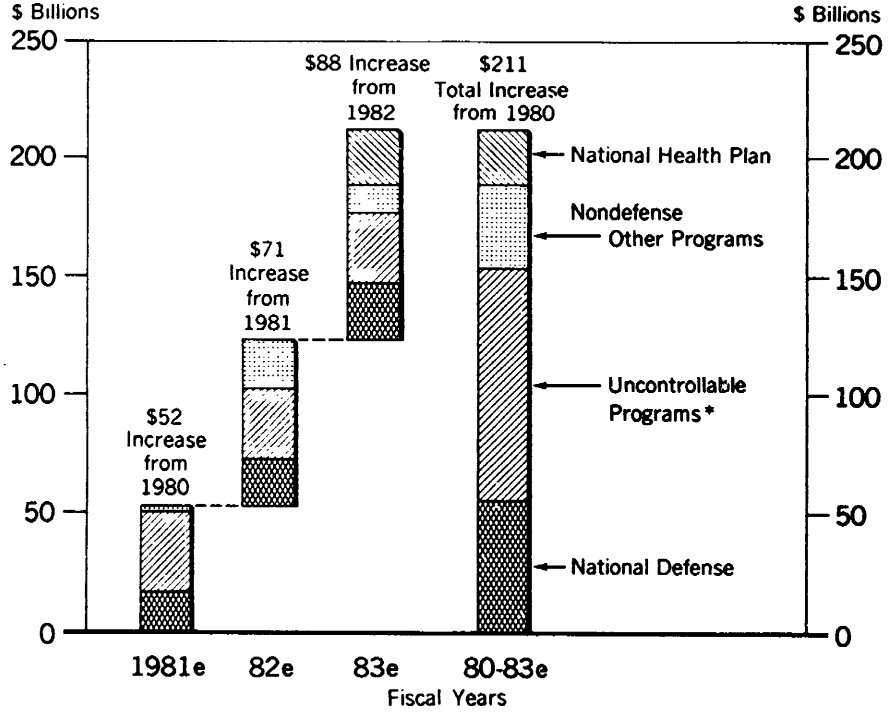
Current Services Estimates for 1981

(In Billions of Dollars)

	Outlays
Current Services	612.0
Major Increases:	
Defense Program Increases	5.4
Energy Programs	1.0
Countercyclical Fiscal Assistance	1.0
Contingencies and Welfare Reform	1.5
Low Income Heating Bill Aid	0.8
Energy-Efficient Transportation	0.6
Other	3.2
Subtotal	13.5
Major Decreases: (—)	
Pay Reform	—2.7
Hospital Cost Containment Savings	—0.8
Interest	—1.2
Export Credit Sales (CCC)	—0.8
Higher Education	—0.8
Other	—3.4
Subtotal	—9.7
Administration Request	615.8

Exhibit 16

Increases in Budget Outlays from 1980



* Excludes Outlays from Prior Year Contracts

Exhibit 17

Budget Outlays - Constant 1981 Dollars

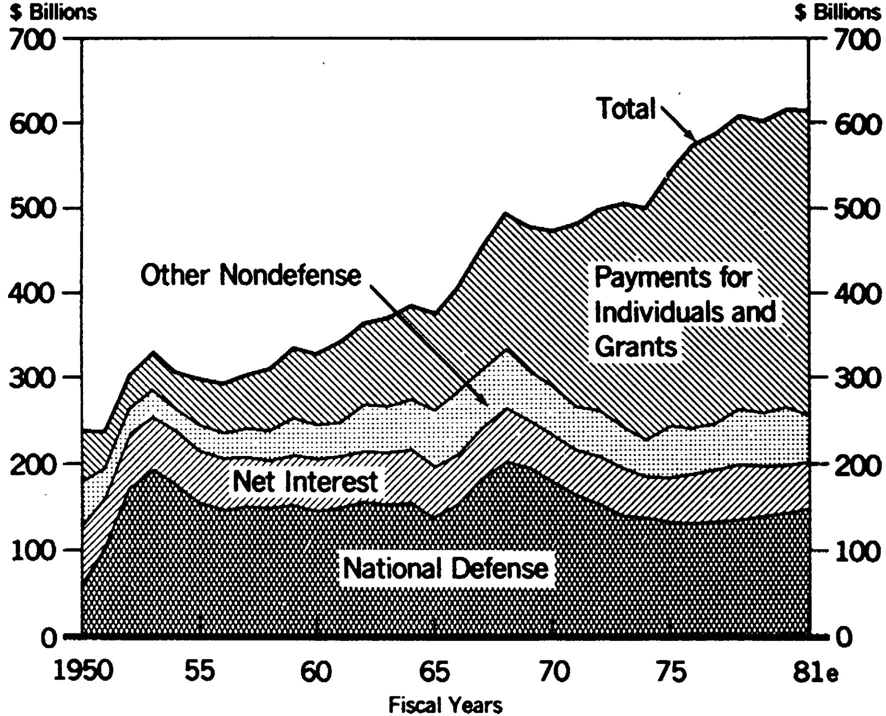


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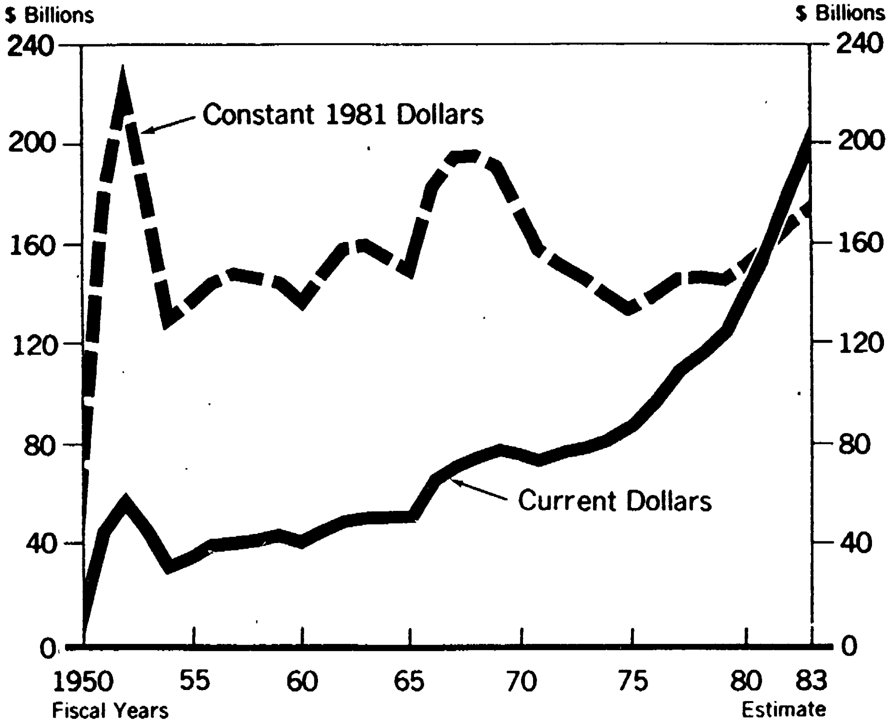
Exhibit 18

Military Programs, 1950-1983*



*Total Obligational Authority

Exhibit 19

Federal Obligations for Basic Research

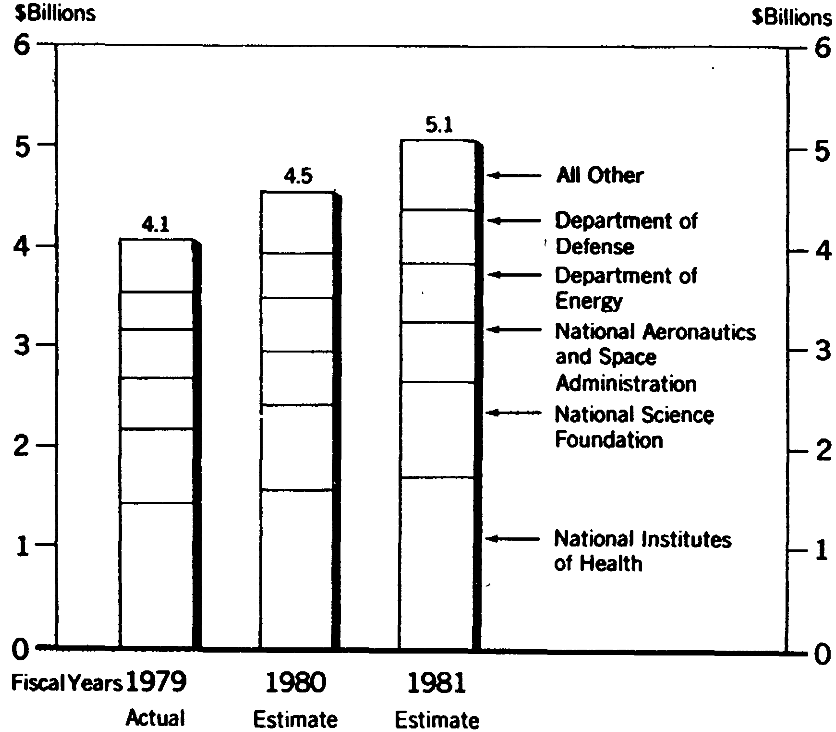
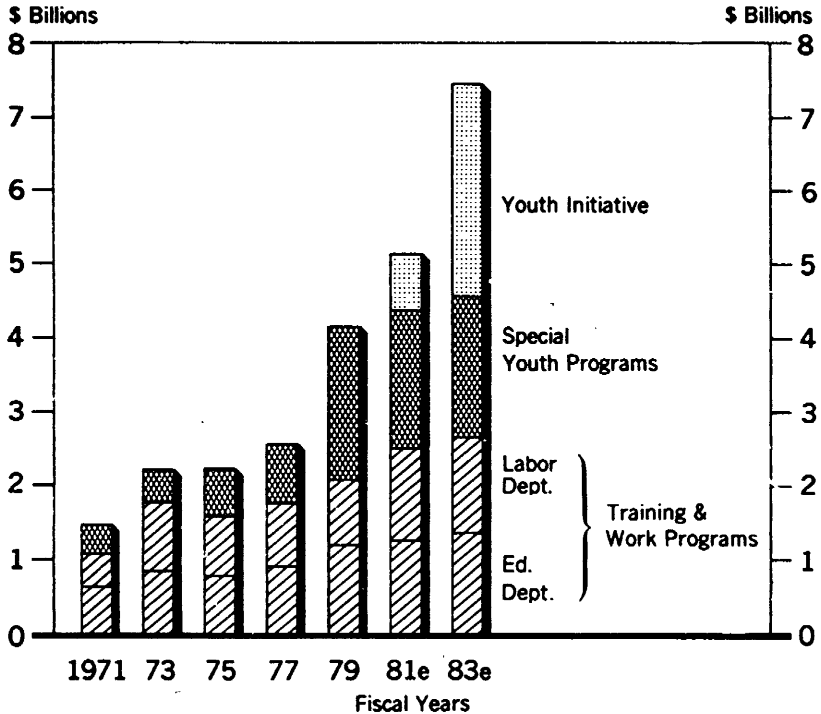


Exhibit 20

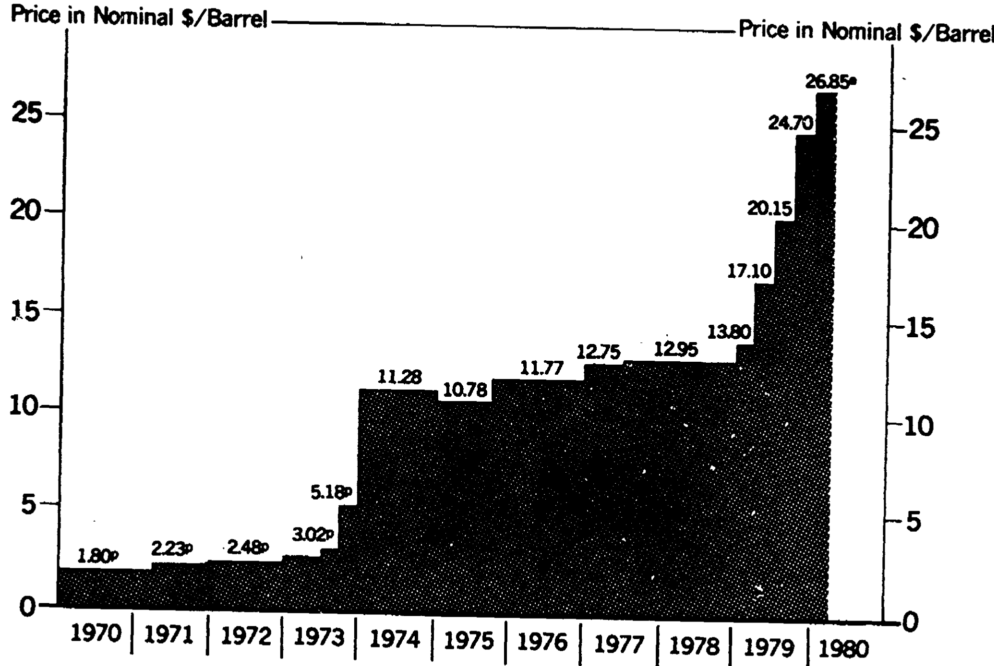
Youth Training and Employment Programs



World Oil Prices

Exhibit 21

Average OPEC Price in Nominal Dollars per Barrel, FAS



Note: Before 1974 OPEC oil usually cost about 60% of posted price. Such discounts phased out during 1974.
p indicates posted reference price.
e, first quarter 1980 estimate.

U.S. Imported Oil Bill 1970–79

Exhibit 22

Nominal Dollars, Balance of Payments Basis

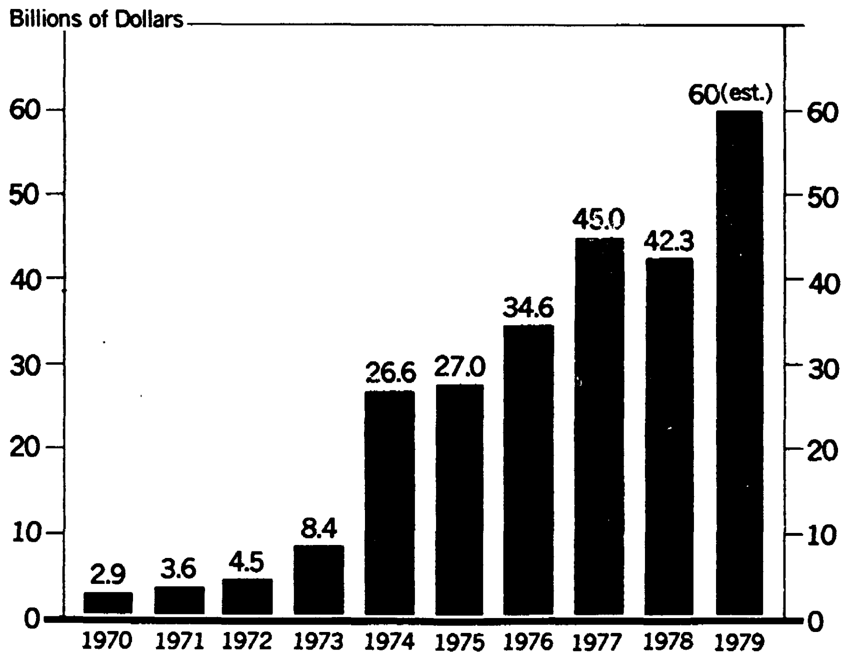
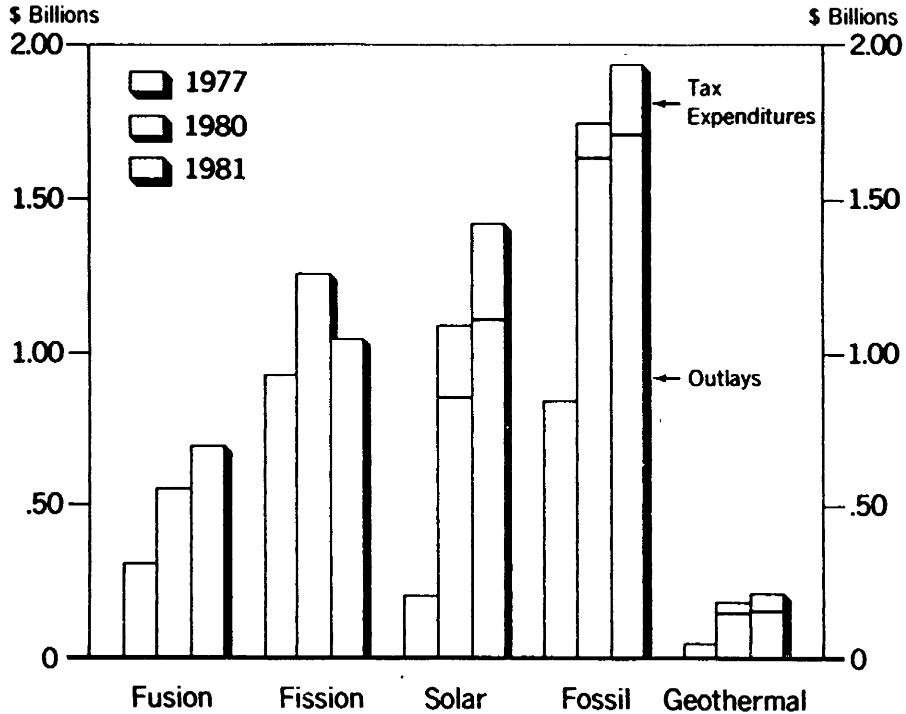


Exhibit 23

Principal Elements of Energy Supply Programs *



* Includes Programs in Other Functions, Excludes Power Marketing and Other

Exhibit 24

Effect of Administration's Oil Import Reduction Program

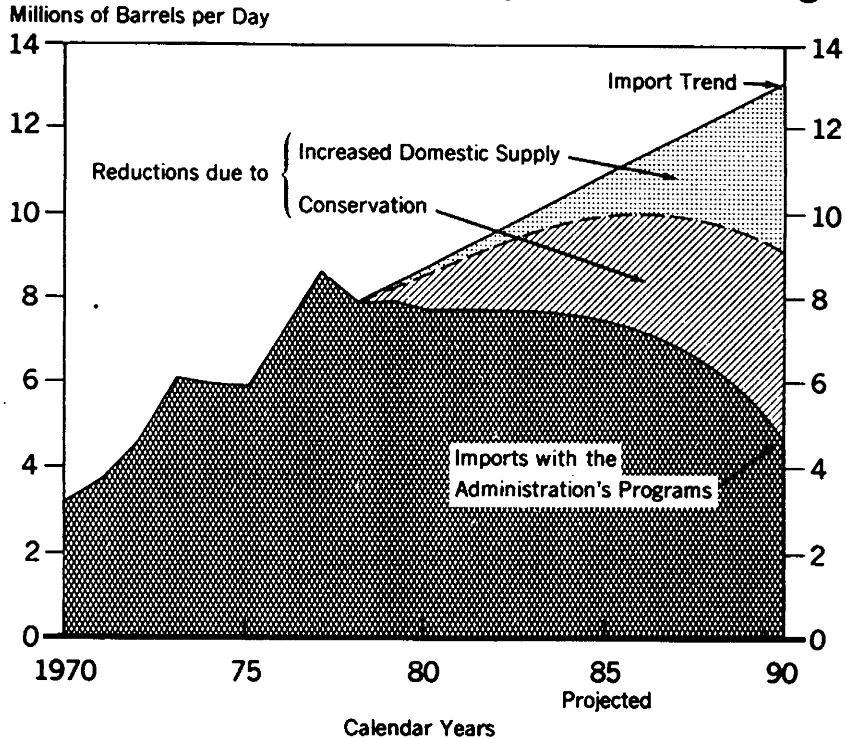
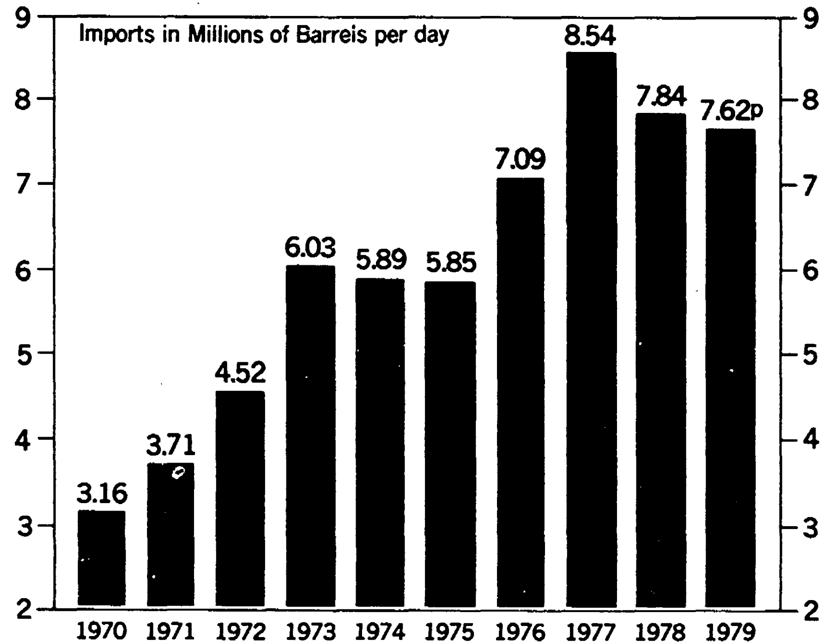


Exhibit 25

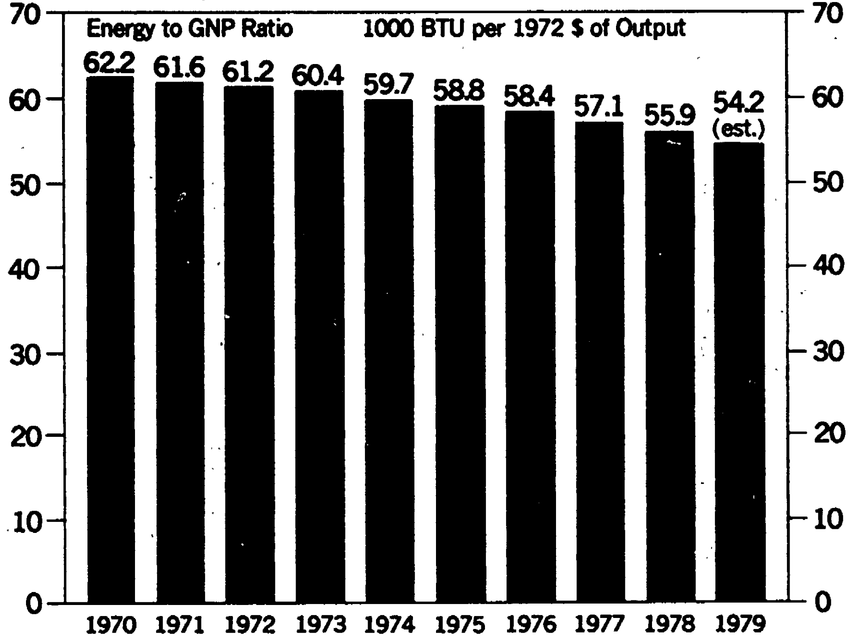
U.S. Oil Imports 1970—79*



*Department of Energy basis. Net of exports. Excludes imports for strategic petroleum reserve.

Exhibit 26

Energy Use per Unit of Real GNP, 1970—79



Representative BROWN. Mr. McIntyre, I thank you for a really very effective capsulization of a very involved budget, and an involved job. And I want you to know that we do, on this committee, appreciate the devotion and specialization that you have developed in this field, and we know that you are under certain admonitions from the administration and those that make the decisions in the administration, wherever and whoever they are, to do certain things and not do other things. And so you will understand that our questioning doesn't represent any personal criticism of you but rather a criticism of policy decisions that have been taken in certain areas.

Now, you said that you had to work within political reality, and I am going to try to keep my questions—I trust somebody on the staff will admonish me—as brief as possible in order to allow Congressman Rousselot of California, who is with us this morning and who is a specialist in the budget area from the congressional standpoint, to get in plenty of time for his questions. You said you had to work within political reality, and the Washington Post, I think within the last day or so, in an article by Robert Samuelson, said: "Calling much spending uncontrollable usually signifies an unwillingness, not an inability, to control it."

Would you comment on that for us, please.

Mr. MCINTYRE. Would you read the last part of his quote?

Representative BROWN. It says, "Calling much spending uncontrollable usually signifies an unwillingness, not an inability, to control it."

Mr. MCINTYRE. I don't know whether Mr. Samuelson has ever tried to control Federal spending; I have. And I would say to you that last year we made recommendations to the Congress specifically on some of the entitlement programs, to try to change the effects of provisions that have been long standing. Frankly, the results of that effort were discouraging. As I have been quoted saying before, some of those proposals are buried so deep in committee they will never see the light of day—at least this year. But that doesn't mean and is not intended to mean that we should not continue to try to deal with those problems.

When we call some spending items relatively uncontrollable, it has a specific meaning. It means that they are uncontrollable under the laws by which those programs are currently authorized. Certainly the Congress can come back and change those laws and can change the effects of those laws. But I don't think even you, Mr. Brown, would quarrel with the fact that if we go out and borrow money and agree to pay a certain rate of interest on that money, we have to pay that rate of interest.

If we enter into a contract to build a ship, then we must continue to fund that contract. Those items are also part of those uncontrollables. To change those kinds of decisions means we would have to reverse policies that we have all agreed upon. It also means you have to violate a contract. And I think our Constitution protects the impairment of an obligation of a contract. But even so, where you have clauses to get out of a contract, it costs the Government money.

So those are the things we are referring to in the budget; those you can change by legislation are not in the purest sense of the word uncontrollable, but from a budget point of view we have to fund those programs unless the law is changed. And to that extent they are not controllable by us.

Representative BROWN. The President has inferred that we can move into the defense area with spending and in some other areas with continual increase in spending without giving us a very strong admonition that we must reduce the expenditures in other areas in order to accomplish a balanced budget. And some of my colleagues in the Congress have said much the same thing.

I must say to you that I think perhaps then we need more than passive leadership, if I can call it that, in this area; that a really vigorous force of attempting to get the Congress to address this problem—it is, after all, the President's Congress in terms of its political orientation—is called for at this point and into the future.

I don't know why the President couldn't have asked, for instance, in certain areas of Government management, for a reduction of, say, 3, 5 percent. After all, on a budget that exceeds $600 billion, a percentage saving of that degree might be significant. And if we could then lay on the further savings of some of the so-called uncontrollables, we might be better off.

Can we anticipate any such kind of vigorous effort by the President?

Mr. MCINTYRE. Well, I think this budget represents the President's decision as to what, in his best judgment, is the appropriate fiscal plan for the Federal Government. It takes into account a number of changes that were made by the Office of Management and Budget in terms of including management efficiencies, looking at various levels of management efficiency and making decisions as to what level we would fund those. It incorporates those kinds of reductions and changes throughout the Government.

Furthermore, the President has made a number of recommendations for savings in this budget that require legislation. I hope that the Congress will act expeditiously on those savings so that we can enjoy the benefits of them.

Let me give you some figures.

The annual real growth of Federal Government spending between 1950 and 1960 was about 3.5 percent. Between 1960 and 1970 it was 3.7 percent. From 1970 to 1977 it was 3.1 percent. The annual real growth between 1977 and 1981 is expected to be 1.1 percent.

Now, that shows a dramatic slowdown in the rate of Federal spending, which is what you're talking about, Congressman Brown. I think we have held down this growth in spite of the tremendous pressure put on us from the so-called noncontrollable programs as well as increased defense spending. That represents some real reduction somewhere.

Representative BROWN. I must tell you I have a son who is in college who is a discus thrower and a weight lifter, and his growth rate has slowed down some but it doesn't stop him from being a little bit unusual in terms of his size. And like him, I think we need to be more aggressive about the prospect of a diet for the Government.

We have talked about the realism of the budget, and I am not, again, trying to suggest any duplicity on your part, but you mentioned interest. You've got an interest reduction in your current services estimate for 1981, exhibit 15, of $1.2 billion. You have hospital cost containment savings of $0.8 billion, and higher education reduction of $0.8 billion. And I guess my question is: How realistic do you think those savings are?

Mr. McIntyre. Congressman Brown, you can't criticize me in one breath for not coming up with changes in the uncontrollables and in the next raise questions about the realism of making changes in some of the uncontrollables, such as hospital cost containment.

Representative Brown. Sure, you can, because hospital cost containment has been fought and fought and fought, and the administration has not won the battle, because the Congress is apparently unwilling to address the problem.

Now, you also just reversed the argument on me a moment ago and said clearly we couldn't reduce interest payments, and then I look at the schedule and see we are reducing interest payments.

Mr. McIntyre. That's right, and the reason for that is very simple. We would expect that that is consistent with our assumptions that inflation will abate in 1981, and therefore our interest rate should go down some, and we have taken that into account. That is simply consistent with our economic assumptions.

And as my associate, Mr. McOmber, points out, there is also a difference in the size of the deficits that will be financed, which also reduces interest outlays in the 1981 budget.

So I think that is consistent.

Our point about hospital cost containment——

Representative Rousselot. Will the gentleman yield just briefly?

Representative Brown. Surely.

Representative Rousselot. How can you show a reduction in interest when the borrowing is going to go up? Your interest rates aren't going to come down that much. That is what I have never understood in the whole budget proposal for 1981.

Mr. McIntyre. That is because the proposed deficit is lower than the current services deficit.

Representative Rousselot. But the actual debt will go up by at least $15 million.

Mr. McOmber. By more.

Mr. McIntyre. Mr. McOmber can speak to this.

Mr. McOmber. Mr. Rousselot, the interest does in fact increase. What you are looking at, what Congressman Brown called attention to, is a reduction in current services, that is, a reduction that shows up because the current services deficit is higher than the budget deficit.

Representative Rousselot. But it is a reduction in interest cost only in current services, not in overall budget, and that is the misnomer.

Mr. McOmber. Yes, Mr. Rousselot, the actual interest payment will increase in the budget, no question about it.

Representative Rousselot. Thank you.

Representative Brown. In your opening statement you talked about political reality, and I am trying to address political reality in a couple of different ways here. The reality, I assume, is that a majority of the House has sponsored 10–5–3 legislation, that is, the legislation to increase the amount of depreciation allowable to certain industries in the country under certain different bases, for building, equipment, and so forth. And the majority of the Senate has cosponsored or endorsed similar support for 10–5–3.

On the basis of political reality, it seems to me, then, that it is appropriate to suggest that the administration might want to endorse that proposal as a means of stimulating industrial expansion because, with that kind of a depreciation rate, it occurs to me we might have a very positive investment in industrial modernization in this country, in other words, a capital boom, at the same time we are anticipating a recession in our productivity of goods and services, which is implicit in your budget, and that those two things, if they were to balance out, might make for more optimistic assumptions in your judgment of what happens with the budget. Do you follow what I'm suggesting?

Mr. McIntyre. I think I understand. I will make a general statement and ask Mr. Van Ooms, my chief economist, to elaborate on it.

First of all, we do not think the time is ripe right now for tax reductions. If and when a tax reduction becomes appropriate, one of the things the administration would have high on its list to look at would be some simplification and improvements in the way that we deal with depreciation. But now the time is not appropriate for tax reduction. When it is, then we will look at it.

Between 1982 and 1985 the tax burden will be increasing substantially. Eventually, action will have to be taken to reduce the tax burden. Do not misunderstand, no one has foreclosed the idea that something needs to be done. I would have some quarrel with the 10–5–3 concept. Severe distortions would result in it if we go that route.

Let Mr. Ooms make a comment on it.

Mr. Ooms. Congressman Brown, I would comment in addition only to say I think this is very much a question of timing. The timing of a tax cut is critical. One would run an extremely grave risk of overstimulating the economy by recommending a tax cut at this time on the assumption that the economy would be a good deal weaker in 1981.

Forecasts have been wrong. To assume we are going to have a weaker economy and to find out, as the administration and forecasters over the country have found out, that the economy was a great deal stronger would mean that we would add the inflationary impetus of aggregate demand to an economy which was not soft. We would run the risk of passing through the oil price increases that we have seen in the inflation rate in 1979 into permanent double-digit inflation. We feel that would be too great a risk to take. The administration does not wish to take this risk because it does not believe people are prepared to live with double-digit inflation as a fact of life.

To conclude, we are sympathetic, but we don't think at this time it would be responsible to recommend a tax reduction.

Representative Brown. We agree with you that every American doesn't want to live with double-digit inflation. The fact is that he is living with it now. He is living with it now in a time that has been considered to be a relatively good time. He is also living with higher rates of unemployment, in a relatively good time, than have been accepted as tolerable in recessionary periods just two recessions back.

And I would suggest to you that in the current pattern of stagflation the demand-management approach just has not worked. We never quite break the inflation with the unemployment that is induced by

Government policy recessions. And we never quite break the unemployment rate with the Government policy stimulations of demand that eventually follow it.

And so what we have is a ratcheting up, what I have called an "iron-maiden" kind of economy. You twist one way and get spiked by unemployment and twist the other way and get spiked by inflation, and each spike goes in deeper than in the past. That is why we are trying to find some method to break that pattern so that we can get away from that.

My time is long since up, and I yield to the gentleman from California, Mr. Rousselot.

Mr. CUTTER. May I comment on your comment on stagflation?

Representative BROWN. Surely.

Mr. CUTTER. It seems to me one has to couple that remark with a recognition that the labor markets during this decade have been dramatically different than they have been in previous decades. I think the rate of entry into the labor market is something like three times, in terms of absolute numbers, in the 1970's what it was in the 1960's and latter part of the 1950's. And I think you have evidence that suggests that will slow again.

I think the ratio of employed to the employable population, as opposed to the unemployment statistics, is at a high point.

I suspect if you took the rate of employment creation that we have seen in the last few years and moved that to a different time, you'd be able to argue that the economy has performed better in that sense than in a previous postwar period.

So I think while it is an important point to make, that we seem to have throughout the 1970's ratcheted up inflation, it is also important to couple that with an understanding that the labor market problems have been extremely difficult.

I don't think one would want to argue that the 5.9 unemployment rate that we experienced in the last year is too high, abstracting from its distribution, some of which is highly inequitable, particularly the rate for minority teenagers.

Representative BROWN. The gentleman from California.

Representative ROUSSELOT. Thank you. And again let me express my appreciation for your willingness to be up here. You must spend half your time testifying before Congress. And we appreciate your willingness to, I'm sure, repeat many times, but I am grateful to you, Mr. McIntyre, for being here.

I want to be sure that I understand your current budget estimates for 1981. Under "Outlays" you show Treasury at $80.3 billion. That is mostly interest charge, I assume, interest on the debt?

Mr. MCINTYRE. A large portion of it.

Representative ROUSSELOT. What is it for 1981? As I recall, it was $64 billion.

Mr. MCINTYRE. $79 billion.

Representative ROUSSELOT. And the $80.3 billion figure is $79 billion?

Mr. MCINTYRE. That is a gross figure. Seventy-nine billion dollars is also a gross figure. We net that out because Treasury also gets interest receipts. So that is a gross figure.

Representative ROUSSELOT. Well, then, clarify for me what you mean by a gross figure. The one that I saw—as you know, in our budget resolution we separate out interest as a separate functional category; you have combined it with Treasury. And so what I am trying to identify is interest.

You say it's $79 billion?

Mr. MCINTYRE. That's the gross amount of interest that we will pay; yes.

Representative ROUSSELOT. So you have very little for the Treasury in there. Is that just their cost of doing business, the difference between $79 billion and $80.3 billion?

Mr. MCINTYRE. I am trying to find the exact figure for you in the budget, and I will have to do that, Mr. Rousselot. What happens is we net out against the gross amount of interest receipts the Treasury gets from repayment of loans and things like that, in which the Treasury actually receives interest payments.

Representative ROUSSELOT. So part of that is repayment. It is not just pure interest charge.

Mr. MCINTYRE. When you net it out. We will have to appropriate outlays in the budget for interest payment lower than the $79 billion.

Representative ROUSSELOT. As I recall your budget document, it was about $64 billion.

Mr. MCINTYRE. That's about the range. That is the figure I was trying to find for you. And the rest of that amount in Treasury would be for its operations, and some of it would be the multilateral development banks.

Representative ROUSSELOT. Which I think we should separate out.

Mr. MCINTYRE. Others would be general revenue sharing.

Representative ROUSSELOT. That is a separate category, too.

Mr. MCINTYRE. Which also shows up in the Treasury.

Representative ROUSSELOT. I was just trying to interpret what you have given us here.

Mr. MCINTYRE. The total outlays for interest would be $67 billion.

Representative ROUSSELOT. $67 billion?

Mr. MCINTYRE. Yes. That is the net.

Representative ROUSSELOT. Now, coming back very quickly and talking about forecasts, as you know, the administration's projections for inflation weren't too good. I think in your original budget it was 7 percent. It ended up being, at the end of the year, close to 14 percent.

The point was made here that we have to look at forecasts and forecasts sometimes can be very wrong.

So I think when many of us are talking about tax cuts, all the Treasury's forecasts on what will happen if we have tax cuts haven't been very good. As a matter of fact, your forecast of what would happen if we reduced the capital gains tax was just dead wrong. So your record—the Treasury as a whole; I'm talking about going back in time frames, not just those of you who are there now or related to it—hasn't been that good when the Ways and Means Committee, on which I sit, asks for projections of what will happen if we have a tax cut here or there or somewhere else. They have been just plain lousy. So I am not sure your projections of what would happen if we had some kind of modest tax cuts in personal taxes, corporate taxes, and other places are all that good as to what would happen to the revenue.

I am not one of those who say that within 1, 2, or 3 years we are going to regain everything. But again I hope you will all study the testimony that we have had for the past week at the Ways and Means Committee from an awful lot of people that have come in to describe to us what their guesses are as to what will happen if we have tax cuts.

Now, I want to come back to this. Have you really looked at the various recommended tax cuts for a long period of time, as to what the ultimate effect will be, say an across-the-board cut in personal tax, or some kind of reduction in a corporate tax—as to what that does in the generation of new potential income?

Mr. McINTYRE. Let me address several questions you have raised.

First of all, with respect to the accuracy of the administration's forecast, I might point out to you that I don't know how many but I would suggest that not very many forecasters were accurate on inflation for 1980, including the Congressional Budget Office.

Representative ROUSSELOT. Some of us in Congress said it was going to be far higher than 7 or 8 percent. We could see that as early as last May and said so in the debate on the budget resolution. As a matter of fact, in my budget proposal that I had as a concurrent resolution, I said it would be at least 10 percent.

But go ahead.

Mr. McINTYRE. We recognized it also, and in July when we published our updated estimates we increased our estimate of inflation to 10.6 percent.

Representative ROUSSELOT. Right.

Mr. McINTYRE. Now, you know I don't pretend to be a clairvoyant. I am not an economist. I have two good economists on either side of me, though. But I think with respect to the administration's estimates, there is one thing you can say about them; We have been as candid as any administration has ever been and more candid than most with respect to our economic assumptions. That doesn't mean we are going to hit everything right on the nose, but we have tried to do an honest job of forecasting. And if we had shaved the unemployment figures a little bit, we could have presented you a balanced budget.

Representative ROUSSELOT. That's right, but you just didn't influence enough members of the Democratic Party in the Congress as to what the inflation rate would be. Because the Democratic leadership in the House stuck with far below 10 percent. So I guess our problem is you didn't influence them when you came up with your estimates. And I do recognize that your estimates were a lot better than the Democratic leadership in the House or the Senate as related to inflation, which does affect tax receipts and does affect other items in the overall budget.

I guess what I'm asking is: If we had some kind of tax cuts, say in the neighborhood of $20 to $25 billion, put into the 1981 budget, it would not mean an absolute direct loss in revenue for the whole year of $20 to $25 billion, which is usually the response when you talk about tax cuts.

Mr. McINTYRE. Obviously, Mr. Rousselot, over a period of time there would be some feedback into the system as a result of that.

Representative ROUSSELOT. You and I understand that.

Mr. McIntyre. As far as that first year, there would be some losses the first year.

Representative Rousselot. What do you usually figure would be the loss?

Mr. McIntyre. Well, it is more than the feedback. What are your calculations on feedback and loss?

Mr. McOmber. Somewhere in the range of 30 and 40 percent.

Representative Rousselot. Feedback?

Mr. McOmber. Yes, but not the first year.

Mr. McIntyre. You wouldn't get that at the end of the first year.

Representative Rousselot. What do you think you'd have at the end of the first year?

Mr. McOmber. Something closer to 20 percent. But, Mr. Rousselot, to back up, the reason you'd have feedback would be because of a higher level of economic activity either in real activity or prices. It goes back to the comment I made earlier.

Representative Rousselot. You assume all tax cuts immediately increase all prices?

Mr. McOmber. No; but I'm saying within a quarter or two, a tax cut is likely to increase either consumption or investment demand by a significant amount.

Representative Rousselot. Both investment and consumption?

Mr. McOmber. That would depend very much on the structure of the tax cut.

Representative Rousselot. But I'm saying it doesn't all go to price increases at the consumer level.

Mr. McOmber. That depends on whether or not the economy is operating close to full capacity. If the economy continues to operate close to capacity and then you cut taxes, you are running a grave risk of accelerating the underlying inflation rate into a double-digit level.

Representative Rousselot. It is already at double digit. It is already at double digit; right? Isn't that correct?

Mr. McOmber. The underlying——

Representative Rousselot. Isn't that correct, that it is already at double digit?

Mr. McIntyre. No; it is not.

Mr. McOmber. I have been referring to the underlying inflation rate.

Representative Brown. Explain to us the distinction between the underlying inflation rate and the current inflation rate, if you will, that is at 13.3, I think, based on the past year. That seems to be a fairly long period of time of high inflation.

Mr. McOmber. The 13.3 percent increase in the CPI was heavily impacted by energy prices and by an increase in mortgage interest rates which was part of the Federal Reserve's anti-inflationary policy. We do not expect those factors to continue.

Representative Brown. You don't expect the Federal Reserve to have an anti-inflation policy?

Mr. McOmber. We expect the Federal Reserve to maintain a policy of continuing restraint. We do not believe that means continuing rises in interest rates. Abstracting from the rise in interest rates and the rise in energy costs, the CPI rose about 9 percent last year. Our estimate is the underlying rate of inflation, which is the rate imbedded in the economy, which is in the 8- to 9-percent range. We would expect

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the actual CPI as measured to come down toward that range over time.

The risk that we take from overly stimulative policies, from not following a policy of restraint, is that we will ratchet up that underlying rate. We feel that is a risk we dare not take.

Representative ROUSSELOT. To come back to my questions relating to what are your calculations as to what the impact is on revenues as it relates to tax cuts, it is not a total loss of all the revenue of the tax cut in most cases. You say that you use a 20-percent feedback factor by the end of the first year of a tax cut going in place?

Mr. MCOMBER. It depends on the structure of the tax cut. Some would impact more slowly and some more quickly with respect to feedback.

Representative ROUSSELOT. And tax cuts are not all highly inflationary. They may contribute to capacity; they may contribute to the supply side.

Mr. MCOMBER. Over the longer term there may be very significant contributions, and that is a point that there is no quarrel with. The problem that we are talking about is those supply side effects tend to take a fair amount of time to come into effect.

Representative ROUSSELOT. How much time do you normally calculate they take?

Mr. MCOMBER. It depends again very much on the type of tax cut.

Representative ROUSSELOT. Let's take the capital gains tax. We have just dealt with that and reduced it rather substantially. Was that a big portion of the inflation?

Mr. MCOMBER. I don't know of any estimates that have tried to separate our the capital gains cut.

Representative ROUSSELOT. You look at it because it's a Treasury revenue.

Mr. MCOMBER. As I remember, the major support of the capital gains tax cut was that it would lead to a 40-percent increase in stock prices, which we have not seen.

Representative ROUSSELOT. I realize you probably won't have all the facts in on that until probably July, but I remember Treasury testifying what the devastating effects would be of reducing the capital gains tax—and it hasn't turned out that way, unless you say to me that what resulted was that it was highly inflationary. Was it?

Mr. MCOMBER. We have no way of separating out the effects of the capital gains tax from the other parts of the taxes that were enacted in 1978.

Representative ROUSSELOT. But you have testified that tax cuts tend to be overstimulative and do stimulate inflation. That is what we are discussing. And we have a specific capital gains tax. I realize July will be a better time to analyze it because it will have a full time to run.

Mr. MCINTYRE. Congressman Rousselot, we have not said that under all circumstances and any circumstances all tax cuts are inflationary.

Representative ROUSSELOT. I am delighted to hear that. That is certainly progress.

Mr. MCINTYRE. But what we have said is that now is not the time to have a tax cut.

Representative ROUSSELOT. Yes, it is timing you have thrown back to me.

Mr. McINTYRE. I know you have an interest in seeing Federal spending reduced as much as I do——

Representative ROUSSELOT. Yes.

Mr. McINTYRE [continuing]. And want to see the budget balanced.

Representative ROUSSELOT. Absolutely.

Mr. McINTYRE. You can't cut taxes without raising the budget deficit. Do you want to do that?

Representative ROUSSELOT. No; I certainly don't want to increase deficit spending, and you know I don't, and in all the arguments I have made in a counterproposal that I have made in a budget resolution I have explained why I think certain tax cuts are not as inflationary as some of the statistics coming out of Treasury—maybe not your office—have tried to indicate. I realize there's a difference in tax cuts, that there is a different effect from different tax cuts. But I say they don't all go to consumption and overstimulation.

Mr. McINTYRE. The problem about people who want tax cuts right now is for some reason they are not looking at the fact that a tax cut is going to increase the budget deficit. And most of the people advocating tax cuts right now are the very people who are trying to balance the budget.

Representative ROUSSELOT. Many of those people who advocate a balanced budget with some kind of tax cut also believe that there could be a better job done in restraining the increases in Federal spending.

Mr. McINTYRE. Congressman Rousselot, the record to date is that we have not been able—and I say "we" because the Congress is a partner in this act.

Representative ROUSSELOT. Very much a part of it.

Mr. McINTYRE. We have not been able to restrain Federal spending any more than the President has recommended to you, and in fact in many cases we have had to battle very hard just to hold the President's restrained level.

Representative ROUSSELOT. I want to address that issue in just a minute.

Representative BROWN. Each of us has overused our time.

Let me pursue the gentleman's point because I want to ask it specifically.

You said that some tax cuts were less inflationary than others. And could you give me an example of which tax cuts you think are less inflationary and which are more inflationary?

Mr. McOMBER. Over the very long term, clearly tax cuts which tend to increase capacity, supply-side economics, if you like, will tend to be less inflationary over the long run than tax cuts which are directed only at stimulating consumption. Even here, one must be very careful to note that consumption itself tends to be a major force over the long term in raising the level of investment.

In the short run—and the short run is the concern that I was addressing in the question about fiscal policy and restraint that is needed at this time—unfortunately, you have a dilemma with respect to investment. Investment can be as inflationary as defense spending and consumption spending in the short run. It creates an aggregate demand for goods and services.

Representative BROWN. If you have open plant capacity, that is not so true.

Mr. McOMBER. That is precisely the distinction that needs to be drawn.

Representative BROWN. I run a business, as I noted to you in my opening remarks. I guess I don't run it as much as I preside over it because someone else is aggressively running it and I serve four times a year as the chairman of the board. But if I had assurance that my depreciation rate—and we make one other assumption, that the business will be profitable so I have something to take a depreciate rate against—if the assurance is there for me that I will return to my business or save in my business through a better depreciation schedule an increased amount of money—in other words, return less to the Federal Government in taxes—then I am much more likely, to replace old, and perhaps in terms of the technology, inefficient equipment with new equipment.

Do you understand that? Or would you agree with that? I don't want to make any assumptions here that you find offensive.

Mr. McOMBER. I would agree to that, that not only with respect to 10–5–3 but with respect to any other tax cut which raises the rate of return on capital.

Representative BROWN. All right. So the point is I am much more likely to invest in the replacement of that equipment sooner than later. And that does stimulate the economy. And if we are anticipating, as I think we are currently, a recession of some kind, that is, a lowered growth, then doesn't it follow that it might be desirable to accept 10–5–3 and the political reality of it in the Congress because that may be the least expensive tax cut in the Federal Government? In other words, the bite doesn't come at one whack. It comes over a period of years because the depreciation rate increase by a modest amount does not reduce my taxes by that much, but it gives me some assurance as an investor in that new piece of equipment.

Do you follow me?

Mr. McOMBER. Certainly I follow you, Congressman. And if one could be certain of the forecast, that would be a very defensible policy. I simply state again that because we are uncertain of that forecast, we feel that the risks of stimulating that investment prematurely in an economy without that additional capacity runs grave inflationary risks, and for that reason the question of timing is essential, and for that reason the President has not recommended tax reductions.

Representative BROWN. Let me just say to you that some of the equipment I will buy will be foreign-made equipment because we previously, through the tax system, destroyed the industry that produces some of that equipment. I happen to be in the printing business, and we are not doing well in the printing business in the United States in terms of the capital goods produced in the printing business. So I am not tightening up any market in the United States or any industry in the United States that exists. And if I had the assurance that we were going to be able to buy an American product, I'd be even more passionate about doing it. But I'm afraid that we may have, at least at the present time, lost some of those producers altogether because of the nature of our tax system.

I might throw in as a matter of information that the DRI has told this committee that 10–5–3 will take something like 3 percent off the inflation rate over the next 10 years. And if that happens to be true, then it seems to me that we are at the point where we ought to be getting started.

I would just like to submit a couple of questions for the record, and then I am going to turn back to Mr. Rousselot for a couple of minutes.

Let me just ask, Mr. McIntyre, did you endorse, or was it shoved down your throat, the recent administration proposal for a bill for countercyclical spending? Because it seems to me that that is an area where you might have gotten loud support on Capitol Hill to hold the line.

Representative ROUSSELOT. It is called a controllable expense.

Mr. MCINTYRE. Going back go your opening statement also, Congressman Brown, I have responsibility for making decisions and making policy, and do so.

In that particular case, as you well know, that recommendation was made to the Congress last year. It was made as one of the measures that would be available should we move into a mild recession. It was made to help State and local governments who would be adversely affected.

Frankly, that particular proposal is a direct result of my stubbornness and my refusing to go along with something that would have been probably a little more generous.

I thought that that was satisfactory and therefore I supported it.

Representative BROWN. Your ability to testify is certainly admirable—and with a straight face, too. [Laughter.]

Was there an adjustment in the defense spending in the budget, either in the budget authority or outlays, after January 1, 1980?

Mr. MCINTYRE. Not after January 1, 1980. We had been preparing for a fairly sizable increase in defense spending for several months. We went into the fall process with that in mind. We looked at the overall program. We had already planned, for example, for such things as enhancing our rapid deployment force capabilities. So we felt that we had a high level of expenditure already planned in the budget, and therefore the budget would be adequate to deal with current situations.

Representative BROWN. So the Afghanistan invasion did not modify your defense budget, in fact?

Mr. MCINTYRE. We had already, in my judgment——

Representative BROWN. Anticipated the Afghanistan invasion?

Mr. MCINTYRE. No, I did not say that. We had already included in the budget a very high level of defense program and expenditures. This budget is not a budget designed to fight a war.

Representative ROUSSELOT. We understand that.

Mr. MCINTYRE. It is not designed to do that. But it is designed to enhance our military capability.

Representative BROWN. I understand that and admire you for it. The Afghanistan invasion did not cause a modification of the budget?

Mr. MCINTYRE. It did modify the budget. For instance, it increased the budget because of the grain embargo decision. So there were some modifications in the budget. Increases in Public Law 480.

Representative BROWN. But not the defense budget?

Mr. MCINTYRE. Not the defense budget.

Representative BROWN. Just one more question, and then Congressman Rousselot.

Just as a matter of summarizing in a very limited way the arguments that Congressman Rousselot and I have been trying to present this morning, you state with some pride the increase in the Federal obligations for basic research. That is exhibit 19. In your budget it is only $600 million in a $600 billion budget, so I appreciate that we are not arguing here about a terribly significant amount of money.

But my question really is this—and it goes to a matter of philosophy: Would we be better off if we gave tax credits to industry and private individuals for research and development and didn't spend Federal money on that, in other words, a direct trade-off in terms of budget revenues and in terms of private control of the budgets?

I have had, as I am sure all of us in the room have had, a couple of rather tragic family circumstances related to the loss of loved ones to cancer. And I must tell you that I don't have a great deal of confidence in the centralization of research in the prevention of cancer in the National Institutes of Health—not that I have a lack of confidence in the National Institutes of Health. I just don't like the concept of a school solution in some of these areas.

I also happen to have a Government installation in my district that does a fair amount of research, which I think may be well called for. But in that area it does not dominate the research activities of those research environments in which the research is done.

And I guess it is a matter of philosophy, but from 1979 to 1981, Federal research has had a billion dollar increase. Wouldn't we have been better off to give a billion dollar tax credit, not spend the billion dollars, and encourage private industry and private investors to do comparable amounts of research on their own?

Mr. McIntyre. I think that is a very good question. It is a question that we have studied in the administration as we made decisions about this budget.

I would like to make a couple of general comments and then ask Mr. Cutter if he would amplify those.

First of all, the information I received during the process of our analysis whether to have tax cuts or expenditures for basic research led me to conclude that we got more for direct expenditures in the area of basic research than we probably would get for an equal amount or an equal expenditure on the tax side.

Second, a large portion of the research done throughout the Federal Government is contracted research, not necessarily in-house research, and is done by a very broad-based base of organizations throughout this country.

Even in the case of the National Institutes of Health, a good bit of that research is contracted out and not necessarily centralized in any one place.

Let me ask Mr. Cutter—he and Mr. Ooms helped to put together the basic information on which we based our decisions on basic research—to amplify on some of the details.

Mr. Cutter. We have made a distinction in our discussion between basic research and research and development. We argued that a great deal of basic research is never going to be done by the private sector, because it is not, in the jargon, "appropriable." Its results are so generalizable that no given firm will get the benefit from the investment made in it. Therefore, society as a whole will underinvest in basic research.

And we believe that quite strongly. We believe the Federal Government has a direct and important role in funding investments in the basic research. That role itself can be decentralized, and we have tried to foster competition and we have tried to foster it in terms of grants and contracts rather than having Government in-house agencies do all of it. We agree with you there.

Representative BROWN. Except that the grants are controlled by people who have a school solution to the problem. The current cancer grant is all viral research, and it may be right and it may not. But the fact is that in polio research, it all tended to one direction, and the system you use does not embrace the system embraced by Federal Government grant-directed research.

Mr. CUTTER. We say the Federal Government must invest in basic research, but on the other end of the spectrum in development work we think that is clearly the province of the private sector. The Government ought to stay out of it as much as possible. We fought that battle repeatedly inside the administration and Mr. McIntyre and I have disappointed audiences from the west coast to the east coast when we made that argument outside the Government.

There is clearly a gray area where those two come together. When it is argued that developmental investments are in fact basic or that there are specific situations when the private sector would invest in regardless of whether we gave them credits. We believe there is a spectrum. At one end there is a clear, definable private-sector role which the public sector has no business in, and on the other end a role for the public sector.

Representative ROUSSELOT. As a follow up on that, Mr. McIntyre, have you done an analysis of the topic in enough detail that you can show us what your formula is by which you decide a dollar spent by the Federal Government is a dollar better spent than a private dollar spent?

Mr. MCINTYRE. Oh, come on, Congressman Rousselot. I said we'd presented the results of our R. & D. proposals——

Representative ROUSSELOT. Believe it or not, I have read your documents.

Mr. MCINTYRE. I wish more people did.

Representative ROUSSELOT. Me, too, especially here in Congress.

Mr. MCINTYRE. Obviously we don't have such a sophisticated formula.

Representative ROUSSELOT. Well, a formula.

Mr. MCINTYRE. I think it gets down to a question, as Mr. Cutter said, of what type of research is more appropriate.

Representative ROUSSELOT. Is most productive.

Mr. MCINTYRE. Is most appropriate for the Federal Government to sponsor and which is to be done by the private sector.

Representative ROUSSELOT. If you have arrived at a mechanical method of arriving at that or some way of making those decisions, and if you say you have defined it pretty well in the budget thing, fine, I'll look at it again.

Mr. MCINTYRE. Mr. Rousselot, we have to take each individual request for expenditures and examine it in the budget process like we do not for just R. & D. but all expenditures. We try to examine it in light of a whole range of questions.

Representative ROUSSELOT. Maybe I shouldn't have picked up on that because I may have misheard you, that dollar for dollar you have arrived at a way to allocate what the Federal Government should spend and what the private sector should spend.

Mr. McINTYRE. In a judgmental manner. We all have judgments. You have judgments.

Representative ROUSSELOT. Of course.

Representative BROWN. It is just my hope that we get the other two witnesses along at 11:30, and they will summarize their testimony and that will let us go on. I want to urge both Congressman Rousselot and the witness to sharpen their questions and their answers so we can get to some other point.

And we will probably go a little past noon with the other witnesses.

Representative ROUSSELOT. I'll move on.

On your chart, exhibit 17, you show the payments for individuals and grants, which is obviously the biggest chunk of the budget. And we got into a discussion a little earlier about the problem of entitlements which I recognize as a problem that you have to deal with. Part of the problem is that most of the open-ended entitlements are in that portion of the budget—payments for individuals and grants.

Mr. McINTYRE. That's right.

Representative ROUSSELOT. Whereas, when you talk about buying a ship that becomes a pretty steady thing, which you gave as an example that you can't stop the payment in the middle of construction of, say, an aircraft carrier. And we recognize that.

Have you done a lot of work in finding out what we as a Congress could do to help you reduce the open-ended entitlements and heavy level of expenditure in that area? One way to reduce the deficit is to restrain the increases in expenditures. And, since this is one of the biggest areas of increase in expenditures since 1975 on your exhibit, we obviously have a tremendous amount of work to do as a Congress in this area, and I'd like all the help I can get from you. When I was on the Budget Committee I spent a lot of time in that area and we didn't get much help from Congress as a majority.

Mr. McINTYRE. Congressman Rousselot, as I said earlier, we did make some recommendations last year for some changes in the entitlements programs. We have made recommendations for legislative savings that amount to over $5 billion in 1981.

Representative ROUSSELOT. In just this area?

Mr. McINTYRE. No, not in just that area. For example, the hospital cost containment is in that area. Some of it is in that area. And we are going to push hard on that.

Representative ROUSSELOT. How about food stamps?

Mr. McINTYRE. Food stamps is in that area.

Representative ROUSSELOT. You have made several suggestions on the entitlement problem.

Mr. McINTYRE. There have been several suggestions in the budget.

Representative ROUSSELOT. Is Mr. Foley listening?

Mr. McINTYRE. Well, we are going to work hard on it. We don't know if we can get a majority of the Congress to agree with us. We think they are reasonable recommendations.

Representative ROUSSELOT. Do you still believe we should have a cap on food stamps?

Mr. McINTYRE. Listen, the question of the cap—you and I both know that even with a cap that program is going to be funded by the Congress as an entitlement program.

Representative ROUSSELOT. Well, try us. We may improve in our educational ability of understanding it.

Mr. McINTYRE. We have made a number of recommendations that would in effect save the taxpayers money in the short and long term. Our recommendation to change the way we approach pay comparability for Federal employees is very important. We are not necessarily going to cut Federal pay but we will look at the definition of comparability and try to determine what pay increases Federal employees should have each year to keep up with pay in the private sector. We ought to compare total compensation, including wages, salaries, and fringe benefits.

Representative ROUSSELOT. Like parking, say.

Mr. McINTYRE. That is not a fringe benefit in the executive branch anymore, Congressman Rousselot. [Laughter.]

Representative ROUSSELOT. I know that.

Mr. McINTYRE. In fact, it was a very difficult decision, but it is tough decisions of this sort that characterize the entire budget process.

Now, if you don't like what we have recommended, we have given you some alternative proposals back here.

Representative ROUSSELOT. I like a lot of things you've recommended.

Mr. McINTYRE. There are some other alternatives.

Mr. McOMBER. One group totals about $20 billion and another group about $4 billion.

Representative ROUSSELOT. Of which document? The big budget itself?

Mr. McINTYRE. Yes. We don't think those changes are desirable. If we did, we would have made them. But there they are for you to consider. They represent the tough trade-offs the President has to make in putting together his recommendations for the Federal budget.

Representative ROUSSELOT. Let me say to you as one who has tried to look very carefully at the expenditures side of the Federal Government—and I have spent a lot of time on it as well as the revenue side relating to taxes—I just think there is a tremendous amount of work that we both need to do, especially the Congress, in stopping the open-ended entitlements. We have in so many programs, and that presents a real problem for you to be able to pay the bills.

Mr. McINTYRE. After trying last year, I concluded that the first step in achieving that goal is to increase the public's consciousness about the effects of these programs. Only then can the Congress come to grips with the problem in politically realistic terms.

Representative ROUSSELOT. We did it in California.

Mr. McINTYRE. I don't think the Congress is going to have the incentive to move until there is a higher level of public awareness about this.

So we have begun to take steps to raise that level of awareness.

Representative ROUSSELOT. Well, we raised the level of awareness in California as it relates to the State government by proposition 13, and proposition 4, though it isn't a perfect mechanism, and now we will face in June cutting the income tax in half, assuming that the polls are right. And I have always believed if you cut down some of the money you begin to force real recognition that these entitlements that you have talked about need to be looked at very seriously. I'd be glad to help you in your effort on entitlements.

Mr. McINTYRE. Thanks.

Representative BROWN. Mr. McIntyre, the budget-maker's life is not a happy one, and I am not sure that we have made it any happier for you today. You have done very well in your testimony and we appreciate your directness very much. We have not, unfortunately, completed one of the agenda items I enunciated when I opened the hearing, and that is comments on the regulatory budget. Senator Bentsen and I are both very serious about it. And I would like to ask you to give us in some written version—and I don't think you have done so previously—your comments on the proposal for regulatory budget embraced in the Bentsen-Brown bills.

Could you do that for us?

Mr. McINTYRE. Yes. And if you have any other questions that you did not get to ask, Congressman, we will be glad to submit them for the record.

Representative BROWN. I appreciate that. We will in all likelihood have some questions submitted by members who are not here, and we will have an additional series of questions based on your comments on the Bentsen-Brown bills, and I'd be pleased if you'd send your response in duplicate form to Senator Bentsen at the committee and me at my office.

Mr. McINTYRE. We will, and we will answer promptly.

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

RESPONSE OF HON. JAMES T. McINTYRE, JR., TO REPRESENTATIVE BROWN'S REQUEST FOR AN EVALUATION OF S. 51, REGULATORY BUDGET LEGISLATION

You requested OMB views on S. 51 to establish a regulatory budget for each Federal agency that would set a maximum cost of compliance for all rules and regulations issued by the agency.

We share your concern that regulatory decisions be made on the most cost-effective and efficient basis possible. That is the purpose of our regulatory reform program that include S. 755, now under consideration in the Senate Judiciary and Governmental Affairs Committees. The Administration does not believe that we are now in a position to adopt a regulatory budget as a government-wide requirement.

One of the difficulties is our current limited ability to measure the costs and benefits of regulation. Measuring even the direct costs of regulation is a difficult task that we are not yet equipped to undertake on a routine basis. To deal with this problem, the Administration is considering several options and the resources that would be required to improve agency cost estimation procedures.

We are working with a number of agencies to develop the methodology needed to increase the accuracy and reliability of compliance cost estimates. We have been encouraged by the support and interest of the Committee in surmounting the problems in developing that methodology. We do not believe, however, that it would be possible or appropriate to implement a regulatory budget on the basis of our current knowledge.

Representative BROWN. Thank you. We appreciate your testimony on the one hand and, on the other hand, your comments.

Mr. McINTYRE. Thank you.

Representative BROWN. Our next witnesses are Mr. Franklin Lindsay, chairman of the Research and Policy Committee of the Committee for Economic Development, and chairman of Itek Corp.; and Mr. Leon Keyserling, who has testified frequently before this committee and it is always a pleasure to have on our panel. Mr. Keyserling is the president of the Conference on Economic Progress, and former chairman of the Council of Economic Advisers under President Truman.

I am going to ask Mr. Lindsay and Mr. Keyserling both to make their statements as brief as possible. We have prepared statements from both of you. I had a chance to look through Mr. Lindsay's comments, and we will have an opportunity to do those things we do so well, three things at the same time—look at Mr. Keyserling's comments while we are listening to both of you gentlemen.

So if you will make your opening remarks as brief as possible so we can pursue some of the questions that your remarks raise for us.

Mr. Lindsay.

STATEMENT OF FRANKLIN A. LINDSAY, CHAIRMAN, RESEARCH AND POLICY COMMITTEE, COMMITTEE FOR ECONOMIC DEVELOPMENT; AND CHAIRMAN, ITEK CORP.

Mr. LINDSAY. Thank you, Congressman Brown, I will summarize my prepared statement which I'd like to submit for the record. In summarizing, I'd simply like to say that I applauded your opening statement on the one hand; and on the other hand, I thought it said much of what I had to say, so I will therefore be brief in my statement.

The plain fact is we ask more of our economy, and will certainly ask more in the future, than hobbling restraints and competing priorities allow it to provide—in jobs and real income, in ample and efficiently produced goods, in international competitiveness, and in global economic and military security. Nor, with this increasing overload, is the economy creating that margin of surplus wealth which would enable us to afford the quality of life we have come to expect in terms of health, safety, and environmental standards, of income support to the disadvantaged, and of renewed social and economic viability for our deteriorated central cities.

Inflation is both a symptom and a major contributing cause of this widening gap between expectations and performance. Chronic inflation will continue to distort and limit the economy's performance until we root out the underlying causes of the disorder.

Restraint of aggregate demand is clearly an essential aspect of a corrective strategy, but fiscal and monetary discipline alone will not overcome the serious deficiencies on the supply side of the economy. Demand restraint will reduce the bloat, but it will not build up the sagging muscles. The active aspects of a counterinflationary, capacity-strengthening strategy must include, at the minimum, measures deliberately targeted to:

One: Promote higher investment in both physical and human capital in order to update and ugrade plant and skills to perform efficiently and competitively the real economic tasks of the future;

Two: Stimulate increased investment in innovative technologies, products, and manufacturing processes in order to regain the momentum and rewards of world scientific and industrial leadership for the United States;

Three: Achieve more stringent energy conservation, faster exploitation of abundant domestic energy resources, and accelerated development of synfuels in order to reduce as fast as practical vulnerabilities to the insecurities of price and supply of imported energy; and

Four: Remove unnecessary regulatory impediments to competition, and rationalize excessively costly regulatory regimes in order to exploit the efficiencies of the marketplace in attaining—and financing—legitimate social goals.

In a strategy for strengthening capacity, we consider the number one priority to be accelerated capital recovery. The proposal appears to have widespread support, not only in the business community, but also among academics and in Congress—and you have expressed this yourself today—as well as, in principle, in the White House. Yet, the President's budget contains no such proposal, on grounds that accelerated depreciation would be a tax cut and should, therefore, be considered only if the economic situation deteriorates sharply. Mr. McIntyre repeated this in his statement today. I find it difficult reasoning to accept.

Among what the President's budget has called "selected essential increases in areas of high priority and great national concern" ought certainly to be included tax incentives for more rapid capital recovery. A budgetary plan that balances fiscal discipline with counterinflationary structural reform should give high priority to encouraging capital investment to expand and modernize capacity, improve productivity, and fight inflation over the longer run. These are structural goals that are sound, whether or not we have a recession. Indeed, the longer the rate of new capital investment continues to lag, the more precipitously will the existing capital stock deteriorate, and the more certain we will face future supply bottlenecks which will in themselves exacerbate inflation.

Building up the strength and efficiency of the supply side of the economy entails more than increased investment in new physical plant. It also requires parallel investment in human capital, especially for those just entering the work force and the structurally unemployed and underemployed. Just as we cannot afford obsolete plant and equipment, neither can we afford undeveloped or obsolete skills. CED trustees are convinced that the public-private partnership for on-the-job and near-the-job skill training is making real progress by providing direct entry to permanent private jobs. It merits continuing support of Congress.

A strategy for recapitalizing the American economy should also include a range of measures to induce higher levels of private investment in longer term and often high-risk R. & D. leading to innovation and its diffusion throughout the economy. The industries most directly benefited by stepped-up and sustained R. & D. include those on which the Nation will increasingly depend for efficiency, international competitiveness, rising real income, and national security.

I will mention two additional priorities in an effective counterinflationary, capacity-building strategy. One is a more energetic program to achieve in the nearer term energy self-sufficiency. I recognize that allowing domestic energy costs to rise to world market levels will add to short-term inflationary pressures, but the faster the true costs of energy are accepted as the basis for both investment and consumption decisions, the sooner we will reduce our energy insecurity. The other priority, for which there appears to be considerable support in the administration and Congress, is regulatory reform, not for the purpose of abandoning reasonable health, safety, and environmental standards, but for achieving these standards more efficiently.

In closing I do want to offer two cautions.

First, I could not help noting that the President's budget allows for various downside contingencies, depending on the economy's performance over the coming year. It does not, however, consider any upside contingencies, such as the possibility of a substantial rise in defense expenditures. I would caution that, should these increases become necessary, we must avoid our error during the Vietnam buildup of the late 1960's, when we thought we could have both guns and butter, and thus created the overload which launched our now chronic inflation. If defense costs rise, so must the revenues to pay for them.

I would caution also, in our present economic straits, against settling on any simple, quick-fix solution to an inflation which has become pandemic throughout the society. In particular, I reject the proposal for comprehensive wage and price controls in peacetime. Controls would only incubate rather than cure inflation, by camouflaging real costs, which are the most efficient means for reallocating resources. Sole or excessive reliance on demand restraint would also, in my view, be a simplistic and inadequate corrective to the present unsatisfactory performance of the American economy.

If I could leave one thought with you it is this, that the modernization and expansion of our store of human and physical capital cannot be treated as a countercyclical option. It is urgent to begin now and to pursue steadfastly a redressing of the past imbalance in budgetary policy which has favored consumption at the expense of investment. Thank you.

[The prepared statement of Mr. Lindsay follows:]

Prepared Statement of Franklin A. Lindsay

Mr. Chairman, members of the Joint Economic Committee: On behalf of the Committee for Economic Development, I welcome this opportunity to comment on the present unsatisfactory state of the American economy, and on appropriate policy remedies for the short and the long term.

The plain fact is we ask more of our economy, and will certainly ask more in the future, than hobbling restraints and competing priorities allow it to provide—in jobs and real income, in ample and efficiently produced goods, in international competitiveness, and in global economic and military security. Nor, with this increasing overload, is the economy creating that margin of surplus wealth which would enable us to afford the quality of life we have come to expect in terms of health, safety and environmental standards, of income support to the disadvantaged, and of renewed social and economic viability for our deteriorated central cities.

Inflation is both a symptom and a major contributing cause of this widening gap between expectations and performance. Chronic inflation will continue to distort and limit the economy's performance until we root out the underlying causes of the disorder.

Adequate restraint of total demand is clearly a key prerequisite for bringing inflation under control. But such measures by themselves are not sufficient to do the job. We strongly believe that a major part of the solution must lie in measures to strengthen the long-term productivity, supply capacity, and competitiveness of our economy. Such measures should, in particular, include a sharply increased emphasis on investment in physical and human capital; on stimulating innovation and technological progress; on strengthening the net availability of domestic energy resources and reducing dependence on foreign energy supplies; and on removing impediments to efficiency through unnecessary or unduly costly regulations.

The President's economic messages contain positive recommendations in each of the areas cited, many of which we support. But we also believe that the President's proposals fall well short of what is required. Our economic policy needs to give much higher priority to strengthening the investment and supply side of the economy than is now the case.

Before turning to supply-related issues, let me first comment on the Administration's proposed strategy for overall demand management. We welcome the strong emphasis in the President's budget and economic messages on the need for overall demand restraint. If inflation is to be brought under control, firm adherence of both fiscal and monetary policies to such a strategy of restraint will be essential. We also applaud the introduction of the concept of a credit budget and of the related new system to subject federal credit activities to a disciplinary process somewhat comparable to the process that places annual limitations on outlays under the regular budget.

Clearly, however, many of the assumptions underlying the President's messages are subject to unusual uncertainties. A question can also be raised whether the Administration's forecast of renewed economic growth in the first half of 1981 is consistent with its projection of a sharp further tightening in the bite of fiscal policy as a result of the scheduled large increase in Social Security taxes at the beginning of that year. For these reasons, it is appropriate that the budget contains some discussion of contingency plans in the event that the economy should turn out to be significantly weaker than expected. I shall return to one aspect of this discussion in a moment.

What concerns me, however, is that there is no discussion in these messages of the contingency measures that might have to be taken if changes in the international situation and greater-than-expected increases in defense-related expenditures should risk a significant enlargement in the budget deficit over the levels now projected, either during the current fiscal year or in fiscal 1981. I am not suggesting that such overruns are bound to occur. Given the very long lead periods involved in building new weapons systems, even very significant increases in authorizations for new military hardware may not affect actual outlays for quite some time. Moreover, I am personally convinced that major improvements in our overall defense readiness are possible through more effective allocation of existing defense dollars. Nevertheless, if authorizations or spending for national security related purposes turn out to be significantly larger than now budgeted, the Administration and the Congress need to make certain that timely offsetting actions are taken—either in terms of added expenditure restraints, foregone tax reductions, or if necessary, even tax increases—to allow continued adherence to overall fiscal restraint. In other words, thought should be given now as to what needs to be done to avoid the disastrous mistake of the guns-plus-butter, buy-now-pay-later fiscal policy that was followed during the escalation of the Vietnam War in the mid-1960s.

Let me now turn to the needed policies on the supply side. Here, I think, it is clear that no single measure is more important than the provision of more adequate incentives for investment in new plant and equipment. There is strong evidence that since 1973, a low rate of capital formation has contributed substantially to our dismal productivity record; according to experts in the Bureau of Labor Statistics, it actually was the predominant cause of that lag. Moreover, the escalating cost of energy and new environmental regulations have in many cases rendered existing plant and equipment inadequate or obsolete. Because of inadequate capital formation, furthermore, we are faced with actual or potential bottlenecks in key industries; a lag in the competitive race with foreign countries that are installing more efficient and up-to-date equipment; and a reduced potential for innovation and rapid technological progress.

While the lag in adequate capital investment is a long-term contributor to inflation, the high rates of inflation since the early 1970s have themselves also been a major factor in reducing the incentives for capital investment. This has happened because allowable depreciation of existing plant and equipment is based on historical costs, which in a period of rapid inflation is much lower than replacement costs.

The seriousness of the problem was described in dramatic language by Fletcher Byrom, Chairman of the Koppers Company and Chairman of the Committee for Economic Development, in his testimony before this Committee last year. He said,

"To be blunt, we are rapidly liquidating the capital base of the core of the nation's economic system. This is happening because of the combination of high fixed costs of new physical capital; the long lead time needed to expand or modernize capacity, or to launch a new product; the unpredictability of possible added costs created by regulatory uncertainties; outmoded accounting practices and taxing policies; and anti-growth depreciation policies."

How can this problem be overcome? Our Research and Policy Committee has concluded that the number-one priority measure to stimulate investment in new plant and equipment should be the prompt introduction of more rapid capital recovery allowances. We believe that a substantial shortening of depreciation schedules is the most equitable and effective way of providing the needed investment incentives. Our Committee arrived at this conclusion after more than a year's intensive work on CED's new policy statement "Stimulating Technology Progress" that has just been issued. To provide further background on the reasoning behind our recommendations, I am submitting the summary chapter of our new policy statement with the request that it be included in the record.

It is striking that there is now widespread support in principle for more rapid capital recovery allowances, not only within the business community but also within the Congress and in the academic community. The President's economic messages suggest that the Administration, too, sees major merit in such an approach. Yet there is no proposal along this line in the President's budget, on the ground that accelerated depreciation involves a tax cut that ought to be considered only if the economic situation and prospects should worsen sharply.

To be quite frank, Mr. Chairman, this line of reasoning simply does not add up. Tax incentives to encourage more capital investment are urgently needed as a way to improve productivity and fight inflation over the long run. It makes no sense to say that we cannot adopt such long-term structural measures unless there is a recession. Indeed, by delaying the introduction of improved depreciation allowances, we will fall further behind in our efforts to produce the new capital—and prevent the deterioration of existing capital—needed to avoid major inflationary supply bottlenecks in the future.

In presenting his budget for 1981, the President stated that he is proposing "selected, essential increases in areas of high priority and great national concern" but that he found a way to accommodate these increases within a framework of sufficient overall budget restraint to cope with the danger of excessive demand. I believe—and I think that this view is generally shared by my fellow CED trustees—that adequate provisions for more rapid capital recovery need to be included among the highest priority items in our fiscal program. If we are to win the long-run battle of inflation, a way needs to be found to include such a measure in a budgetary plan that meets the essential requirements for overall fiscal discipline.

More rapid capital recovery allowances are, of course, only one of the steps required to strengthen capital investment and stimulate technological progress. Among other needed steps are a range of measures to encourage a high level of private investment in longer-term, and often high-risk, ventures that lead to innovation and its diffusion throughout the economy. Our new policy statement presents a comprehensive set of proposals in that connection. They include a shift to "flexible depreciation" of R & D equipment and structures; major reforms in the patent system to make it more efficient and effective, such as voluntary arbitration, a single court of patent appeals, and a first-to-file patent system; and increased public support for basic research. While the Administration has recently also come out with a set of proposals for stimulating technological progress—many of which we support—our own recommendations in this area call for much more forceful and comprehensive action.

Another major impediment to investment, innovation and economic efficiency stems from the costs and delays imposed by unnecessarily burdensome regulatory processes. In this connection, we welcome most of the Congressional initiatives and the Administration's proposals for overhauling the regulatory system. Many of these are fairly close to the recommendations in our own recent policy statement on this subject.[1] These recommendations include:

The use of cost-benefit analyses prior to the adoption of new regulatory regimes;

Steps to remove inconsistencies, bureaucratic delays and unnecessary paperwork;

A shift in emphasis toward regulatory performance standards which industry can meet in the most efficient way, as an alternative to regulatory practices that dictate to industry exactly how and with what tools it must achieve regulatory goals; and

Other reforms intended to make the regulatory climate more predictable, less costly, and more hospitable to private initiatives and innovation.

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[1] "Redefining the Governments Role in the Market System," July 1979.

We very much hope that the Administration and the Congress will move expeditiously toward implementing these proposals.

My comments so far have largely focused on strengthening the physical capital base of the private sector of the economy. We also need to face up to the serious problem of inadequate investment in the public sector and particularly the deteriorating infrastructure in many of our major cities. While there is not enough time here to discuss this issue in detail, I do want to note that CED has just started a new study on the revitalization of America's cities which will address this and related issues, placing particular emphasis on the potentials for more effective public-private partnerships to cope with our urban problems.

Next, a few comments on the critically important subject of energy. More adequate domestic energy resources and reduced dependence on unreliable foreign supplies will clearly be of key importance for the efficient long-term performance of our economy. Greater efforts at energy conservation as well as intensified programs to expand domestic energy supplies can greatly help in containing the rise in real energy costs over the long term and preventing supply shortages and bottlenecks that could exacerbate long-term inflation. But this does not mean that the correct current policy is to keep energy prices artificially low. Indeed, we are convinced that allowing energy prices to rise to levels determined by market forces is the best way to encourage more energy conservation and production.

As Professor Thomas Schelling stated in a recent study prepared for our Committee,[2] "Keeping fuel prices artificially below the replacement cost of the fuels being used subsidizes excessive consumption, inhibits exploration and development of supply and misrepresents the worth of technological changes that economize energy." I fully recognize that adequate ways must be found to assist those in our society for whom very large and sudden increases in energy costs can be a crushing economic burden. This problem, however, should be solved by direct income supplements to those in need rather than by interference with market prices.

Another key element for coping with the longer-term energy problem will be the development of an initial capability for commercial-scale domestic production of synthetic fuels. In a policy statement issued last July,[3] our Committee outlined a specific approach for accomplishing this objective. That approach places primary reliance on private sector resources and market incentives and limits the first stage of the program to construction of approximately ten plants that would be sufficient to demonstrate the viability of various synthetic fuel options. We are pleased that the legislative program now emerging in the Congress is closely in line with the basic approach we recommended. The principal need now is to make sure that an effective synthetic fuel program will be passed and put into operation as soon as possible and that its implementation does not become bogged down in delays and uncertainties.

Finally, let me turn to the need for increased investment in human capital and particularly for greatly intensified efforts to provide adequate skill training and productive jobs for the structurally unemployed and underemployed. In our January 1978 policy statement on jobs for the hard-to-employ,[4] we called for a major new public-private partnership to achieve these goals, placing special emphasis on involving business much more actively in skill training of the disadvantaged and in fostering a better transition from school to work. We strongly believe that such efforts are not merely desirable to aid the less fortunate in our society but are vitally needed to make our economy more productive and to alleviate potential future inflationary problems arising from skill shortages and labor supply bottlenecks.

As you know, the Private Sector Initiative Program under CETA which has been developed by the Administration and the Congress since the time our Report appeared closely follows the basic approach we recommended. We very much welcome this effort and are pleased to have had a role in its initiation. In our view, the program deserves continuing strong support by the Congress.

It is our impression—reinforced by what we learned at the policy forums we held in six major cities over the last year and a half—that the Private Sector Initiative Program is making real progress. Many of the new Private Industry Councils now being established in communities throughout the country are becoming catalysts for a constructive public-private partnership. It is also clear,

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[2] "Thinking Through the Energy Problem," CED Supplementary Paper, April 1979.

[3] "Helping Insure Our Energy Future: A Program for Developing Synthetic Fuel Plants Now," July 1979.

[4] "Jobs for the Hard-to-Employ: New Directions for a Public-Private Partnership," January 1978.

however, that the process of successful institution-building takes considerable time. Hence, we believe that the Congress should allow ample time before making detailed judgments about the performance of these Councils. There should, however, be continuous intensive monitoring of the way in which the Councils are evolving to assure that they are in fact providing for really meaningful involvement of the private business sector in the training and jobs effort.

We also strongly favor the basic approaches under the new Youth Employment Initiative Program that the President has just announced, particularly the strong emphasis on a better transition from school to work: on providing both in-school and out-of-school teenagers with a better chance to acquire jobs skills needed in the private sector; and on clear performance standards for both program participants and service providers.

While the programs I have cited are directed at the disadvantaged, the need for improved skill training and upgrading really extends very broadly throughout our labor force. The more we can improve the skills of our workers at all levels, the greater will be the productivity of our economy and our ability to combat inflation.

Let me conclude, Mr. Chairman, by emphasizing that my remarks today have not been intended to cover the full range of steps that need to be included in a successful anti-inflatiornary strategy. Our committee is continuing to devote intensive study to the most promising approaches for dealing with the inflation problem. It is clear, however, that there is no simple or one-dimensional answer. In particular, we reject proposals for quick fixes, such as the imposition of comprehensive wage and price controls in peacetime. Such a step would only worsen the longer-term inflation problem by seriously interfering with needed incentives for efficient allocation of resources. Nor, in my view, does the answer lie in sole or excessive reliance on demand restraint. Instead, a major part of the solution must consist of positive steps to make the economy more productive and innovative and to foster an environment of sustained long-term economic growth.

I want to leave one thought with you: that the modernization and expansion of our store of human physical capital cannot be treated as a countercyclical option. It is urgent to begin now, and to pursue steadfastly, a redressing of the past imbalance in budgetary policy which has favored consumption at the expense of investment.

Representative BROWN. Mr. Lindsay, thank you very much. You have done pretty well in keeping within my 5 or 6 minutes' admonition, and I will ask Mr. Keyserling to do the same thing now, and then we will open it up for questions. This will give you an opportunity, Mr. Keyserling, to present your views, attack Mr. Lindsay if you like, attack members of the panel, or just attack in general. Help yourself.

STATEMENT OF LEON H. KEYSERLING, PRESIDENT AND DIRECTOR, CONFERENCE ON ECONOMIC PROGRESS, WASHINGTON, D.C., AND FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. KEYSERLING. Well, Congressman Brown, and members of the committee, I am glad to be here. I will try to observe your admonition as to time except to say that the idea that anybody who has had public success in this field and had 47 years of experience and usually turned out to be right on his forecasts and policy views can, within 5 minutes, do justice to this committee is optimistic indeed.

Representative BROWN. You are quite right, Mr. Keyserling, and let me apologize for the fact that unfortunately with Mr. McIntyre we had the whole budget to go through, and anybody who can go through the budget in 1½ hours isn't doing too bad.

Mr. KEYSERLING. I agree. So I will be brief here today, and rely upon my prepared statement and charts to amplify.

First of all, let me say I could score some quick points about the budget views presented here today—which are most disturbing. Much of what they say is not responsive to the facts. Much is not in accord with their own record as demonstrated, and much is not consistent.

To make the claim that their forecasts have been moderately good, in view of all the difficulties, is preposterous. It is just as preposterous as their claim that they are going to come in with only a $16 million deficit in the fiscal year 1981 with the policies that they are following.

A year ago I published a document which said that the inflation would be about twice as big as they then suggested, and for the reasons I gave, and I was correct.

Second, the President's program makes some forecasts to 1988. To focus ~~so much~~ upon so-called forecasts is utterly confusing as to the duties and responsibilities of the Government of a great nation. Faced with the kind of problems we have, forecasts are of some value, but for the Government to forecast that we are going to have an 8.5 average percent rate of inflation for the next 5 years and only get to reasonable price stability 8 years from now, and tell that to the American people when we have so much experience in how to do a better job, and when these forecasts are based upon repetition of the same policies which are so largely responsible for the inflation of today, is little short of irresponsible.

What I want to say in the main, though, doesn't go to these quick points. What I want to say in the main is that the Economic Report and budget message are so far off the track on what to do about the essence of our problems at home and in the world that one doesn't need to talk about the details. If a train is on the right track and is going where we need to go, you can talk about improving the engineer or using a different kind of fuel, but if you are on the wrong track going in the wrong direction, that becomes irrelevant until you change your track. National policy is now on the wrong track.

Now, where national policy is utterly on the wrong track is indicated by what I say, beginning on the first page of my prepared statement:

Let us look first at the objective situation. We need to undertake a substantially increased national security burden which imposes increased strains upon the economy; and we should recognize the possibility that, in the not too distant future, we may need to do far more along these lines than we now anticipate. We need to try to meet the competition of some oversea economies which are making great inroads upon our domestic markets, exhibiting real economic growth rates several times as high as ours, and with far less inflation and far less unemployment; and we need to recognize, despite a mass of abstruse financial discussion, that the extent to which we are being outdistanced in these matters is the most important single reason for the overseas lack of confidence in the U.S. economy, that being the main single explanation of the weakness of the dollar, the gold price extravaganza, and powerful aspects of inflation itself. We need to respond effectively to vast domestic needs in energy, environment, and urban aid. Confronted by increasing poverty and neglected human services, we need to enlarge many domestic programs.

Now, let me state what is as true as anything has ever been in economic discourse, although this administration doesn't appear to see it.

The fundamental way we earlier attacked problems fundamentally similar to those today with more success, even when they were greater than they are today, was to recognize that the real road to economic power and wealth is to call forth the cornucopia of the capacity of the American economy to produce more goods and services and to use them more intelligently.

This involves policies and programs very different from the current ones, and it involves those which improve the use rather than deteriorate the use of our full capabilities as my prepared statement says:

> No amount of economists' dialectics, obscurantism, or pure mumbo-jumbo can be permitted to blot out this towering truth: The ultimate source and support of all we need and attempt to do, materially speaking, is how much we produce in goods and services and how wisely we use the product, with due regard for our great priorities, domestic and international. All other economic efforts, urgent and vexatious though they may be, must be made subservient to this ultimate purpose. If we abandon or even swerve from this ultimate purpose to deal with other problems, we burn the house in the attempt to roast the pig, as the experience so clearly shows, and also fail to roast the pig, as the record on inflation shows. Thus, to seek price stabilization in a deliberately stunted economy is both futile and a distorted sense of priorities.

Now, let me skip all the way over to near the end of what I have to say and read something that was uttered in a marvelous unanimous report issued by the Joint Economic Committee 1 year ago. This appears in its introduction:

> The enormous benefits to be gained by the whole nation from rapid economic growth have united the Joint Economic Committee Majority and Minority. This committee believes that we must and can produce our way out of our economic policy.
>
> First, policies which produce slow growth will not also produce price stability. A slow-growth scenario for the 1980's implies a concomitant rapid rise in the cost of living and how true that is.
>
> The fight against inflation can be won only by policies which increase production. A stagnating economy means more double digit inflation. It means protracted and rising unemployment. It means a reduced standard of living. Policies which lead to slow growth will lead to many and unnecessary cruel hardships for disadvantaged Americans.

Never before did the Joint Economic Committee more clearly state the truth. The Joint Economic Committee now has the opportunity to help put the administration back on the track. The President was incorrect and in violation of law—the Humphrey-Hawkins Act—when he said, in support of his policies which would strike hammer blows at the American economy, that it will take 8 years—until 1988—to get inflation down to the moderate figure or 8 percent, and 5 years—until 1985—to get a reduction in unemployment from 5.9 at the end of last year to 4.0; or 2 years later than mandated for 1983 in that 1978 act.

He says that he is modifying in these respects the Humphrey-Hawkins timetables regarding unemployment and inflation, but the law does not permit him to modify them. The law permits him only to bring before the Congress of the United States any proposed recommendations for modification, and this only after showing that he is still trying to reach the timetable objectives defined by the Congress. It is then up to the Congress to reshape and modify what the President proposes in conformity with the objectives of the act and in accord with the JEC language which I have just read, and which represents the greatest combination of commonsense and reason and empirical evidence in the history of the Joint Economic Committee.

Now, what is the President saying to America? The President is saying to America, in substance: We can't begin to do as well as Germany or Japan, which is growing 4 to 5 percent a year in real terms. We can grow only 2.5 percent over the next 5 to 8 years, and have a recession first, and perhaps more than one. These countries are experiencing less than half the inflation we have, but we must wait until 1988 to get even reasonable price stability.

I want to call your attention to my chart 10 in my prepared statement. That is the only chart I want to call your attention to now. Pass over quickly the top cross section of it in which I set forth my own judgments as to what we need to do to call forth the great nonsecret weapon of America's production and growth powers. All I can say is that what I portray is only an effort to do nearly as well as we did on other occasions when we had the need to do well.

Let me call your attention more particularly to the second cross section of my chart 10, which is what the President says is his program for America.

First a recession; second, a figure for consumer spending representing a decline of 0.7 percent in real terms for 1979 to 1980. But the Joint Economic Committee said in its 1979 midyear economic review that the greatest threat to investment in 1979 was the fact that consumer spending wasn't holding up, and that the greatest threat to investment in 1980 would be if consumer spending continued to be weak.

I share the belief expressed by two members of the committee that investment needs to grow faster. The President is showing for gross private domestic investment a growth rate figure for only 1 year, from 1979 to 1980. He shows a figure of minus 4 percent in real terms. In terms of the impact of this upon productivity, output, and employment, this would be a terrible development.

The administration's position as of January 1980 is just as outlandish as in January 1979, when it came forward with the proposal to increase unemployment to 6.2 percent in 1979. I must say they didn't quite make this outlandish goal. It took until January 1980 to do what was sought in 1979. Where would we have been in 1979 on inflation or growth or balancing the budget, through driving unemployment upward—which is an index, merely an index, of how the whole economy is doing, at what level our economy is operating overall?

The 1980 economic report and fiscal 1981 budget message represent a horrible repudiation of the purposes and the capabilities of America. Domestically, they are dangerous; internationally, they could destroy us because they would gradually undermine and corrode our power to support the kind of national security program that we need.

I haven't advanced any radical or unusual notions. I have advanced what, if the truth were told, the American people feel is politically feasible. I am merely saying that the ultimate source of our strength is what we produce and how we use it.

We have not reached the last horizons. The administration's current program is the first time in American history, certainly the first time since the Employment Act of 1946, when a President of the United States has deliberately projected a recession. To say it is merely "an honest forecast" is like a doctor coming in and taking one glance at a patient and saying, "Well, my forecast is that he is going to die."

That is not why the doctor is there. The doctor is trying to reverse a fatal forecast, not embrace it. Certainly that reversal is what we have done before in our economy every time we have had that kind of situation and had great needs.

I also have some material here on Federal Reserve policy.

I can't understand the Budget spokesmen. I can't understand their saying that, apart from the noncontrollable items, inflation isn't so great. Interest rates are not a noncontrollable item. It is an artificiality to say that the President and Congress can do nothing about them. To have that come from a President who searched the country with a fine-tooth comb and got a new head of the Reserve Board who is committed to higher interest rates than anybody else in the country—I can't understand the administration. To say the cost of energy is not controllable because somebody else is doing it—we have always had to deal with what other people were doing. During World War II, we had to deal with a shortage of rubber, and later on with a Western Europe infinitely worse off than now and threatened with Communist destruction.

We can't afford to say that we will not really cope with enormous difficulties, and especially when they have been multiplied by the errors of those now offering the alibis. Thank you.

[The prepared statement of Mr. Keyserling, together with the charts referred to, follows:]

PREPARED STATEMENT OF LEON H. KEYSERLING [1]

Mr. Chairman and members of the committee, I appreciate this opportunity to appear once again before you. At this time, I will deal far less than is my custom with technicalities and details, for I believe there is one overwhelming issue of a general nature which this Committee should put above all others and treat fully and promptly.

This issue, as I see it, is based upon my conclusion that the President's 1980 Economic Report and Fiscal 1981 Budget Message move strongly in directions which do not square with reason or empirical evidence; utterly violate the Humphrey-Hawkins Act; evidence weakness, irresolution, and inconsistency at a juncture which calls for strength, decisiveness, and programmatic unity; resign themselves to evils which we have the power to overcome if only we exhibit the will and discernment; and sell America short. The two official documents do this by grossly underestimating the capabilities of our economy and our institutions, at a critical juncture when a correct appraisal and full marshaling of these capabilities is imperatively called for by the domestic difficulties confronting us, and by the mounting burdens imposed upon us by the dangerous and evolving world situation. This evolving situation is by no means limited to Iran and Afghanistan, nor even to the Persian Gulf area.

Let us look first at the objective situation. We need to undertake a substantially increased national security burden which imposes increased strains upon the economy; and we should recognize the possibility that, in the not too distant future, we may need to do far more along these lines than we now anticipate. We need to try to meet the competition of some overseas economies which are making great inroads upon our domestic markets, exhibiting real economic growth rates several times as high as ours, and with far less inflation and far less unemployment; and we need to recognize, despite a mass of abstruse financial discussion, that the extent to which we are being outdistanced in these matters is the most important single reason for the overseas lack of confidence in the U.S. economy, that being the main single explanation of the weakness of the dollar, the gold price extravaganza, and powerful aspects of inflation itself. We need to respond effectively to vast domestic needs in energy, environment, and urban aid. Confronted by increasing poverty and neglected human services, we need to enlarge many domestic programs. These needs depend for their fulfillment upon vast increased avail-

[1] Chairman, Council of Economic Advisers under President Truman. President, Conference on Economic Progress.

ability and utilization of goods and services, whether through public or private means or some combination of the two.

What does all this call for in national policies and programs? What it calls for in clarion tones may be determined by the simplest exercise of realistic common sense. It may also be determined by candid examination of those periods in the past when we met similar and even greater problems successfully, by following in the main and with relatively slight exceptions the course which we should follow now if we are not to become a second- or third-rate economic power, repudiate the just expectations and aspirations of our own people, and greatly corrode the very foundations of our ability to protect ourselves and hold or win the respect of others on the international scene. What we must do today, as we have done so successfully before, is to call forth more fully the greatest of America's non-secret weapons, the power to expand our real output of goods and services, and to utilize this expansion with due regard for the urgent priorities of our domestic and international needs. The true limits of such expansion are still very far off, viewing our unrivaled technology, labor force, business skills, free institutions, and responsive citizenry, when put to reasonably full use.

No amount of economists' dialectics, obscurantism, or pure mumbo jumbo can be permitted to blot out this towering truth: The ultimate source and support of all we need and attempt to do, materially speaking, is how much we produce in goods and services and how wisely we use the product, with due regard for our great priorities, domestic and international. All other economic efforts, urgent and vexatious though they may be, must be made subservient to this ultimate purpose. If we abandon or even swerve from this ultimate purpose to deal with other problems, we burn the house in the attempt to roast the pig, and also fail to roast the pig. Thus, to seek price stabilization in a deliberately stunted economy is both futile and a distorted sense of priorities.

For a long time, as this Committee so well knows, we have not been calling forth this great non-secret weapon of our power to enlarge our real economic strength and to use it. My Chart 1, and I shall not linger on any of the charts in detail, depicts the frequent periods of stagnation and recession which have caused a serious and even dangerous shrinkage in our rates of real economic growth, from annual averages of 4.6 percent and 5.4 percent during substantial periods without the galvanizing effects of large scale war, to an average of only 2.9 percent during 1969–1979 and only 0.8 percent from fourth quarter 1978 to fourth quarter 1979. My Chart 2 shows that, conservatively estimated, we have from 1953 through 1979 forfeited about 7.1 trillion 1978 dollars worth of GNP and more than 80 million man-, woman- and teenager-years of employment opportunity by the abnormally low rate of real economic growth. My Chart 3 shows that, if we allow these trends to persist during the years ahead, we will in the four years 1980–1983 inclusive forfeit another 707 billion 1978 dollars worth of GNP, and suffer more than another 12 million years of loss in employment opportunity.

Reflecting some studies which I believe have not been attempted elsewhere or before, my Chart 4 translates this into forfeitures in output, personal income, and employment in the 12 largest cities in the U.S. during 1953–1979. And my Chart 5 estimates the forfeiture in output and employment opportunity in 20 major areas of economic activity in the United States during the same 27 years.

But this is only one aspect of the portrayal of what we have lost. Rejecting many of the ideas about the causes of the decline in productivity, my Chart 6 indicates clearly that the productivity growth rate is destroyed by stagnation and recession, and is very highly rewarding during periods of optimum or even adequate real economic growth as generated by reasonably full utilization of labor force and other productions resources. And my Chart 7 shows that, despite the recent and current collapse of productivity as conventionally measured, we are still witnessing a tremendous increase in the productivity potential in a technological sense. This means very simply that, to maintain reasonably full use of our resources, the real economic growth rate will need to average during the years ahead probably higher than during very good periods in the past.

My Chart 8 shows what the chronic stagnation and recession syndrome has done in terms of comparisons between our real economic growth rates and those of some of the other nations, including Japan and West Germany, who are our most serious competitors and are outdistancing us in one respect after another.

My Chart 9 shows, as the members of this Committee already know, that the fundamental and primary cause of the chronic increases in the Federal deficits, which many held to be inflationary in nature, have been and still are the shortfalls in our real economic growth rates, for the blood of adequate Federal revenues cannot be squeezed from the turnip of a stunted economy. These unremedied deficits will make it harder and harder for us to bear an increased national security burden without increased inflationary pressures, and without translating the legitimate problem of guns and butter into dangerous divisive conflicts among our people. In the context of the situation today and tomorrow, there can be no viable solution to the guns and butter problem except in an economy moving vigorously toward and then maintaining a reasonably full use of its labor force and other production resources.

I now come to just how the Administration's 1980 Economic Report and Fiscal 1981 Budget Message fly blind and in defiance of our needs and capabilities, thus selling America short and subjecting it to ever-increasing difficulties and danger. Just about a year ago, the Economic Report and Budget Message set out deliberately to slow down the rate of our real economic growth, to increase unemployment, and to project for several years ahead an average rate of real GNP performance consistent with only maintenance and enlargement of the creeping paralysis which has afflicted us for so long. At that time, I pointed out before this Committee and in other publications that this course of action would produce results even worse than those forecast by the official documents. And in the main, this came to pass. To take a few examples of many, the actual real economic growth rate in 1979 was greatly lower than that projected by the official documents in January 1979, and the Federal Budget deficit is very much higher. We have gained nothing, and we have lost terrifically by attempting to do better by deliberately doing worse.

Instead of profiting one iota by experience during 1979 and many earlier years, the two official documents I am now discussing project for 1980 a negative economic growth rate of about 1 percent—an absolute recession. This is to be contrasted not with the mere avoidance of recession, but with the 5 to 6 percent real economic growth rate needed during 1980 to begin to move realistically toward the full use of our greatest non-secret weapon. The average annual real economic growth rate projected by the official documents for 1980–1983 inclusive is less than 2.5 percent, or tragically below any substantial number of years since the Great Depression, and the unemployment projections are for a rate of 7.5 percent by the end of 1980, 5.6 percent by the end of 1983, and 4.0 percent in 1985 (see Chart 10).

Viewing the policies set forth in the official documents, I now predict, as I did correctly a year ago, that the actual economic performance will be in the main much worse than the official projections now made. And calling these official projections honest forecasts instead of goals obscures the whole nature of the problem. For in times of difficulty or so-called crisis, it is not the job of the Government of this great nation supinely to accept forecasts of all the bad things that will happen if nature is allowed to take its course, but rather to propose programs and policies to move against these evils and to translate our general capabilities into performance. Never before, as I recollect, did any Administration set a recession and many years of stagnation as a goal or even accept it as a forecast not to be overcome. Never in times as urgent and critical as these did an Administration, in its basic policies, fold up instead of standing up.

Just think of it. The official targets or goals—which are interchangeable with forecasts because they are officially accepted, apologized for, and made subject to policies consistent with them—are that the real rate of economic growth be minus 1.0 percent from 1979 to 1980 and average only 3.0 percent during 1979–1983; that from 1979 to 1980, real consumer spending decline 0.7 percent, and real gross private domestic investment decline 4.0 percent; that productivity decline 0.5 percent from 1979 to 1980, and grow only 1.5 percent on the average during 1979–1983; that CPI inflation be 10.7 percent in 1980, 8.5 percent in 1983, and not get down to reasonable price stability at 3.0 percent until 1988—eight long years from now; and that unemployment be 7.5 percent in 1980, 5.9 percent in 1983, and not reach 4.0 percent until 1985—five long years from now. These figures are on full-year bases, and not to be confused with some of the figures in the official reports which are year-end figures (see again Chart 10). Mr. Chairman and Members of the Committee, what a concept of America's responsibilities at home or perils throughout the world is it, which seems to impel our top national leadership to tell us not only that this is where we are going but also where we ought to go? What has happened to America, and what is going to happen to us if we cannot do better than this?

The excuses and alibis which the official documents evoke in support of the insupportable defy both reason and experience. The argument that we cannot move at a more tolerable and rewarding pace than reduction of unemployment from 5.9 percent at the end of 1979 to 4.0 percent between five and six years later, the argument that we cannot get the inflation rate to 3 percent until about eight years from now—these are horrible things to tell the American people. These goals or forecasts have no scintilla of support in terms of earlier years when we made much more rapid improvements, as demonstrated on some of my charts, and as known to all informed people.

Then, the official documents offer that most discredited of all excuses, the repeated insistence that all of these nationwide deficiencies must be perpetuated and all of these national and international dangers aggravated in order to reduce inflation. In the whole history of national economic policy, I can think of no more sorry exhibition than the obdurate and uninformed insistence that a "trade-off" between unemployment and inflation, a remedy which has failed so egregiously for so many years, will begin to work if only it continues to be tried for another five or eight years; the insistence that the failure of the wrong policies to date is a reason for bringing on even more failure by using the same policies again and again.

I will not linger upon the refutation of the so-called "trade-off" which I have been presenting to this Committee and elsewhere since it first reared its pernicious head circa 1953, although my Charts 11 and 12 repeat the evidence. But I will quote a magnificent passage in the Introduction by the Chairman of this Committee to its Mid-Year Economic Review issued on August 9, 1979, as follows:

"The enormous benefits to be gained by the whole nation from rapid economic growth have united the Joint Economic Committee Majority and Minority * * * This Committee believes that we must and can produce our way out of our economic problems. (p. 1)

"First, policies which produce slow growth will not also produce price stability. A slow-growth scenario for the 1980s implies a concomitant rapid rise in the cost of living. The fight against inflation can be won only by policies which increase production * * * A stagnating economy means more double digit inflation * * * It means protracted and rising unemployment * * * It means a reduced standard of living * * * Policies which lead to slow growth will lead to many and unnecessary cruel hardships for disadvantaged Americans." (pp. 2–3)

There could be no more profound antithesis than that between this sound statement, unanimously agreed to by the Joint Economic Committee about half a year ago, and what the official documents now propose. Those interested in the future of America can only hope and pray that this Committee will stand by its guns and that the Congress will likewise insist, as the Humphrey-Hawkins Act mandates, that the goals and policies of the Administration be brought into line with the crying needs of today and tomorrow and our true ability to meet them. To borrow a phrase from Thomas Jefferson, "I shudder for the future of my country when I consider" the economic and moral ideology of Dr. Schultze.

I cannot refrain from a few words about the mistaken claim made by the President that his deferral of the timetables in the Humphrey-Hawkins Act relating to the reduction of unemployment and the reduction of inflation are authorized by that Act as of the time of the January 1980 Economic Report. Nothing could be further from the actual facts. The three points to be made are these:

(1) The Act requires the President, in his 1980 Economic Report, to review progress under the Act and, if necessary, propose corrective actions to achieve the goals within the original timetables (Sec. 104). The President has not done this.

(2) The Act requires that, if such corrective action is necessary, the President shall utilize reservoir, or last-resort, employment projects, if such be necessary, as a part of such corrective action, to meet the original timetables of the Act (Sec. 206 (c)). The President has made no attempt to do this.

(3) Even if the above two steps were taken, as mandated by the Act, The President would not then be authorized to change the original timetables. He is authorized only to recommend modifications of the timetables, in which event Congress may take such action as it deems desirable (Sec. 104) to accept or change the President's recommendations (Sec. 304).

In these connections, I would also call attention to the Report issued late in 1979 by the House Committee on Education and Labor, responsive to a mandate in the Humphrey-Hawkins Act, reading as follows:

"The goals and timetables set forth in the Act are both reasonable and essential, and should not be modified. The Act should be observed and its objectives brought to fulfillment within the timetables in the Act. But the national programs and policies thus far initiated by the President in his 1979 Economic Report and Budget Message, and thus far adopted by the Congress, are not at all in accord with the explicit requirements of the Act, and indeed move in opposite directions."

The OPEC price increases in 1979 and in some earlier years do not conflict with the above conclusions. The chronic rise to date in the rate of inflation since 1966 got started long before the OPEC price actions in 1979 or earlier. The underlying rate of inflation, excluding the impact of OPEC actions, is now more than three times what it was during the earlier periods when we came close to a full economy, for example 1947–1953, and 1961–1966. Some of the largest price increases have been in areas not closely related to energy price increases.

The Congress was correct, in the Humphrey-Hawkins Act, in proscribing the use of the thoroughly discredited "trade-off" between unemployment and inflation. And the international situation and the greatly enlarged defense budget make it even more urgent that we combat inflation and build our supporting economic strength, not be continued economic slowdown, but rather by policies and programs effectively used to help achieve the 1983 goals and timetable for the reduction of unemployment, and for real GNP growth and expansion of real production and productivity. The energy problem may make this more difficult, but also make it more essential. And it is entirely feasible, with an adequate energy program including conservation and development and other national policies to encourage shifts in the composition of GNP to save energy and responsive to priorities of need.

Despite limitations of time, I want to call some attention to the terrible impact of Federal Reserve Board policies upon the rate of real economic growth, the pace of inflation, the Federal deficit, the costs imposed upon American families, and the especially severe impact upon the cost and occupancy of homes. This last is doubly important, because housing is of such great importance in the performance of the whole economy, and because the rate of inflation in this area has been especially severe, and so closely traceable to monetary policies, and relatively rather remote from the energy problem.

In these connections, my Chart 13 indicates the dangerous increase in consumer credit and in debts, occasioned in large measure by the impact of adverse economic trends upon the real incomes and buying power of a majority of our people.

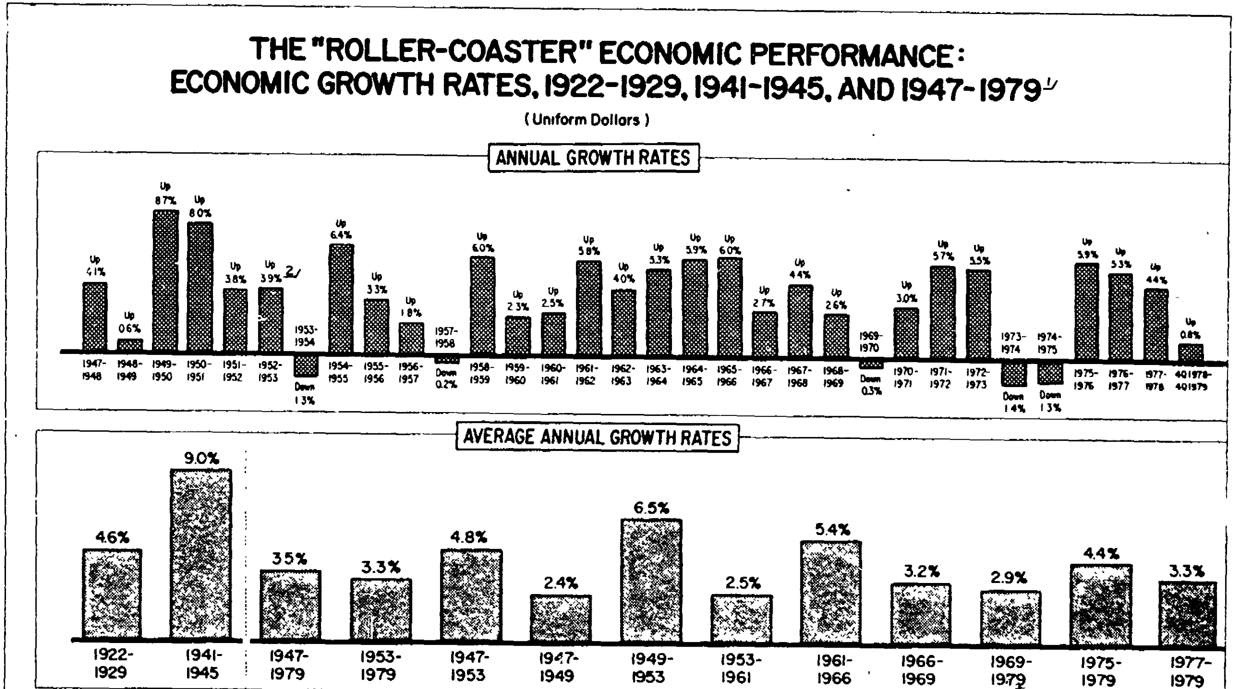
My Chart 14 shows, for various industries, the sharply rising ratio of debt to total capital, aggravated in its consequences by the fantastic upward movement of borrowing costs. My Chart 15 indicates that, measured properly in real terms, the growth rate in the money supply has been infinitesimal on the average since 1953, and has been negative in many years leading up to stagnation and recession, including the most recent period; and the chart also shows the effects of this upon rates of real economic growth. My Chart 16 depicts the soaring interest rates across the board; my Chart 17 estimates the costs imposed by this spiral upon private and public borrowers; and my Chart 18 shows the extent to which the increased interest costs imposed upon the Federal Government explain the Federal deficit and compare with budget outlays for some of the greatest priorities of our national needs, in part served necessarily by the Federal Budget. My Chart 19 shows the unfortunate decline of housing in relationship to the total economic performance, this being a major factor in the unacceptable performance as a whole.

My Chart 20 shows the virtual tripling of interest rates on home mortgages since 1953, and my Chart 21 depicts the awful effects of this upon the costs borne by home occupants, whether owners or renters, and indicates how this progressively contributes to the inabliity of more and more families to enter the market for a preponderance of the housing that is being built.

It is not historically true that national Administrations and Presidents have not properly and effectively concerned themselves with the management of the people's money through the Federal Reserve System. I find it shocking and even frightening that the current Administration, in these parlous times, is actually encouraging a pervasive monetary policy which squares only with the current policies of the Administration itself and, in so doing, defies what we need to do and are well able to do.

Never in the 24 years since enactment of the Employment Act of 1946, now reinforced mightily by the Humphrey-Hawkins Act of 1978 if only it were to be observed, has this Committee been faced with more awesome responsibilities than it has now, as an evaluator and potential modifier of the proposals of the Administration, as a vital guardian of the American people. I trust and believe that the Committee, this year, will respond to the challenges confronting it.

Chart 1

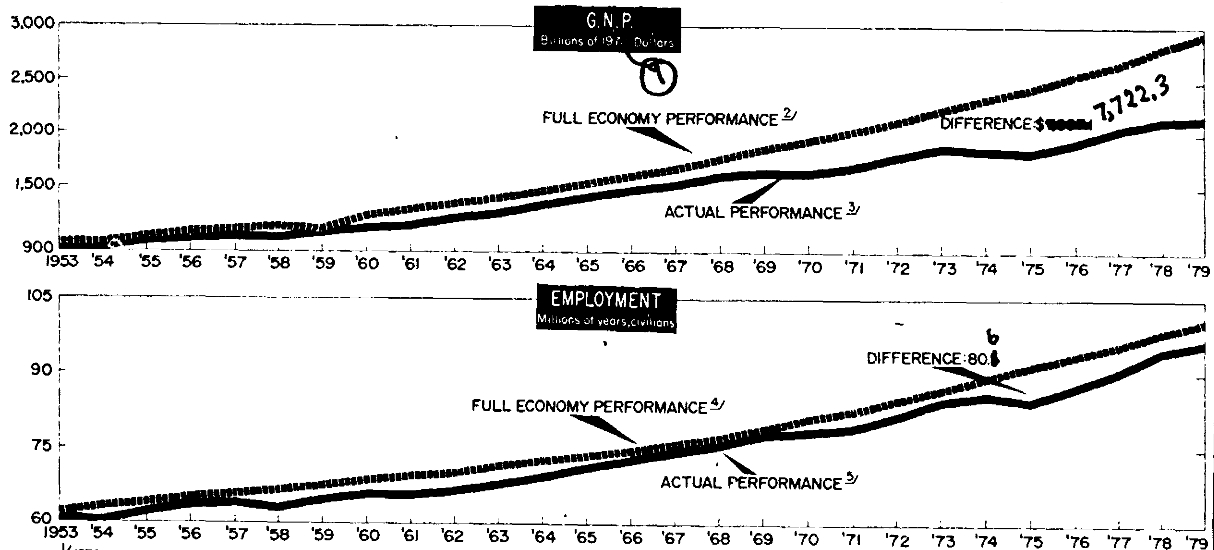


1/ 1979 estimated

2/ Recession during part of period. There were five recessions, 1953-1978, but some were entirely within one year, and began and ended in different years.

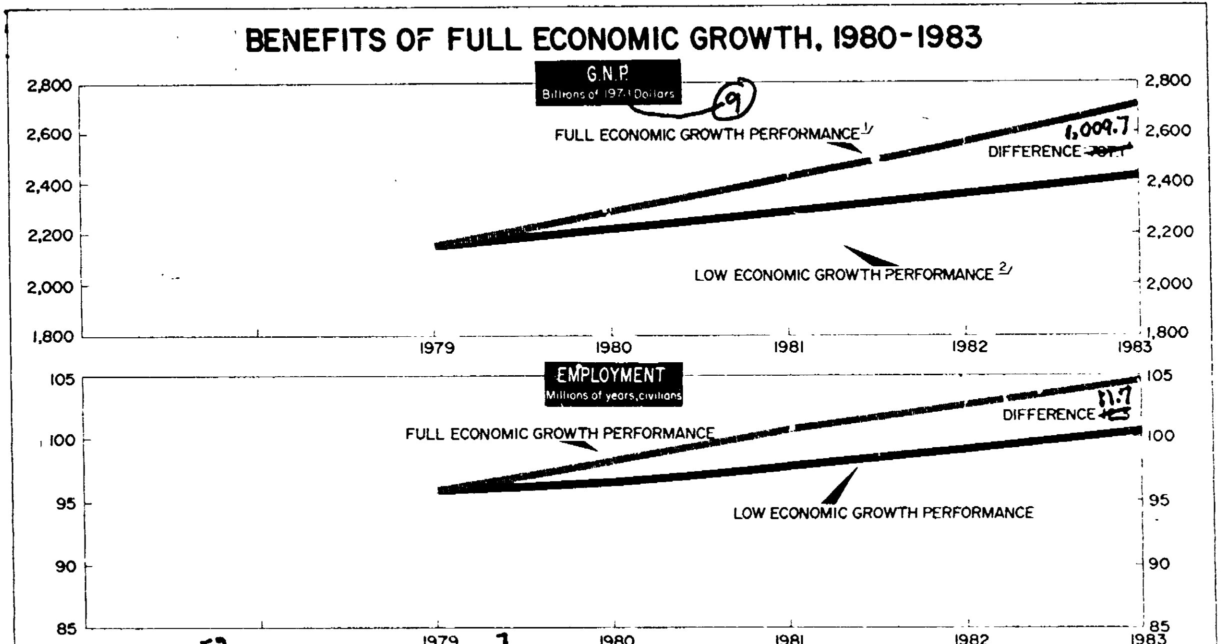
CHART 2

COST OF DEPARTURES FROM FULL ECONOMY, 1953-1979 1/



1/ 1979 estimated
2/ Real average annual growth rate of 4.4 percent
3/ Real average annual growth rate of 3.3 percent, the 1953-1979 average.
4/ Average true level of unemployment of 4.1 percent, or 2.9 percent full-time unemployment
5/ Average true level of unemployment of 7.8 percent, or 5.2 percent full-time unemployment
Basic Data: Dept of Commerce, Dept of Labor

CHART 3

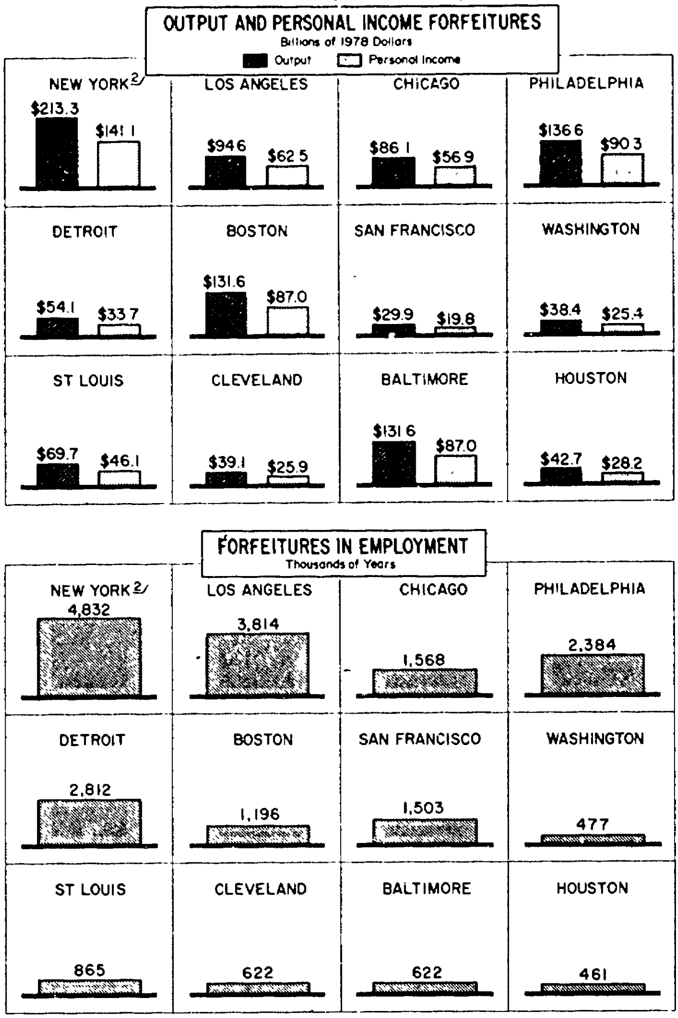


1/ Real growth rate of 5.2%, 1979-'80 Real average annual growth rate of 5 7%, 1979-1983, & 5.8% 1980-'83. These growth rates would be consistent with reducing overall unemployment to 4% by the middle of 1983

2/ Real average annual growth rate of 3.0%, compared with 2.8%, 1969-1979 (The [illegible] average annual rate, 1979-1983 in the President's 1980 Economic Report is deemed unattainable under policies and programs in such Economic Report)

CHART 4

FORFEITURES IN OUTPUT, PERSONAL INCOME, AND EMPLOYMENT, BY CITY, 1953-1979[1]



[1] Output forfeitures are portion of G N P forfeitures 7 1 billion 1978 dollars, 1953-1979 Employment forfeitures are portion of nationwide forfeitures of 80 5 million years of employment, 1953-1979

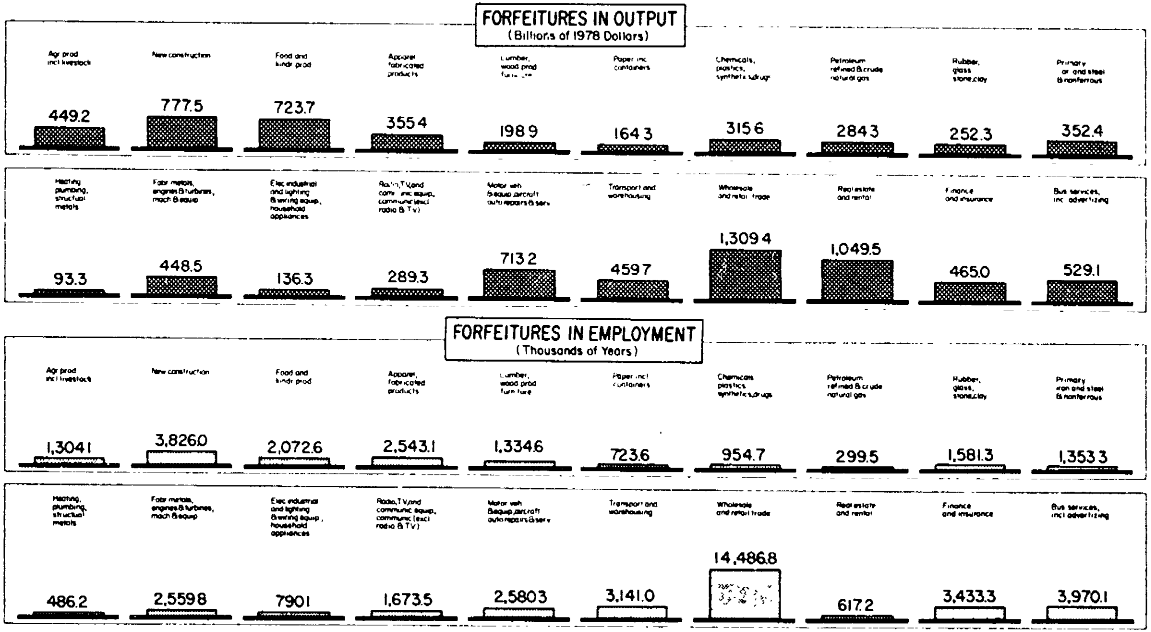
[2] SMSA for all cities

Note Employment forfeitures do not correlate closely with output & income forfeitures, which involve other factors

Basic Data Dept of Labor, Dept of Commerce

CHART 5

FORFEITURES IN OUTPUT AND EMPLOYMENT IN VARIOUS INDUSTRIES, 1953-1979[1]



[1] Output forfeitures are portion of G N P forfeiture of 7 1 billion 1978 dollars, & employment forfeitures are portion of nationwide employment forfeiture of 80 5 million years, 1953-1979

CHART 6

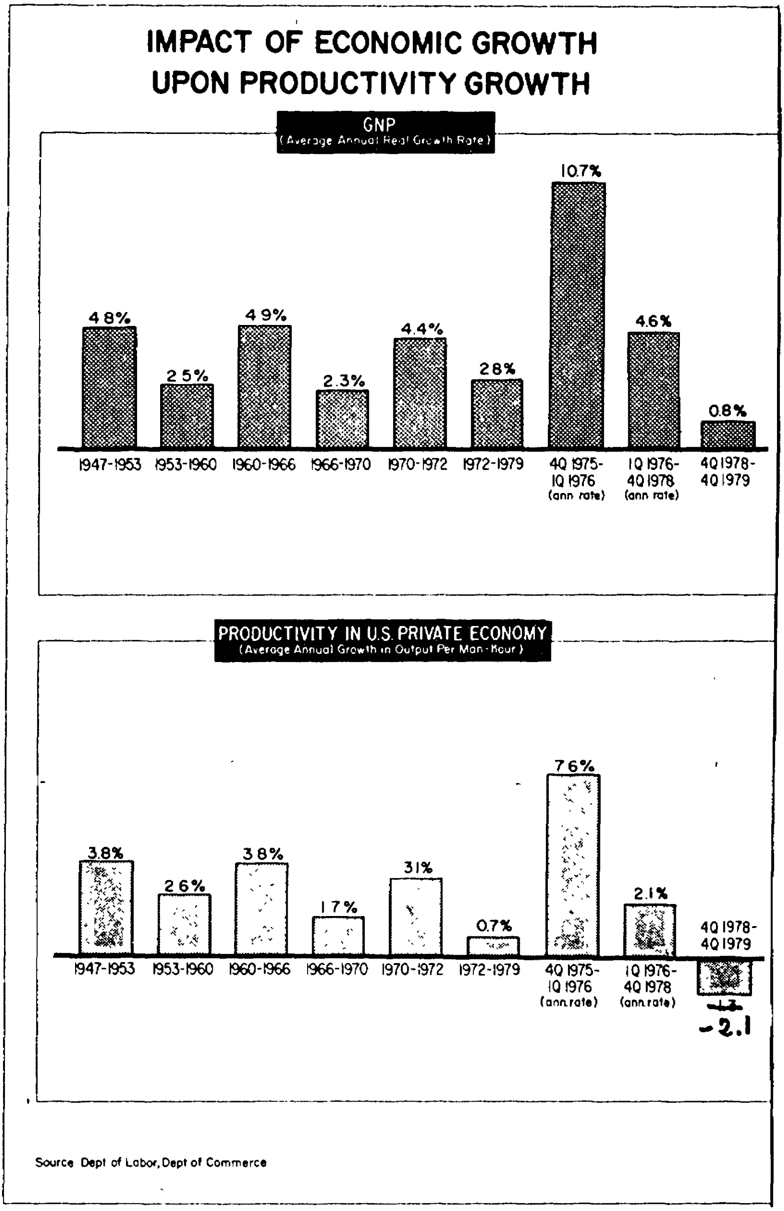
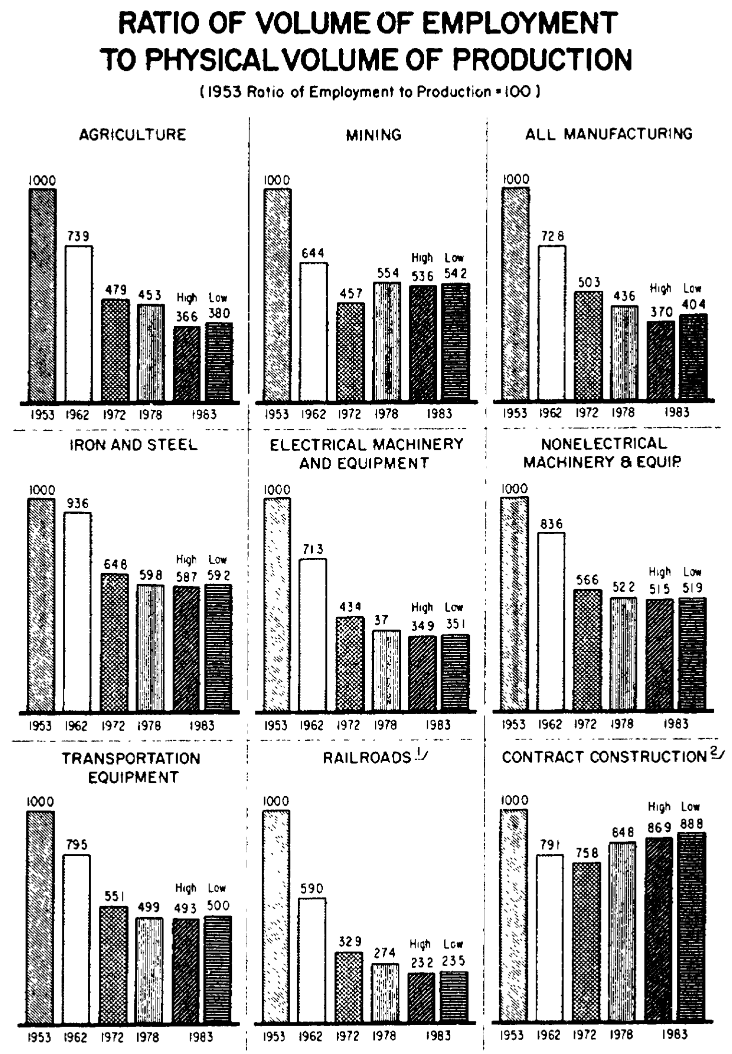

IMPACT OF ECONOMIC GROWTH
UPON PRODUCTIVITY GROWTH
GNP
(Average Annual Real Growth Rate)
4.8%
2.5%
4.9%
2.3%
4.4%
2.8%
10.7%
4.6%
0.8%
1947-1953
1953-1960
1960-1966
1966-1970
1970-1972
1972-1979
4Q 1975-1Q 1976 (ann rate)
1Q 1976-4Q 1978 (ann rate)
4Q 1978-4Q 1979
PRODUCTIVITY IN U.S. PRIVATE ECONOMY
(Average Annual Growth in Output Per Man-Hour)
3.8%
2.6%
3.8%
1.7%
3.1%
0.7%
7.6%
2.1%
-2.1
1947-1953
1953-1960
1960-1966
1966-1970
1970-1972
1972-1979
4Q 1975-1Q 1976 (ann.rate)
1Q 1976-4Q 1978 (ann.rate)
4Q 1978-4Q 1979
Source Dept of Labor, Dept of Commerce

CHART 7



1/ Rates of index of employment for all railroads to index of revenue ton-miles carried by Class I railroads

2/ Ratio of index of employment in contract construction to index of constant dollar value of structures put in place

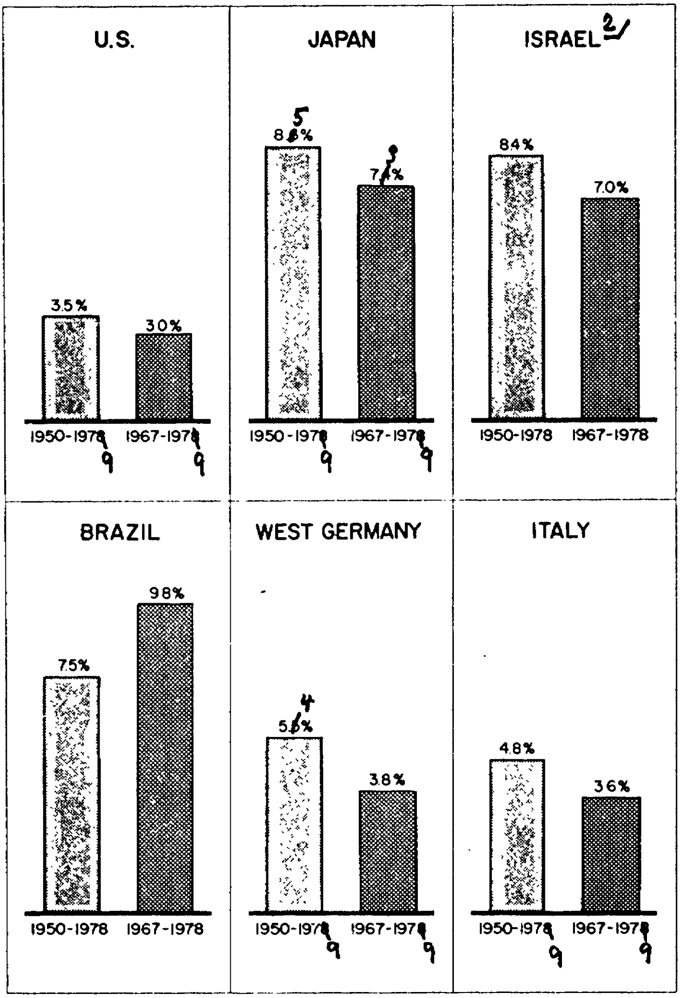
Note: The highs and lows represent developments in accord with Humphrey-Hawkins Act goals compared with estimated developments under projections of current national economic policies

Sources through 1978: B.L.S., B.E.A., F.R.B.

CHART 8

COMPARATIVE REAL ECONOMIC GROWTH RATES VARIOUS COUNTRIES, 1953-1979 AND 1969-1979[1]

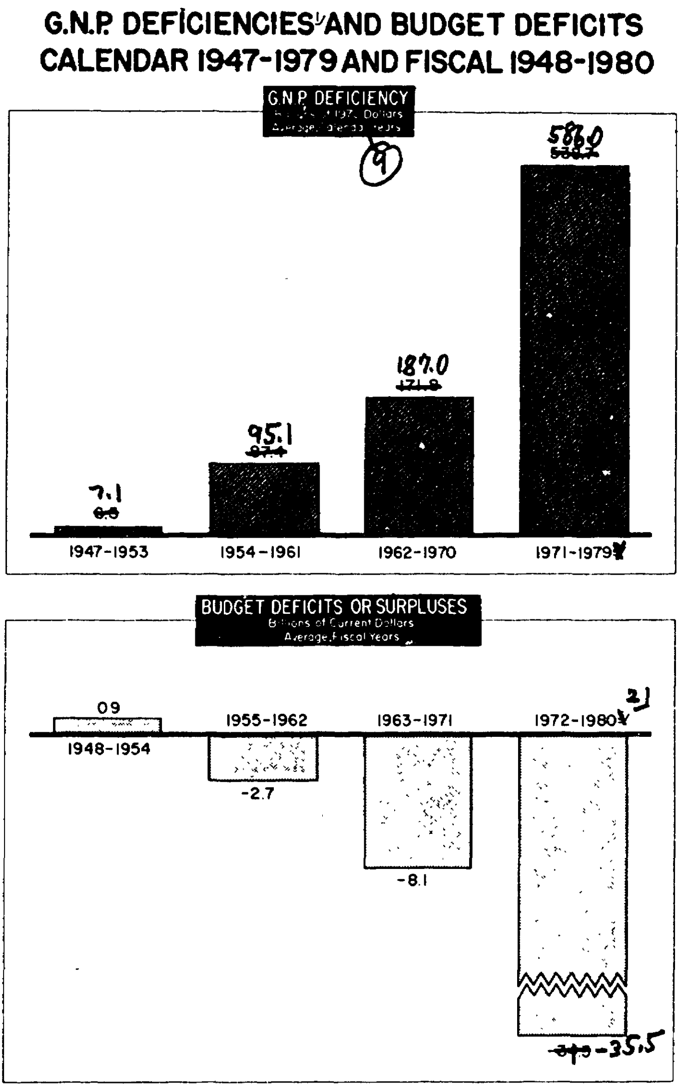
Average Annual Rates of Growth



1/ G N P for U S , Japan, & Germany Gross domestic product for all other countries

2/ 1979 not available.

Chart 9



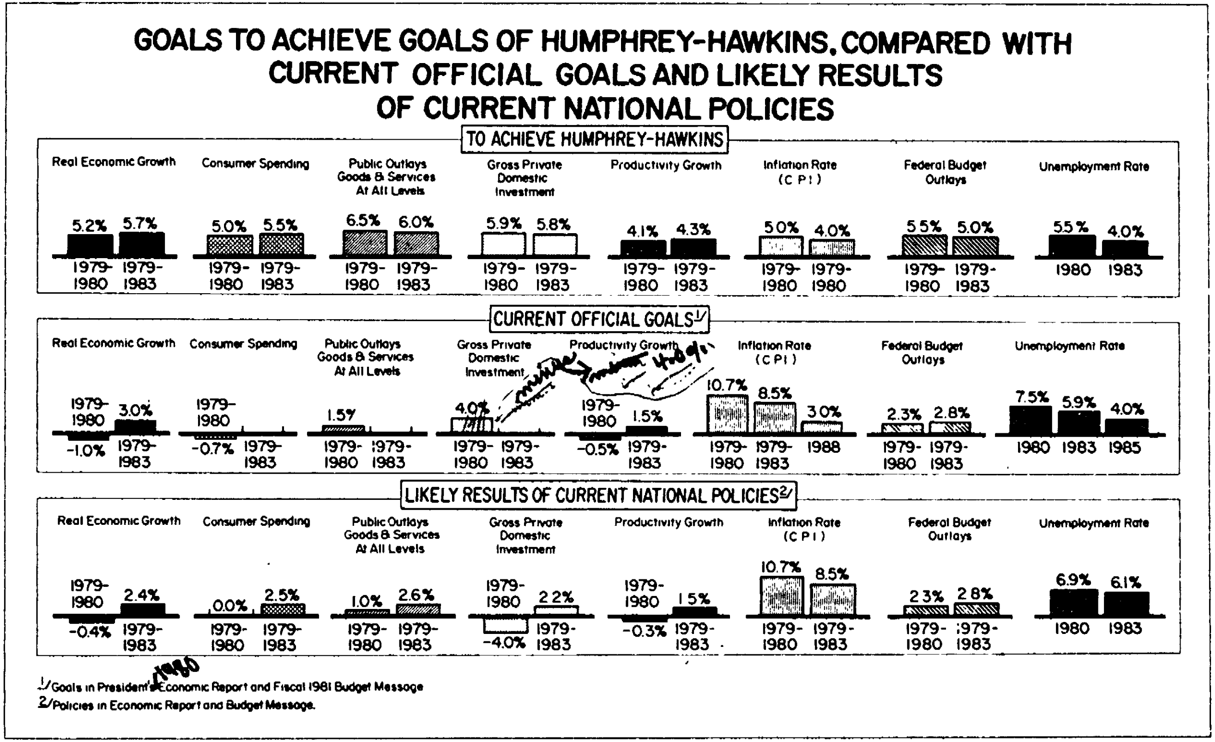
1/ Production deficiencies represent differences between actual production and production at full economy rate of growth. Projections from 1946. Allowing for nonrecouperable losses, over the years, GNP 190-245 billion below full economy in 1979

~~2/ 1979 estimated.~~

2/ ~~3/~~ ~~1979 and~~ 1980 deficits ~~are~~ is ~~the~~ estimate in the President's 1981 Budget, as of January 28, 1980.

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

CHART 10



GOALS TO ACHIEVE GOALS OF HUMPHREY-HAWKINS, COMPARED WITH CURRENT OFFICIAL GOALS AND LIKELY RESULTS OF CURRENT NATIONAL POLICIES
TO ACHIEVE HUMPHREY-HAWKINS
Real Economic Growth
5.2% 5.7%
1979-1980 1979-1983
Consumer Spending
5.0% 5.5%
1979-1980 1979-1983
Public Outlays Goods & Services At All Levels
6.5% 6.0%
1979-1980 1979-1983
Gross Private Domestic Investment
5.9% 5.8%
1979-1980 1979-1983
Productivity Growth
4.1% 4.3%
1979-1980 1979-1983
Inflation Rate (CPI)
5.0% 4.0%
1979-1980 1979-1980
Federal Budget Outlays
5.5% 5.0%
1979-1980 1979-1983
Unemployment Rate
5.5% 4.0%
1980 1983
CURRENT OFFICIAL GOALS1/
Real Economic Growth
1979-1980 -1.0% 3.0% 1979-1983
Consumer Spending
1979-1980 -0.7% 1979-1983
Public Outlays Goods & Services At All Levels
1.5% 1979-1980 1979-1983
Gross Private Domestic Investment
4.0% 1979-1980 1979-1983
Productivity Growth
1979-1980 -0.5% 1.5% 1979-1983
Inflation Rate (CPI)
10.7% 8.5% 3.0%
1979-1980 1979-1983 1988
Federal Budget Outlays
2.3% 2.8%
1979-1980 1979-1983
Unemployment Rate
7.5% 5.9% 4.0%
1980 1983 1985
LIKELY RESULTS OF CURRENT NATIONAL POLICIES2/
Real Economic Growth
1979-1980 -0.4% 2.4% 1979-1983
Consumer Spending
0.0% 2.5%
1979-1980 1979-1983
Public Outlays Goods & Services At All Levels
1.0% 2.6%
1979-1980 1979-1983
Gross Private Domestic Investment
1979-1980 -4.0% 2.2% 1979-1983
Productivity Growth
1979-1980 -0.3% 1.5% 1979-1983
Inflation Rate (CPI)
10.7% 8.5%
1979-1980 1979-1983
Federal Budget Outlays
2.3% 2.8%
1979-1980 1979-1983
Unemployment Rate
6.9% 6.1%
1980 1983
1/Goals in President's Economic Report and Fiscal 1981 Budget Message
2/Policies in Economic Report and Budget Message.

CHART 11

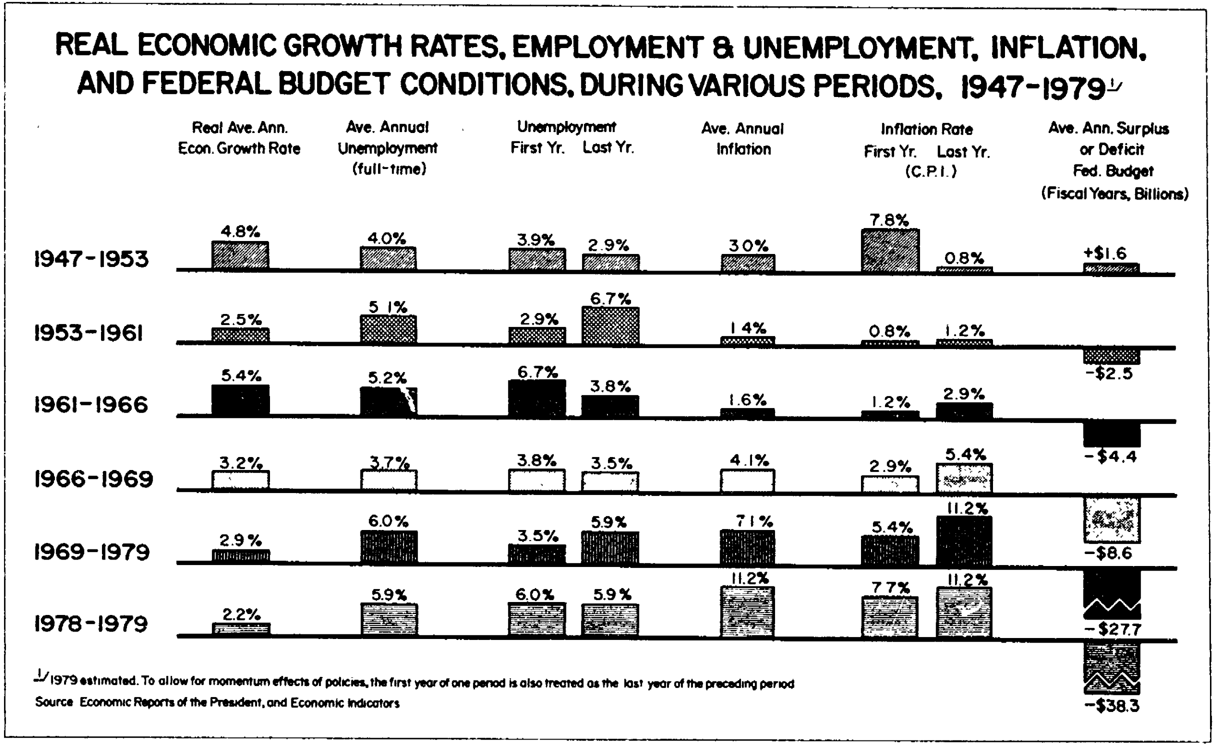
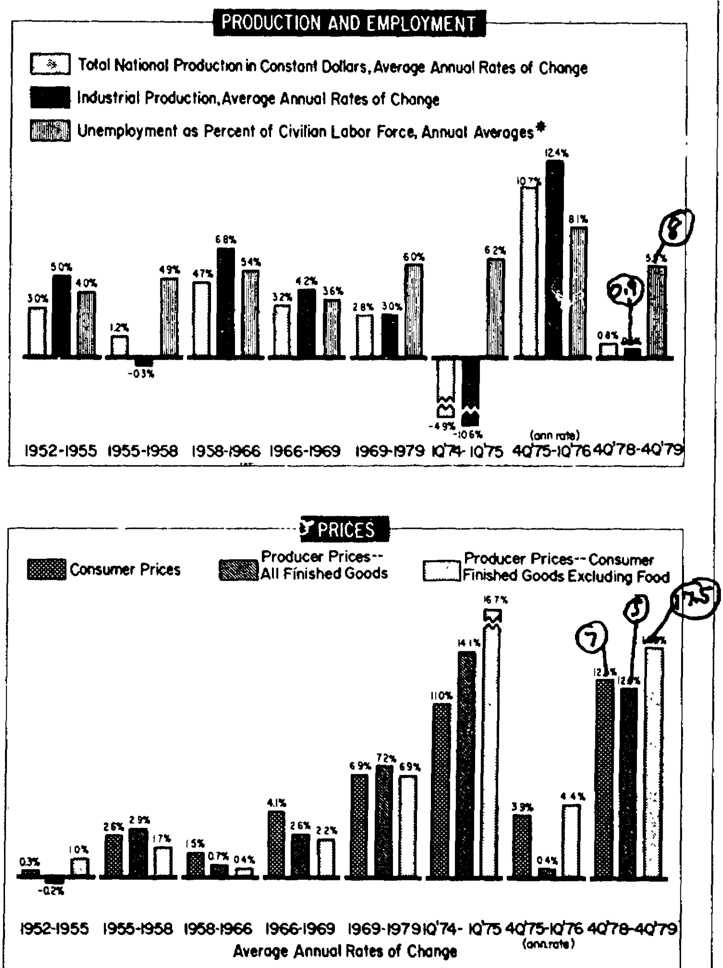

REAL ECONOMIC GROWTH RATES, EMPLOYMENT & UNEMPLOYMENT, INFLATION, AND FEDERAL BUDGET CONDITIONS, DURING VARIOUS PERIODS, 1947-1979[1]
Real Ave. Ann. Econ. Growth Rate
Ave. Annual Unemployment (full-time)
Unemployment First Yr. Last Yr.
Ave. Annual Inflation
Inflation Rate First Yr. Last Yr. (C.P.I.)
Ave. Ann. Surplus or Deficit Fed. Budget (Fiscal Years, Billions)
1947-1953
4.8%
4.0%
3.9%
2.9%
3.0%
7.8%
0.8%
+$1.6
1953-1961
2.5%
5.1%
2.9%
6.7%
1.4%
0.8%
1.2%
-$2.5
1961-1966
5.4%
5.2%
6.7%
3.8%
1.6%
1.2%
2.9%
-$4.4
1966-1969
3.2%
3.7%
3.8%
3.5%
4.1%
2.9%
5.4%
-$8.6
1969-1979
2.9%
6.0%
3.5%
5.9%
7.1%
5.4%
11.2%
-$27.7
1978-1979
2.2%
5.9%
6.0%
5.9%
11.2%
7.7%
11.2%
-$38.3
[1] 1979 estimated. To allow for momentum effects of policies, the first year of one period is also treated as the last year of the preceding period
Source Economic Reports of the President, and Economic Indicators

CHART 12

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952-1979[p]

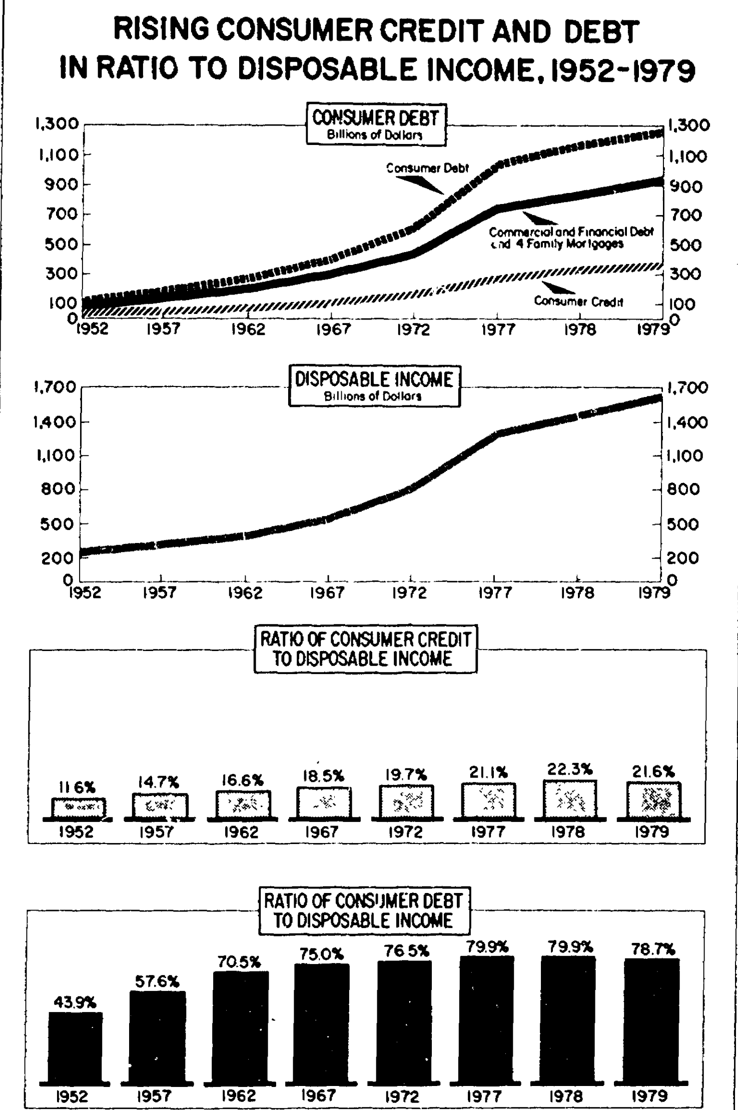


~~p/ 1979 estimated.~~

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

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

CHART 13



1/ 1977, 1978, and 1979 estimated

Basic data Dept of Commerce, Federal Reserve Board

CHART 14

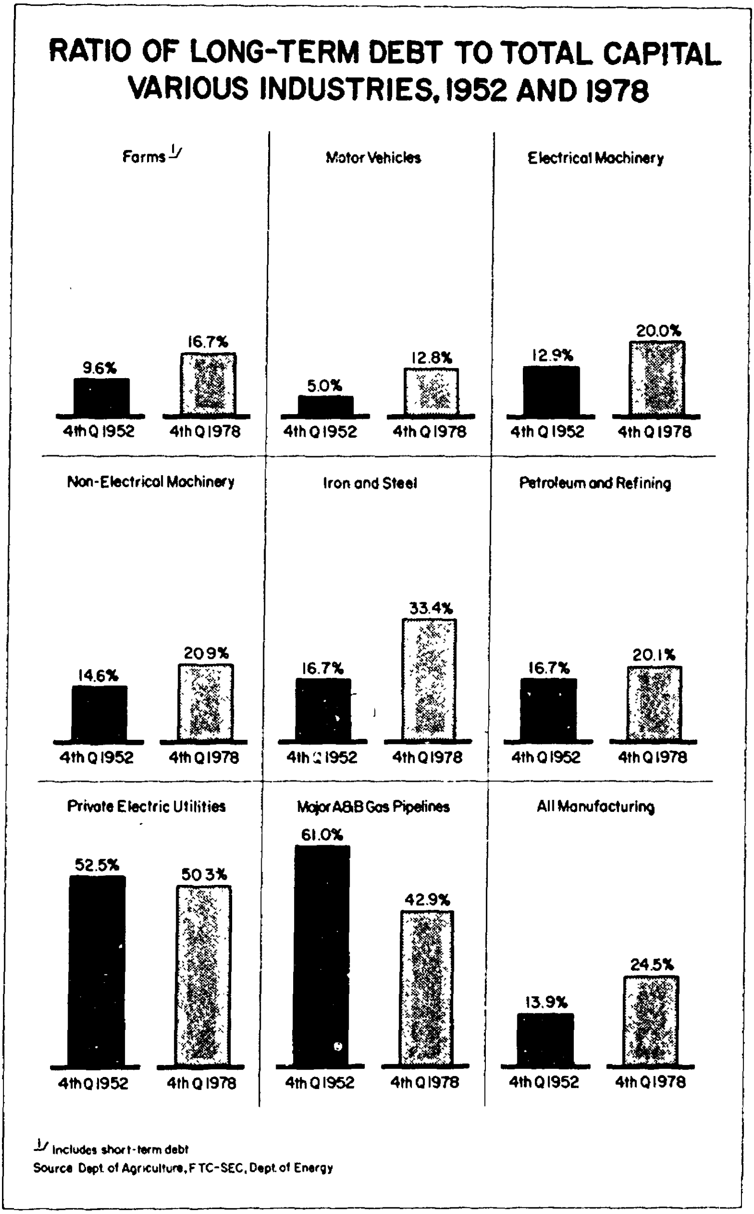

RATIO OF LONG-TERM DEBT TO TOTAL CAPITAL
VARIOUS INDUSTRIES, 1952 AND 1978
Farms 1/
9.6%
16.7%
4th Q 1952
4th Q 1978
Motor Vehicles
5.0%
12.8%
4th Q 1952
4th Q 1978
Electrical Machinery
12.9%
20.0%
4th Q 1952
4th Q 1978
Non-Electrical Machinery
14.6%
20.9%
4th Q 1952
4th Q 1978
Iron and Steel
16.7%
33.4%
4th Q 1952
4th Q 1978
Petroleum and Refining
16.7%
20.1%
4th Q 1952
4th Q 1978
Private Electric Utilities
52.5%
50.3%
4th Q 1952
4th Q 1978
Major A&B Gas Pipelines
61.0%
42.9%
4th Q 1952
4th Q 1978
All Manufacturing
13.9%
24.5%
4th Q 1952
4th Q 1978
1/ Includes short-term debt
Source Dept. of Agriculture, FTC-SEC, Dept. of Energy

CHART 15

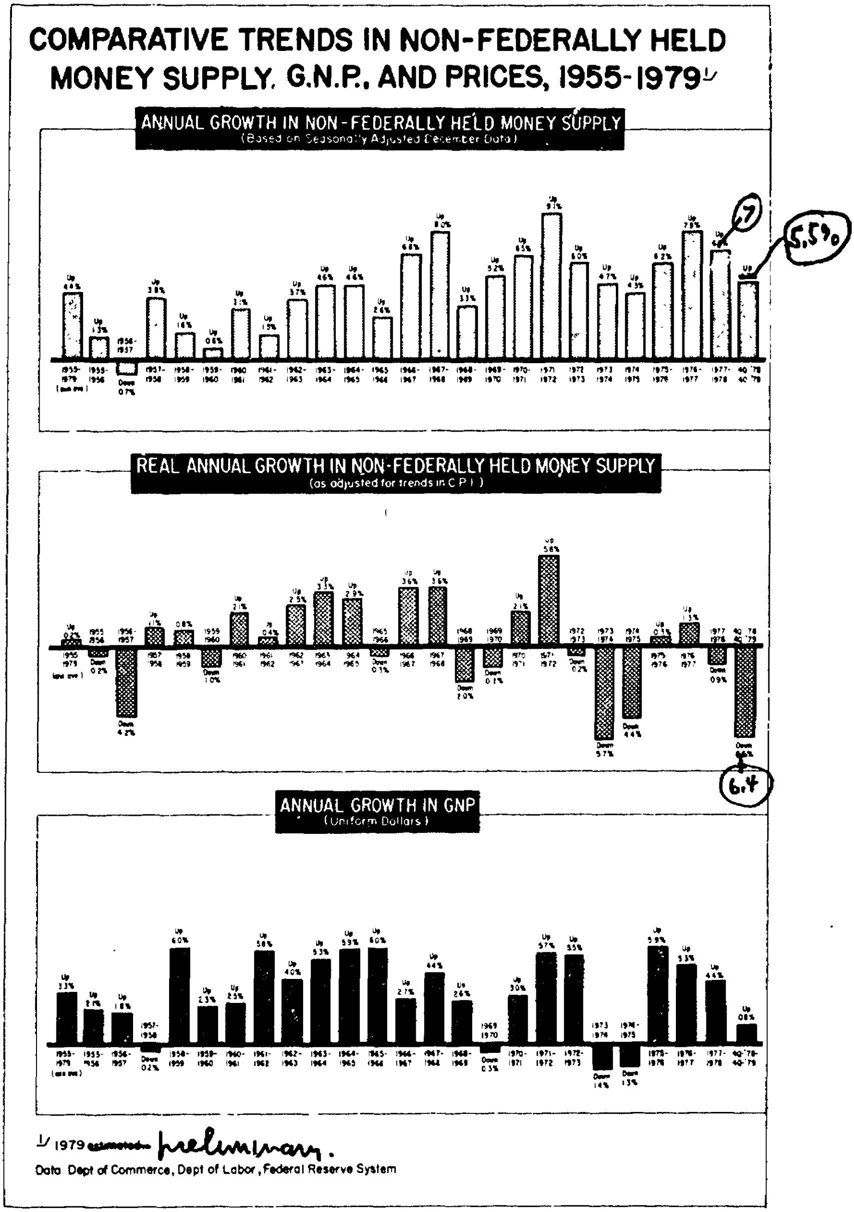

COMPARATIVE TRENDS IN NON-FEDERALLY HELD MONEY SUPPLY, G.N.P., AND PRICES, 1955-1979 1/
ANNUAL GROWTH IN NON-FEDERALLY HELD MONEY SUPPLY
(Based on Seasonally Adjusted December Data)
7
5.5%
REAL ANNUAL GROWTH IN NON-FEDERALLY HELD MONEY SUPPLY
(as adjusted for trends in C.P.I.)
6.4
ANNUAL GROWTH IN GNP
(Uniform Dollars)
1/ 1979 preliminary.
Data Dept of Commerce, Dept of Labor, Federal Reserve System

CHART 16

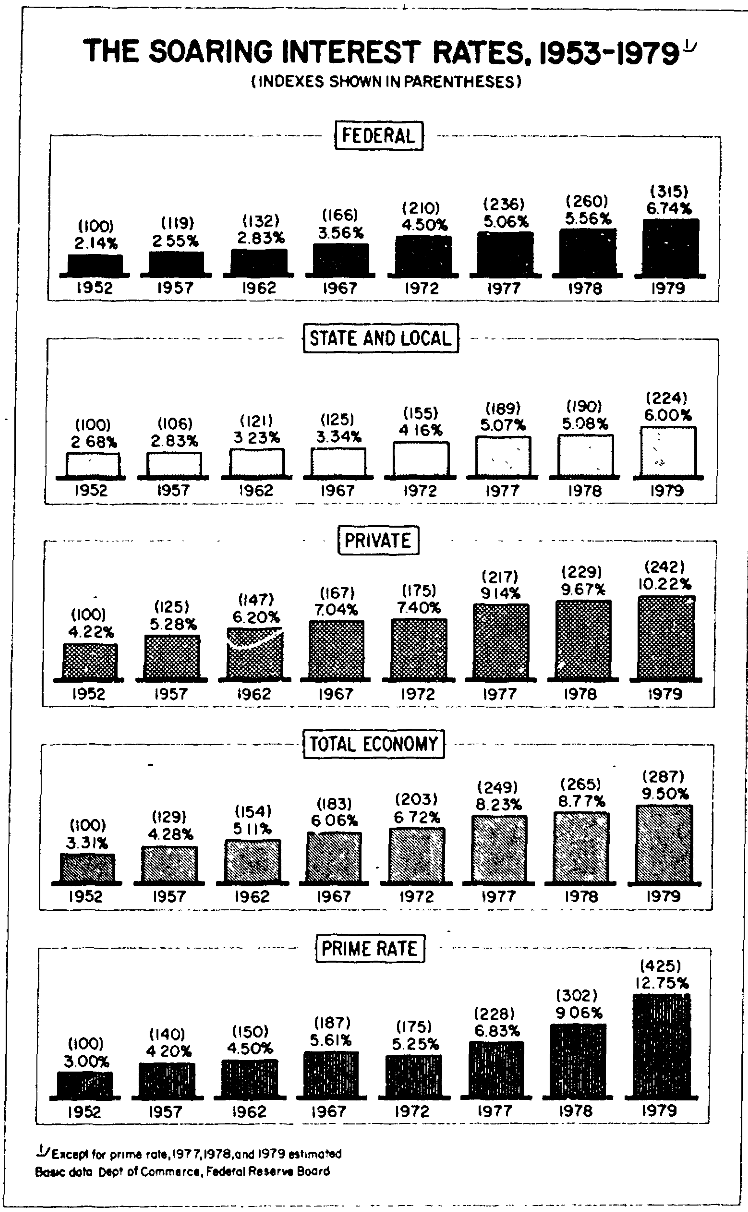

THE SOARING INTEREST RATES, 1953-1979[1]
(INDEXES SHOWN IN PARENTHESES)
FEDERAL
(100) 2.14% 1952
(119) 2.55% 1957
(132) 2.83% 1962
(166) 3.56% 1967
(210) 4.50% 1972
(236) 5.06% 1977
(260) 5.56% 1978
(315) 6.74% 1979
STATE AND LOCAL
(100) 2.68% 1952
(106) 2.83% 1957
(121) 3.23% 1962
(125) 3.34% 1967
(155) 4.16% 1972
(189) 5.07% 1977
(190) 5.08% 1978
(224) 6.00% 1979
PRIVATE
(100) 4.22% 1952
(125) 5.28% 1957
(147) 6.20% 1962
(167) 7.04% 1967
(175) 7.40% 1972
(217) 9.14% 1977
(229) 9.67% 1978
(242) 10.22% 1979
TOTAL ECONOMY
(100) 3.31% 1952
(129) 4.28% 1957
(154) 5.11% 1962
(183) 6.06% 1967
(203) 6.72% 1972
(249) 8.23% 1977
(265) 8.77% 1978
(287) 9.50% 1979
PRIME RATE
(100) 3.00% 1952
(140) 4.20% 1957
(150) 4.50% 1962
(187) 5.61% 1967
(175) 5.25% 1972
(228) 6.83% 1977
(302) 9.06% 1978
(425) 12.75% 1979
[1] Except for prime rate, 1977, 1978, and 1979 estimated
Basic data: Dept of Commerce, Federal Reserve Board

CHART 17

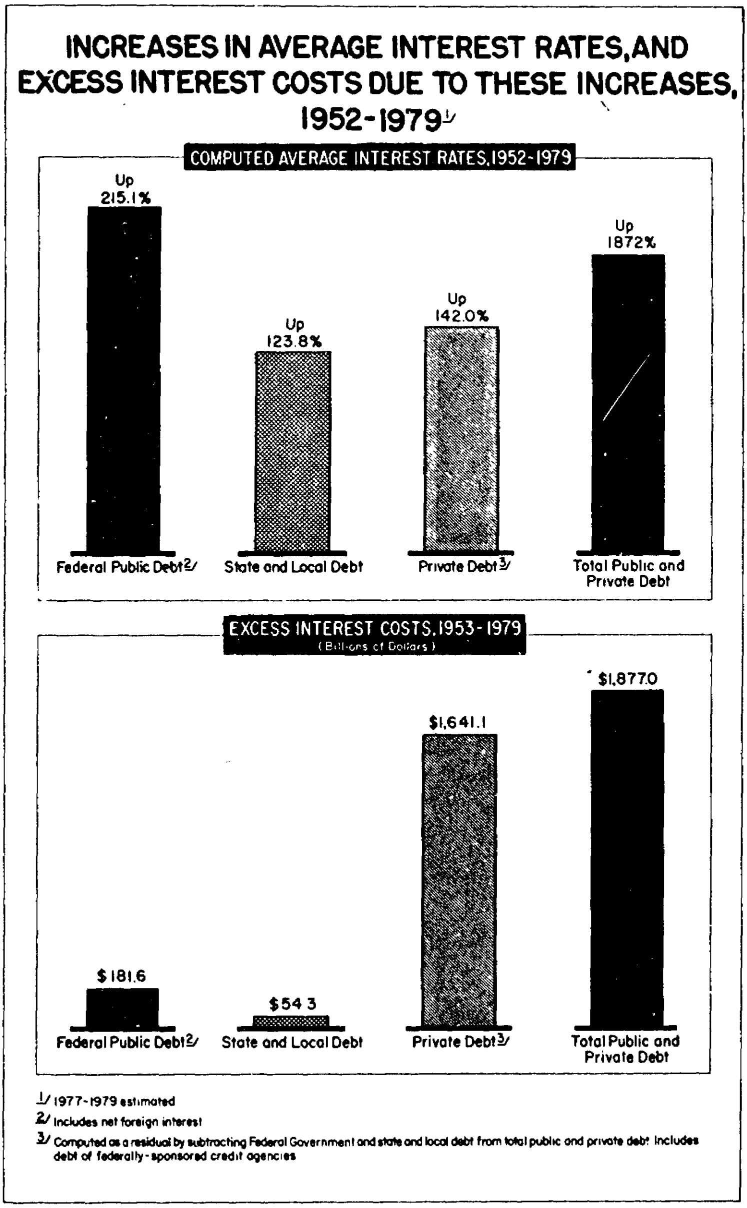
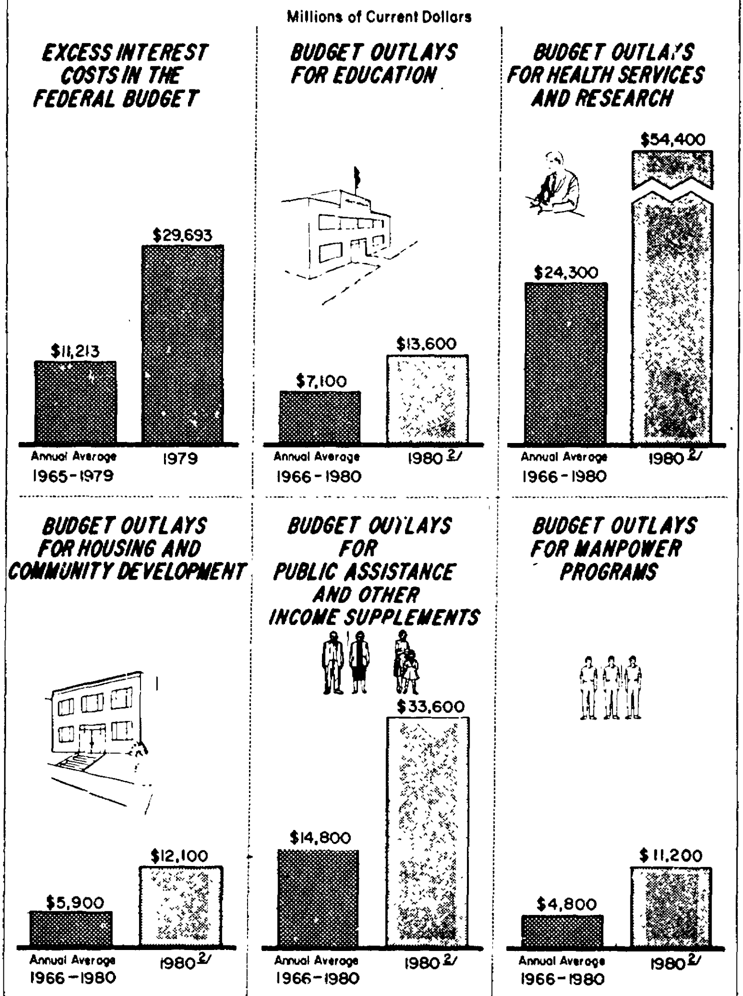

INCREASES IN AVERAGE INTEREST RATES, AND EXCESS INTEREST COSTS DUE TO THESE INCREASES, 1952-1979[1]
COMPUTED AVERAGE INTEREST RATES, 1952-1979
Up 215.1%
Up 123.8%
Up 142.0%
Up 1872%
Federal Public Debt[2]
State and Local Debt
Private Debt[3]
Total Public and Private Debt
EXCESS INTEREST COSTS, 1953-1979
(Billions of Dollars)
$181.6
$54 3
$1,641.1
$1,877.0
Federal Public Debt[2]
State and Local Debt
Private Debt[3]
Total Public and Private Debt
1/ 1977-1979 estimated
2/ Includes net foreign interest
3/ Computed as a residual by subtracting Federal Government and state and local debt from total public and private debt. Includes debt of federally-sponsored credit agencies

CHART 18

EXCESS INTEREST COSTS IN THE FEDERAL BUDGET 1965-1979 CONTRASTED WITH OTHER COSTS FOR SELECTED BUDGET PROGRAMS

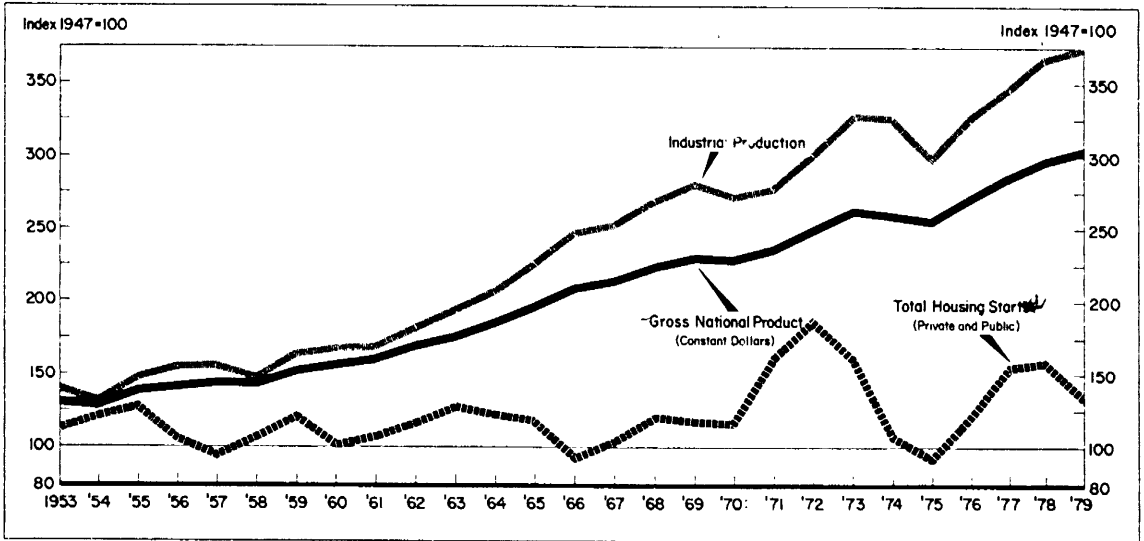


1/ Interest costs, calendar years, budget outlays, fiscal years. 1979 interest costs estimated

2/ As shown for fiscal 1980 in President's Budget, as revised in Mid-Session Review, July 12, 1979

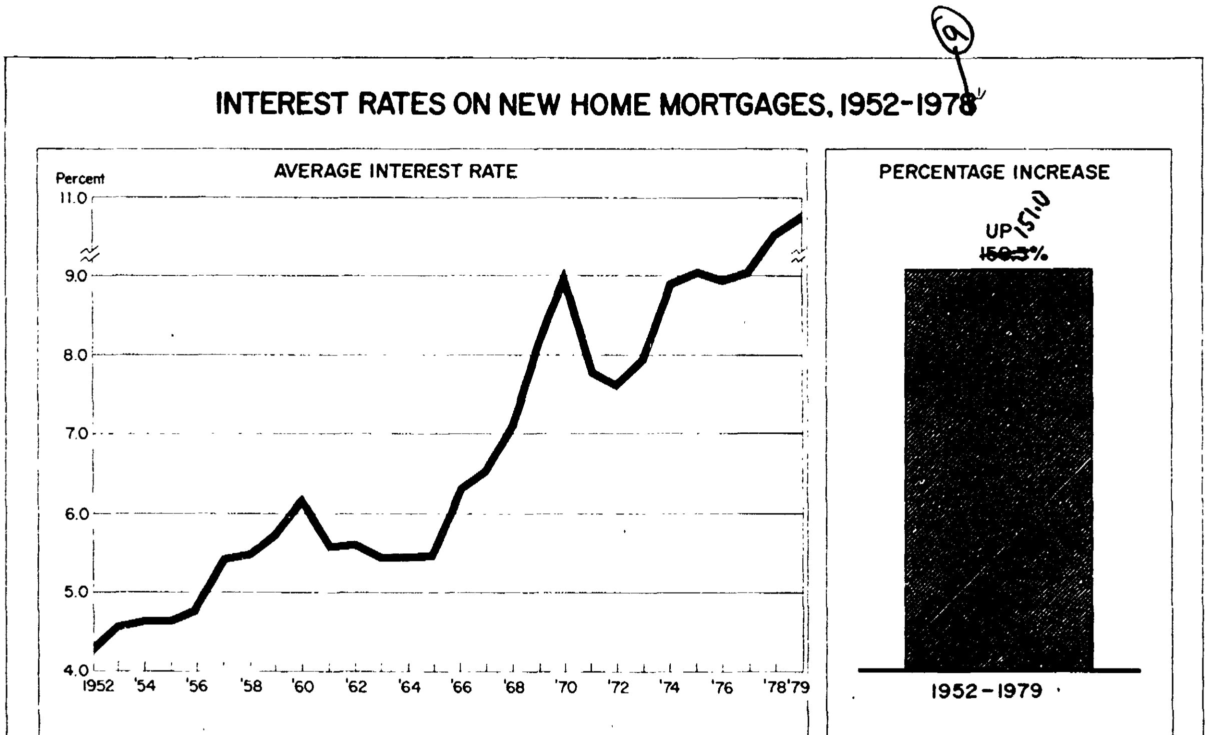
CHART 19

HOUSING STARTS, INDUSTRIAL PRODUCTION AND GROSS NATIONAL PRODUCT, 1947-1979[1]



[1] 1979 estimated
[2] 1953-1958 is non-farm only
Source: Dept of Commerce, FHA, and VA

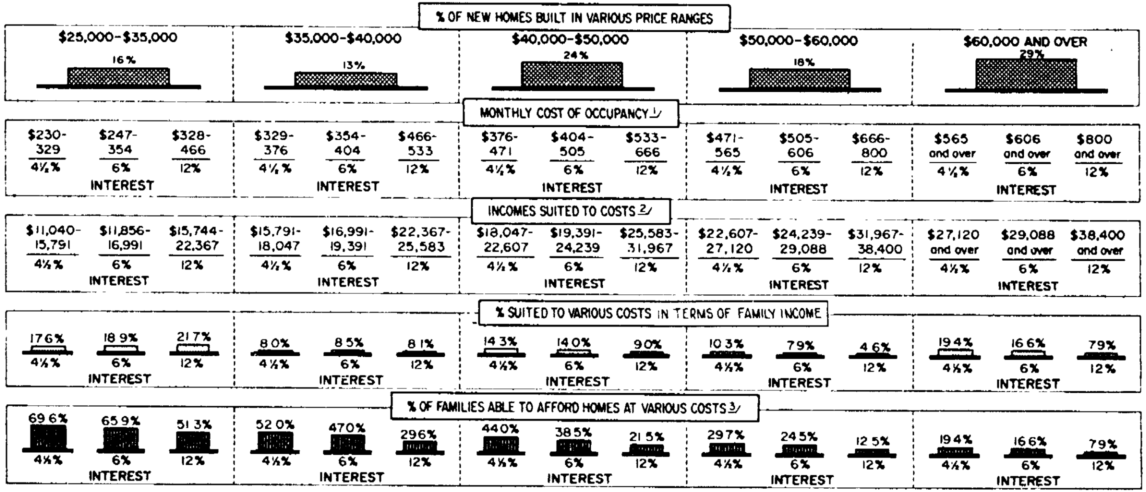
CHART 20



1/ 1979 estimated FHA mortgages through 1976 Federal Home Loan Bank Board conventional mortgages, 1977-1979
Data *Economic Report of the President*, Economic Indicators

Chart 21

NEW HOMES BUILT AT VARIOUS PRICE RANGES AND COSTS, AND FAMILY INCOMES RELATED TO THESE COSTS, 1977 ASSUMING 30 YEAR AMORTIZATION



1/ Total monthly costs, with variations in costs due to variations in interest rates only 25% down payment assumed throughout

2/ Applicable incomes are monthly costs times 12 times 4

3/ Includes all families from bottom to top who can afford houses in each cost range About 30% of all families have incomes below cost requirements even for $25,000-35,000 homes at 4 1/2% interest, and about 49% are below at 12% interest

Basic Data Dept of Housing and Urban Development, Dept of Commerce, Library of Congress

Representative BROWN. Mr. Keyserling, you have done an excellent job in summarizing your testimony and expressing yourself in terms that at least take you out of the doubtful column on this issue.

Now I have to turn to one of our more moderate members [laughter], Congressman Rousselot, for his questions.

Representative ROUSSELOT. I am many times in the doubtful column, too.

Mr. Keyserling, thank you for quoting from our excellent report of last year. We appreciate that. Then as a followup to that, you stated that you didn't think this advice or these proposals that we had given in our Joint Economic Committee—you endorsed them, but you didn't think, as I read it, that Mr. Schultze had done too well in his economic and moral ideology.

Do you have a specific as it relates to his testimony yesterday, or a statement or something?

Mr. KEYSERLING. Mayor LaGuardia once said, when he made a mistake and had to defend it, "I almost never make a mistake but when I do, it's a beaut."

One of the mistakes I made was giving Charlie Schultze a job on the Council of Economic Advisers that I headed. That gave him his start, and I have watched him ever since. I watched him come up before the Congress 3 or 4 years ago when he was still in the Brookings Institution peddling his pernicious doctrine that you couldn't get down to 5 percent unemployment without roaring inflation. I showed him the unanswerable evidence to the reverse, that we got the roaring inflation by going to higher unemployment and not to lower unemployment, because you do not increase the efficiency of the economy by unused resources.

I would call attention to chart 6 in my prepared statement, on productivity, which shows the positive correlation between the rate of real economic growth and productivity growth. Yet, Charlie Schultze is trying to explain the low productivity growth by everything under the sun, including regulations to prevent people from breathing in lung dust, instead or looking at the facts. I think he is utterly and completely wrong, because his whole idea is based on the proposition that striking hammer blows at full production, full employment, and economic growth is going to reduce inflation and increase productivity. It reeks in everything he says, and it always will, and it will never be right. It is being proved more wrong every year and every day and every month.

I don't like to criticize the President of the United States. I first became a Democrat because I was born in South Carolina and, of course, I haven't got the intelligence to reconsider matters.

Representative ROUSSELOT. We'd be glad to reregister you today. [Laughter.] We need all the help we can get.

Mr. KEYSERLING. I am not asking for that. But I think the committee members are absolutely correct in saying the economy needs stimulation now. I think we might have some differences of opinion as to the details, but when you're on the wrong track, the important thing is not whether you are using exactly the right fuel, but that if you are on the wrong track, it will be lucky if the trains stalls completely because then the situation may be created where you begin to get on the right track. Charlie Schultze is moving in the wrong direction on everything.

Representative ROUSSELOT. Including tax cuts?

Mr. KEYSERLING. Including tax cuts, because the economy needs large stimulation now, and he resists that. I agree, I think it should be some proper combination—which I can't burden this committee with now—of selected, pinpointed tax cuts and selective, pinpointed increases in public investment.

You know, everybody says—these economists in Brookings and everywhere around——

Representative ROUSSELOT. Personal tax cuts?

Mr. KEYSERLING. I'd advise selective tax cuts, aimed toward the increase of supply of the things of which we are in most short supply and need most. We did that in the Truman administration. We had all kinds of pinpointed tax cuts. I'm not against tax cuts as such. These economists who have made so much trouble are so unable to meet me in debate that they are constantly trying to disparage me by saying I'm a "spendthrift." Well, I had something to do with the economics policy during the 7 years of the Truman administration, which was the only time since before the Great Depression that we ran a budget surplus, despite the fact we were fighting a war.

Representative ROUSSELOT. You had two, didn't you?

Mr. KEYSERLING. We had an average surplus during 7 years 1947–53 of $1.7 billion a year. It was good for the whole economy to have a high real economic growth rate and a balanced budget, and stable prices despite an inflationary postwar overhang due to bonds sold during World War II and cashed thereafter.

So these impossible alibi guys who say to the American people, "Wait until 1988 to have reasonable price stability"—they ought to be run out of government. The President is a well-meaning, honest man. He has just been betrayed by people like Charlie Schultze.

That's my answer on Charlie Schultze.

Representative BROWN. If the gentleman will yield, I am old enough, and I know the gentleman isn't, to remember that at the end of World War II it was assumed that we were headed for a rather substantial recession because we couldn't absorb the need for conversion from wartime activity to peacetime activity. I just have to say that that perhaps comes as the greatest tribute to the American economy that there is, because in that time that conversion was made by the individuality, if you will, or the ability of the American people. And I share your concern about predicting a recession.

Representative ROUSSELOT. Well, I want to correct my part of the record.

Out of 7 years that Mr. Truman was in office, there were five surpluses.

Mr. KEYSERLING. That's right.

Representative ROUSSELOT. And to what degree you had something to do with that, I think we will compare your testimony to Mr. Schultze—and your record.

Mr. KEYSERLING. I just want to say something about the remark——

Representative ROUSSELOT. I was old enough to remember it.

Mr. KEYSERLING. Well, you're all babies compared with me in age. I just passed my 72d birthday. But the Congressman is right in saying that near the end of World War II, the same kind of economists who are hopeless about the United States now said we had to have 8 million unemployed when the war ended. I said it was bunk and that how many unemployed we had would depend on what we did, and that America had the strength and genius and skill and initiative and courage not to have 8 million unemployed, and we didn't. We had a quick and smooth transition, despite cutting the defense budget about $100 billion, about $12 billion within 1 year, with very little unemployment. This was achieved because we defined what needed to be done and knew that it could be done and didn't say that nothing could be done and didn't cite the difficulties due to mistakes as evidence that these difficulties were insuperable.

Representative ROUSSELOT. Thank you, Mr. Keyserling, and I appreciate your quoting so extensively from our report of 1979.

Mr. Lindsay, your statement, "Our economic policy needs to give much higher priority to strengthening the investment and supply side of the economy than is now the case"—does that include tax cuts?

Mr. LINDSAY. It places primary emphasis on tilting the budget and other Government policies toward increasing investment and, to the degree necessary, reducing consumption to control inflationary pressures.

Representative ROUSSELOT. Right. Do you want to speak to the specific area of tax cuts?

Mr. LINDSAY. You have considered changes in depreciation as a tax cut, which I'm not sure I do. I consider it a shift.

Representative ROUSSELOT. That is the way it is considered in our Ways and Means Committee that deals with it.

Mr. LINDSAY. I think that is the most effective single thing that can be done and you know far better than I whether this is politically more acceptable. It is not a tax credit. It is not reducing the amount of total taxes to be paid. It is, rather, Government's sharing with industry the risks of future inflation—putting more money back into the economy and certainly inducing industry, or causing them in their own self-interest to relpace obsolete equipment much more rapidly than otherwise.

Whether it is a tax cut or not, my assumption is, from what Mr. McIntyre has said today, that he regards it as a tax cut, and it is too dangerous to consider now.

Representative ROUSSELOT. Yes.

Mr. LINDSAY. I don't believe it is too dangerous. I think we need a multiyear strategy, and we should begin it now with investment incentives. To the extent it is necessary to control inflation, we should do it by reducing consumption, not investment.

Representative ROUSSELOT. I have looked through your testimony. Do you have some specifics? Since I serve on the Ways and Means Committee which deals with this, do you have some specific ideas in mind of ways in which we could legislate to do that?

Mr. LINDSAY. I think both in research and development areas, providing for immediate tax writeoff of research and development, labor and equipment costs would certainly be important.

I think the patent area is important, particularly where the Government has supported research leading to patents. There should be a greater incentive to private enterprise to use the fruits of this research in a productive way and share with the Government through tax returns on successful new businesses created.

Representative ROUSSELOT. I have gone over my time. Thank you both for being here. I appreciate it.

Representative BROWN. Thank you, Congressman Rousselot.

Let me, Mr. Lindsay, ask: With reference to the regulatory burdens and their impact on investment, can you give us some specific examples, or has your organization done any study of the specific impacts of these burdens upon investment?

Mr. LINDSAY. Let me give you one that comes to mind, and I think a very important one.

As you well know, we are now importing 25 percent of our metallurgical coke from abroad, in spite of being a nation with some of the greatest coal reserves, and in spite of the fact that we have metallurgical coal mining capacity already available and not producing to full capacity.

Last night I had dinner with a director of one of the major eastern coal companies, and he told me that that company had decided to pass its dividend because it was unable to sell its metallurgical coal.

The reason it is unable to sell low-sulfur, high-grade coking coal is because the coking capacity within the United States is inadequate because environmental regulations have shut down much of our capacity.

This does not mean that we should go back to the old types of coking furnaces that had lots of environmental problems. Realistic regulations on the emissions of coking coal furnaces, plus a realistic incentive for capital recovery, would have permitted, and can still permit, new coke ovens to be built so that we can use domestic coal instead of importing 25 percent of our total national requirements for coking coal in the form of coke from abroad.

This is one example that comes to mind, and an important one.

Representative BROWN. Are you aware of anyone doing general study on the impact of specific priorities of reducing regulation in this area? It seems to me that that would be a very high priority item, given our energy problems.

Is anybody, either in private industry or that you are aware of in the government field, or in private institutions, doing a priority study of what is significant in this area?

Mr. LINDSAY. CED has done a study of regulation and has proposed changes in the regulatory process. We have a new study getting underway on improving productivity and will certainly include regulatory tradeoffs. I think there are a lot of people, including our own CED staff who can give you some material not only on what we have done, but other private and public research organizations as well. I understand you are looking for specific cases.

Representative BROWN. Yes; and prioritization of the regulation reductions.

Mr. LINDSAY. Another one which comes to mind that bears directly on energy is, we have a real bottleneck on heavy steel casting capacity in the United States. That is a bottleneck in producing equipment to expand our coal and to expand all heavy industry. It also creates a further impact on inflation because if you have a major project underway and, as I'm sure you know in your own business, if you desperately need one piece of equipment in short supply, it's economic to pay any price in order to get it delivered on schedule.

Representative BROWN. We are doing it right now with respect to paper purchases in my business. We are in the process of expanding some of our commercial printing, and suddenly we ran into a paper shortage and it became much more economic to pay relatively exorbitant spot prices—I won't suggest black-market prices because there is no such thing in the current marketplace as a black-market price, since prices are not in any way controlled, but they are in a way designated or fixed within the paper-producing industry. We found it is worth it to pick up somebody else's excess paper at any price they want in order to meet our contracts.

Mr. LINDSAY. That is exactly what is happening throughout the economy where bottlenecks are creating inflationary pressures.

I think the same thing is true in shortage of skilled manpower. Once these bottlenecks begin to bind, then they ratchet up, as you suggested earlier, the entire economy.

Representative BROWN. I think we are at an interesting point here, and I want to pursue that question and want your attention to the answer. I want to ask Mr. Keyserling, because it has been a point that we have been on: Inflation back in 1947, according to the book of the Council of Economic Advisers, the President's annual report, was 14 percent. That was the really horrendous postwar period. The reason for it clearly was that all of our domestic production had been in the war—not all of it, but so much of it had been devoted to the war effort that there were tremendous shortages in specific products. Paper was one example again, as I go back in my memory to that period.

But in 1948, the statistics we have indicate the inflation rate was only 7.8 percent, had fallen almost in half, and in 1949 prices fell by 1 percent. While we had tremendous employment adjustments because men were coming home from service and so forth, the unemployment rates did not get radically out of hand, although they were, for a brief period, somewhat higher than they'd been during the 4 years.

I guess I have to ask: How did you move in 2 years from the 14.4 percent inflation rate to a 1-percent decline in prices during that period of time, and the reduction to a great extent of some of the shortages? I know not all were disposed of.

Mr. KEYSERLING. We did it by application of commonsense. We did not move toward it by saying, when we had a double-digit inflation rate, that it was going to take 8 years to work it out. We didn't say that because it's a big problem, let's do less instead of doing more.

We had a great debate during the period I was in the Council—and it is extremely relevant now—between those who said that the way to cure the inflation was to cool off and slow down production and employment and those who said the reverse. This debate became more intense when we got into the Korean war. I remember Mr. Bernie Baruch, who may have been a good adviser during World War I, but who was fuzzy-minded 40-odd years later, and who claimed he was advising every President though none was listening much to him. He said that the way to fight the Korean war was to freeze the whole domestic economy. In fact, at the beginning of World War II, there were those who said we should fight the war with the steel capacity we had then because otherwise we'd have a big depression after the war.

At the beginning of the Korean war, which raised a greater danger to us—and if there was anything I introduced into American economics, it was the concept of real growth. I advised that real growth is the main cure for inflation, and to build the industrial base. We made the right kind of tax incentives available, and we projected goals for increase in investment and for some other increases also.

So great has the productive power of the American economy been that during the Korean war, and even during World War II when we were, as you say, burning up half the total product in fighting the war, we raised the living standards at home. Everybody didn't have joy rides, but the fundamental living standard rose, even though half the product was going to overseas. The reason there was a meat shortage was not because there was less meat, but because people were eating meat who ate nothing but rice and peas or pork fat before the war. They hadn't been able to buy the meat, didn't have the money.

That is what the American economy can do, and that is the basic reason it went down.

If you will look at chart 11 in my prepared statement, although the inflation rate was still 7.8 percent in 1947—and that is when the Council of Economic Advisers and I come in—it averaged only 3 percent over 7 years. The most important thing is the trend. We didn't say, "Wait 8 years." The inflation rate was reduced from 7.8 percent in the first year to 0.8 percent in the last year.

Well, we used some controls. You needed them during the Korean war. But that was not the main reason for the price performance. The main reason was the creation of abundance. Then it was said, "You are suppressing inflation. It will burst forth after the war."

It didn't burst forth. We had price stability for a long period of time after the war, as shown on the same chart.

The inflation burst forth when the policy became effective of trying to fight the inflation by a great decline in the rate of real growth and great enlargement of unused resources.

How did the term "stagflation" arise? It arose through recognition by the people who have continued to do the wrong thing that it's stagflation, not a tradeoff. Within 1973–75 we experienced the highest rate of inflation since the Civil War and the highest rate of unused resources since the Great Depression. Still, instead of learning a thing, the administration is going to "cure" inflation by having still another recession, and by having us do worse during the next 5 years than during the past 5 years, in the face of our tremendous international challenges and burdens which must be financed, in the final analysis, our output and growth. There is nothing you can do on the books of the Government to finance that thing in real terms; it must be supported by real product.

How much are you going to take out of other types of product to do that financing, and are you going to be able to? If you do, what will happen to inflation, because defense outlays are essentially nonproductive, even though necessary.

This is all so obvious; and the more that truth appears, the further away the executive policymakers get from paying any attention to it.

That is how the inflation was stopped, primarily by calling forth again the great nonsecret weapon to which I have referred. There is no direct correlation in economic history, broadly speaking, other than the inverse correlation between the level of economy and the amount of inflation.

Representative BROWN. Gentlemen, thank you very much. I don't know if we have any more questions.

Mr. Lindsay, I may want to ask you a couple of others in some detail, and if we do, we will drop you a note.

Mr. Keyserling, your aggressive testimony and dramatic testimony has been very helpful and gives us a new argument or dedication here to the principles that we share, that all three of us share.

Our hearings tomorrow will be held at 10 a.m., in room 2257, Rayburn House Office Building, and they will include the Assistant Secretary of the Treasury for International Affairs, Mr. Burston, and Ambassador Owen, our roving American Ambassador in international trade.

Again we thank you very much and appreciate your patience in waiting.

Mr. KEYSERLING. Congressman Brown, may I say just one word. I would like to call the attention of you two gentlemen especially to the last five or six of my charts which deal with money policy and the effects that it has on the cost of living, on the dangerous increase in consumer credit, which is twice as high relative to income as it was in 1953——

Representative BROWN. We will indeed.

Mr. KEYSERLING [continuing]. To the staggering blows being struck to the housing industry which is so important to the whole economy, to the increases in the Federal deficit due to the increased interest charges which serve no really useful purpose. They are inflationary as are all increased costs. The increased interest charges in the budget today are greater than the whole Federal deficit a few years ago.

Representative BROWN. We will indeed go through those. I found your charts very interesting, Mr. Keyserling, and very helpful, and think that the two of you ought to share some information back and forth and hope you will have that opportunity.

Representative ROUSSELOT. Thank you for including charts on money supply growth. A lot of them don't talk about that.

Mr. KEYSERLING. The data are misleading because they are expressed in current dollars, and the same Federal Reserve Board which says interest rates should go up because inflation is going up do not adjust money supply growth corresponding. In real terms, we have had a negative money supply growth for several years.

Representative BROWN. I want to tell you a brief story to underscore your concerns about what we face, and I have to do it anonymously because I have yet to get full information from the company involved.

I have in my part of Ohio a company that makes major industrial equipment in one of our currently booming industries—well, it's not booming; it's at least doing rather well.

They have had a traditional customer for a number of years that has made this major production equipment investment from them. This year they were unable to sell on a bid basis one of the pieces of equipment they manufactured to this regular customer, not very far from them geographically, because the customer had gotten a better deal on the product in terms of price and the financing of the product from a British company with the assistance of the British Government in terms of the subsidization of the financing, because of course the British, as we do, have a program for assisting in the development of underdeveloped countries. So the British are now assisting in sales of their products to the United States to the extent that it expands British trade and helps us develop our resources since we are doing so poorly on our own.

Now, if you want a message about whether or not we are in trouble, it seems to me clearly implicit in that story.

The other sad fact is that by being unable to sell the manufacture of this company to their regular customer, the company lost 750 man-years of employment. That is certainly not a very pretty picture in terms of how to resolve either our current problem or the example you have of a conversion from a wartime shortage situation in the United States to one where we expanded our markets.

Mr. LINDSAY. The committee might like to have the study that was completed a year ago.

Representative BROWN. We have copies of it but might welcome any updates you might have or any information on the schedule of your future studies because we always find that CED contributes a great deal to our thinking, and it is all good scholarly stuff, well developed and well backgrounded.

Mr. KEYSERLING. I want to say one word in support of what you gentlemen have said about regulation. We might differ in detail about what regulations to keep and what ones to drop, but I think it is absolutely horrible when people in the Government are reaching out to regulate more and more the private economy and completely neglecting the job which must be theirs and always will remain theirs and which is, without a play on words, really regulation. When you regulate the price of money, that is regulation just as if you are regulating the price of wages. Taxes regulate where money flows. So does the budget. They are doing this upside-down job with the budget, the upside-down job with money policy, and then thinking that they have the brains and the time and the responsibility to go out and regulate more and more of the private sector all over the country.

Representative BROWN. Mr. Keyserling, I am going to suggest that if one of my choices for President gets in office he inquire whether or not you want to get back in harness. We won't necessarily require you to convert those traditional family beliefs that you held, but I certainly wouldn't want you to change any of the ideas you have on how to run the economy.

Thank you, gentlemen, very much.

[Whereupon, at 12:27 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, February 7, 1980.]

THE 1980 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 7, 1980

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

The committee met, pursuant to recess, at 10:10 a.m., in room 2257, Rayburn House Office Building, Hon. John H. Rousselot (member of the committee) presiding.

Present: Representative Rousselot.

Also present: Louis C. Krauthoff II, assistant director-director, SSEC; Kent H. Hughes, Mayanne Karmin, and Paul B. Manchester, professional staff members; Betty Maddox, administrative assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin, minority professional staff member.

OPENING STATEMENT OF REPRESENTATIVE ROUSSELOT, PRESIDING

Representative ROUSSELOT. I will call this hearing to order.

Today we have with us Henry D. Owen, Special Representative of the President for International Economic Summits, and C. Fred Bergsten, Assistant Secretary of the Treasury for International Affairs.

As most know, we turn our analysis today to the international economic situation. Senator Bentsen was unable to be here.

This is yet another area where things do not look as good as they should. It is clearly an area where we as a committee have had a substantial amount of interest; it is very much a part of the various reports that we produce, including our annual report.

The members of the Joint Economic Committee recently held a series of hearings in the Philippines, Hong Kong, Taiwan, and South Korea. Four of us, myself included, were privileged to be part of this study mission. It was an extremely enlightening experience to hear from our American people engaged in business overseas. We also had the opportunity to meet with many of our people in our embassies to listen to their experiences in trying to sell our products and services overseas.

East Asia is the most dynamic of all of the world markets. U.S. exports to East Asia grew by 26 percent in 1978 and the U.S. two-way trade with East Asia in that year was equal to our two-way trade with Western Europe; but within these healthy aggregate figures are large U.S. trade deficits with some Asian nations, as well as major barriers to increased trade in some countries and with some individual businesses.

The committee met with many U.S. businessmen who are on the cutting edge of competition in the world markets in East Asia. They are, indeed, very frustrated. We heard a stream of angered complaints over the barriers they faced—anticompetitive, unfair tax burdens, handicaps in operating within the latter of the foreign corrupt practices law, the weakening effects of applying our antitrust laws to foreign operations, and the inadequacies in U.S. export financing arrangements, all of which delight and amuse our foreign competitors who are extremely aggressive in these same markets.

The U.S. Government many times acts as a referee or umpire, depending upon which sport you like, to American firms doing business abroad by restricting, stopping play, and penalizing our own American enterprisers. Meanwhile foreign competitor governments serve as coaches, or at least cheerleaders, to their business firms in fighting for international business.

So many of us as a result of this trip think it is high time we realize that the United States needs to expand its foreign trade to advance our own economic growth. Heretofore our broad-based domestic economy has made it unnecessary for U.S. businessmen to be as aggressive about our overseas market. However, that day is past.

If oil and other needed imports are to be financed without reducing American living standards, we must increase our sales and investments abroad. To do that, we have to find ways to modernize our industrial plant at home, remove the obvious shackles frcm firms that have the courage to try to compete in foreign markets.

All of this boils down to adopting more incentives for creating Government activity in both macro- and microeconomic policies and regulations.

Senator Bentsen wanted me to state that the President merits praise for placing consistent emphasis on international approaches to solving the economic problems. We are very fortunate, as Senator Bentsen wanted me to state, to have our Ambassador, Henry Owen, who serves as a Special Representative of the President for International Economic Summits.

Ambassador Owen has played a very key role in preparing the President for three past economic summits and is now looking ahead to the next economic summit to be held in Venice in June of this year.

We are also, of course, pleased to have the Assistant Secretary of the Treasury for International Affairs. Both of you have been prolific and proficient writers on a wide range of foreign economic policy matters and we are pleased to have you with us today.

STATEMENT OF HON. HENRY D. OWEN, AMBASSADOR AT LARGE AND SPECIAL REPRESENTATIVE OF THE PRESIDENT FOR INTERNATIONAL ECONOMIC SUMMITS

Mr. Owen. I was told you were particularly interested in our speaking to the question of the interrelationship between foreign economic affairs and domestic economic affairs.

Representative Rousselot. Yes. I think that's the question we asked you to speak to.

Mr. Owen. I looked at the report——

Representative Rousselot. By the way, before either one of you start, we want you to feel free to discuss as much as you want for as long as you want. You are also free to insert a prepared statement in the record as well as any additional charts or other material that you may want to include.

Mr. OWEN. Thank you, Congressman. I will be brief.

In the report which the committee issued in August, I was struck by the three conclusions which the committee advanced: First, you emphasized the need for more rapid growth; second, the need to reduce our reliance on imported oil by encouraging production and by conservation; and third, the need to increase productivity.

I would like to speak to what we have been trying to do to advance these purposes in the international arena over the last 3 years. Let me take first the questions of growth and productivity and trace the way our policy has changed through the last three summits at London in 1977, Bonn in 1978, Tokyo in 1979.

When the administration took office, one of the major problems was the need for more rapid German and Japanese economic growth so that those countries would buy more of our exports and reduce our balance of payments deficit.

At London in 1977, the three countries, Germany, Japan and the United States, pledged themselves to achieve specified growth targets. Of those three countries, we were the only one to achieve our growth targets. Both the Germans and Japanese fell short, although I am sure that they took additional measures as a result of the conference in London; they didn't fulfill the targets.

The lesson we drew from that was that rather than fixing specific growth rates—because after all these are market economies and the Government's role is a limited one—we would specify the additional stimulus measures each government would take.

In Bonn, in 1978, the German pledged themselves to take stimulus measures which would add 1 percent to their GNP. They were as good as their word in the months which immediately followed the summit. They took the measures they had pledged. Their growth rate did rise by 1 percent.

Japan pledged to increase its growth rate by 1.5 percent. Again it fell short, although it achieved a substantial increase. It is a measure of the difference in our own economic situation that in Bonn, rather than pledging growth, we pledged to fight inflation and to give that the first prority over growth.

At the Tokyo summit, still a further change was evident. Although the three main countries, Germany, Japan, and the United States, again pledged to follow growth policies, the main emphasis was on policies to increase productivity, as your committee recommended. I might just read one paragraph in the communique.

George Schultz, who was responsible for prior summit meetings, told me that he thought this was one of the best paragraphs in any of the summit communiques.

> We agree that we must do more to improve the long-term 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.

My guess is that the Venice summit will place more emphasis on that. Increasingly the emphasis of the summit meetings will not be on short-term growth and anti-inflation targets, but on more basic measures to increase productivity, reduce regulation, reduce the growth of the public sector, and so deal with some of the long-term obstacles to productivity which your committee identified.

That's what we have been doing in respect of the recommendations of the committee regarding growth and productivity.

I now turn to your other recommendation, on energy, to increase production of alternative energy sources and reduce reliance on imports of oil.

At the Bonn summit—I should start in London. In London—and it is a measure of how far we have come—there was only a brief reference to energy, and a very general one that countries should try to do better.

In Bonn, there was a good deal more attention to the subject. The most important pledge at Bonn was the President's pledge that he would decontrol crude oil prices by December 31, 1980. This was a pledge which was very much wanted by the other countries at Bonn.

The price of the Germans' agreeing to the increased growth we wanted was our agreeing to the oil decontrol they wanted. As you know, in fact, the date for the completion of decontrol will be September 1981 rather than December 1980; but basically the pledge has been fulfilled.

At Tokyo we went a good deal further. We agreed on the need for national import ceilings for oil for 1980 and for 1985, for each country.

We followed that up in the International Energy Agency by agreeing to these ceilings and to procedures under which these targets will be reviewed quarterly. Adjustments will be made in the targets as necessary to bring them into line with the current situation, and each country will be carefully monitored to make sure that it is adopting the measures that are needed to assure that it doesn't exceed its oil import targets.

So, instead of the countries scrambling against each other with ever higher prices for a limited amount of oil, they will agree in advance not to go over a certain level of imports. As you know, for 1980, the President has set our level at 8.2 and has indicated that he's prepared to go even further below that level if other countries will reduce their imports, and that he's prepared to impose an import fee, if necessary, to assure that the import level is not exceeded.

There was one other measure taken in Tokyo. All the countries agreed to increase resource investment in development of alternative energy sources. They set up an international energy technology group to make recommendations to the Venice summit as to the specific measures that should be taken to this end.

We, of course, are already launching a large synthetic energy program and we are urging our allies in the international energy technology group either to share or adopt comparable programs themselves.

So I think, Congressman, that in these summits and the actions between the summits, we have tried to fulfill the injunction of the committee: strive for higher growth, reduce the obstacles to increased productivity, and move toward lower imports of oil and higher production of alternative energy sources.

Our record leaves a good deal to be desired, but we are trying to move in the directions that the committee has laid out. We are trying to move in the only way that makes sense if those objectives are going to be achieved: with the other countries whose cooperation is essential.

Thank you, Congressman Rousselot.
Representative ROUSSELOT. Thank you Ambassador Owen.
Secretary Bergsten.

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

Mr. BERGSTEN. Thank you, Congressman Rousselot.

I would simply try to amplify briefly how we see the interaction between our international economic policy and our domestic economic policy.

As the President indicated in his economic message 2 days ago, we feel that there are two overwhelming problems facing the U.S. economy: the problem of inflation and the problem of energy. They are, of course, related to each other.

What is most pertinent for today's discussion is the fact that these are both global problems. Practically every country around the world faces major inflationary difficulties. It is clear that from one side or the other of the equation, practically every country faces major energy problems. We, therefore, have to view our response to those two cardinal problems in the global context. One way we have done this, as Henry Owen outlined, is through the series of summit meetings where major decisions have been made in these and other areas.

In the area of fighting inflation, two of the key aspects are what we do with our international monetary policy and what we do with our trade policy. In the international monetary area, it is very clear that a depreciating dollar, a weakening dollar, adds to our inflation at home for the simple reason that it drives up the cost of imported goods and enables domestic industries to raise their prices with less price competition from abroad.

Indeed, substantial depreciation of the dollar in late 1977 and much of 1978 added at least 1½ percentage points to our inflation rate in 1978, which in turn then ratchets into the economy and is more difficult over time to eliminate.

So a stable dollar has got to be one important component of our overall anti-inflation program. Indeed, since the dollar decline in early 1978, it has been stable. Over the past 16 months, the dollar has actually risen by about 6 percent against a trade-weighted average of OECD countries, and has risen by 2 to 3 percent against the SDR, special drawing rights, the unit of account of the International Monetary Fund.

That restablization of the dollar has been an important part of our anti-inflation program. We intend to seek continuation of that stability as part of our effort to reduce inflation at home.

Trade policy, as I mentioned, is also an important aspect of fighting inflation. If we were to raise protectionist barriers against imports, despite the temptation to do so in particular industries, that would clearly add to our inflation rate by driving up costs and reducing competitive pressures on our own industries. There are now pressures to increase trade barriers in a number of key sectors of our economy; but if we succumb to those pressures, we would be running directly counter to our fundamental effort to fight inflation. The administration will countinue to resist that kind of approach.

I might finally comment on the way that energy interrelates with the dollar and our trade balance and come back to the trade questions, Congressman Rousselot, that you raised at the outset.

As is well known, the United States now has a substantial trade deficit. The figures for the full year 1979 were just released. They show about a $30 billion trade deficit. When you dissect that just a little bit, you get a very interesting picture. Our oil imports last year cost us about $60 billion, up from less than $3 billion as recently as 1970.

That means that the rest of our trade balance was in surplus by about $30 billion; and, indeed, if you look at the nonoil part of our trade balance, the evidence is very strong that U.S. competitiveness in the world economy has risen very substantially. The volume of our nonagricultural exports rose last year by 12 percent, after a sharp rise in 1978, indicating a very substantial increase in our share of world markets for manufactured goods, the areas in which we know the United States can compete well.

So, on the one hand, we face the huge and growing problem of oil import costs reinforcing the need to put in place the kind of comprehensive energy program that has been proposed and that Ambassador Owen referred to. At the same time, we can take encouragement, I think, from the fact that the rest of our trade position has been sharply improving, not that it has done well enough, because it has to go even further in order to offset the higher cost of oil imports and assure us of a stable dollar over time. We have, therefore, taken a number of measures to try to stimulate export expansion yet further.

One area has been the Export-Import Bank, where over the first 2 fiscal years of this administration, the lending level of the Export-Import Bank was raised fivefold, and we are proposing—and I think the Congress will accept—further increases for fiscal 1980 and fiscal 1981. We greatly improved the quality of Eximbank loans, matching our foreign competitors even when they have gone beyond the present rules that govern official export credits.

Clearly there are more things we can do. Clearly there are conflicts between the trade objectives and other objectives of U.S. national policy that have kept us from going all out to support exports in every case. But the record is a good one. We are putting in place policies that will enable the record not only to continue but to get better. I think therein lies an important aspect of our overall fight against inflation and our overall effort to assure a stable U.S. economy for the future.

Thank you.

Representative ROUSSELOT. Thank you both. Will each of you want to submit prepared statements? You just want to rely on your oral statements.

Thank you for your comments. I have a pile of questions here submitted by some of my colleagues and others. Let me try to go through some of them if we can. It's been mentioned to me that you have other engagements that you must participate in, so we will try to keep this moving.

Ambassador Owen, as I understand it, the Tokyo summit in June of last year was principally focused on reducing consumption and increasing supplies of energy. Even though you have commented on it, can you tell us what we have done to live up to our goals set by the Tokyo summit?

Mr. OWEN. Yes, sir. The Tokyo summit set two kinds of goals for imports: first, goals for 1980. It indicated that each of the European Community countries would adopt a national goal. We ourselves, Japan, and Canada also adopted national goals. Since then, the European Community countries have adopted their national goals for 1980, and they have pledged themselves to assure that their oil imports in 1980 will not exceed those goals.

In addition, 1985 goals were set, and since then, by agreement among the countries, the 1985 goals have been reduced. But I think the most important thing, Congressman, is not merely carrying out the work of the summit in specifying the national import targets for each country, but setting up a procedure within the International Energy Agency under which those import targets will be monitored and the ministers will come together once a quarter, one, to see whether the targets should be changed; and, two, to see whether any country is exceeding its target and, if so, what additional measures it should take to restrain oil imports.

I think, through these agreements, we are in a fair way to having set up machinery which will assure that the industrial countries allocate oil among themselves in a gross amount which doesn't exceed the total amount of oil that's likely to be available to them.

On the supply side, we set up a group in which all the countries that are summit members and some industrial countries that aren't summit members to try to figure out what additional measures each country could take to increase the production of alternative energy sources. I would be less than frank if I didn't say the enthusiasm varies for this among different countries. We are now engaged in negotiating with them to produce a report for the Venice summit which will enable that summit to reach agreement on additional programs by the European countries and Japan and which will match our own very vigorous program to develop alternative energy sources.

So I think here, too, Congressman, we have a fair chance to follow up successfully the Tokyo agreement to increase the development of alternative energy sources and to increase the investment of resources in that effort.

Representative ROUSSELOT. So that will be on the agenda, you say?

Mr. OWEN. Yes, sir.

Representative ROUSSELOT. Are there other issues likely to share the spotlight with energy?

Mr. OWEN. Yes, sir. I think there will be five issues at Venice. One will be macroeconomic policy, where I think the main emphasis is going to be how to improve productivity and investment over the medium term. Second, energy, which we just discussed. Third, trade, which I think will receive less emphasis than it did at previous summits, because we recently concluded the multilateral trade agreement. Fourth, international monetary policy, where the summit may look at the substitution account and may look at some new proposals the French President is preparing; and finally, north-south relations, where I think the main emphasis will be on how to help developing countries increase their energy production and increase their food production so as to help solve those global problems. I think these will be the five main areas at Venice.

Representative ROUSSELOT. Now the President, as you both discuss, has already set an 8.2-million-barrel-a-day ceiling for U.S. imports. He spoke of imposing an additional fee if imports threaten to breach that ceiling.

Previously the administration had toyed with the idea of a quota. The key problems, however, lie in stimulating domestic production and constraining some domestic demand. One Presidential candidate, as we know, has already proposed a 50-cent-a-gallon tax on gasoline, while another has argued for the immediate adoption of mandatory rationing.

What is the current administration thinking on restricting domestic consumption to meet these targets?

Mr. BERGSTEN. Well, certainly restricting domestic consumption is one of the central elements in our whole strategy, both for dealing with the energy problem per se, and for dealing with the inflation and broader economic problems that I described.

We think we have in place already a number of measures that are pushing toward that end. The decontrol of natural gas prices in 1978 on which the Congress voted and the President's action to decontrol oil prices early last year on a phased basis are of course central steps in that program.

In addition, the Congress has passed a number of pieces of legislation, as you well know, to mandate conservation in a number of areas: for fuel-efficient cars, use of home appliances, and a number of other areas.

I think there, too, the results are modestly encouraging. Despite the continued growth of the U.S. economy last year, the use of oil declined over 2 percent and the use of motor gasoline declined about 8 percent in the fourth quarter of 1979 as compared with the fourth quarter of 1978. These are rather historic turnarounds in U.S. performance. Last year was a year in which our economic growth was continuing—albeit slowly—yet an actual decline occurred in our use of oil, and our use of gasoline more particularly.

So I think we are beginning to see some of the impact of the conservation measures already taken in the past beginning to come on stream. We know it takes a long time to make fundamental changes in the very structure of an economy such as are required to change the American thirst for energy as a whole, and oil products in particular.

That's why we think what happened last year was only the beginning; and that, over time, the measures we have put in place must continue to reduce energy use.

The other side of the equation, as you quite rightly point out, is increased production.

Representative ROUSSELOT. How are we doing on that?

Mr. BERGSTEN. I think it's probably too early to say.

In the natural gas area, however, the decontrol that took place in 1978 has already begun to sharply increase the domestic production of natural gas.

Representative ROUSSELOT. Decontrol has helped?

Mr. BERGSTEN. No question about it. Decontrol has helped.

Representative ROUSSELOT. All the great concerns expressed by some of our colleagues that decontrol would be a disaster haven't actually materialized?

Mr. BERGSTEN. Of course, when some of your colleagues said a disaster, they were thinking of the fact it would raise prices.

Representative ROUSSELOT. That's true, obviously.

Mr. BERGSTEN. That certainly added to the rise in the Consumer Price Index.

Representative ROUSSELOT. How much?

Mr. BERGSTEN. The direct effect of higher energy prices last year——

Representative ROUSSELOT. Relating to higher prices in fuel?

Mr. BERGSTEN. Right. They probably added about 3 percentage points out of the 13-percent increase in the Consumer Price index.

Representative ROUSSELOT. 14 percent?

Mr. BERGSTEN. Whichever one you want to use.

Representative ROUSSELOT. Wherever we are?

Mr. BERGSTEN. Right. A substantial part of the increase in consumer prices was caused by the higher energy prices.

Representative ROUSSELOT. Not as much as some people thought?

Mr. BERGSTEN. Well, it's a substantial element; but viewing both the energy and inflation problems as longrun problems, the President concluded it was essential to bite the energy bullet and decontrol prices for oil.

Representative ROUSSELOT. He promised that in his campaign in 1976. We were glad to see him follow through. In any regard, it didn't have the impact on inflation that many people thought it would? It obviously had some.

Mr. BERGSTEN. I think one has to say in all fairness it had had a substantial impact in further raising prices in the short run. However, we feel it's necessary because of the longer run needed to bring the energy situation under control, which in turn is essential to get a longer run hold on the energy problem.

Representative ROUSSELOT. Well, we hear constantly that OPEC is the cause of our payments problem, our major problem. Many of the other nations that are in a similar condition, far more dependent on OPEC oil imports than the United States, continue to have substantial strength and growth. Yet they import more than we do and don't have the inflation we do.

How do we account for that? For instance, Japan and West Germany?

Mr. BERGSTEN. That statement is perhaps not quite as true today as it might have been several years ago.

Representative ROUSSELOT. But it's still true?

Mr. BERGSTEN. Well, if you look at 1979, Japan moved from a current account surplus of about $16.5 billion in 1978 to a current account deficit of about $9 billion.

Their Wholesale Price Index has been——

Representative ROUSSELOT. Is their inflation rate as great as ours?

Mr. BERGSTEN. It's greater.

Representative ROUSSELOT. Right now?

Mr. BERGSTEN. Yes. Over the last 6 months, the Wholesale Price Index in Japan has been rising much faster.

Representative ROUSSELOT. Their overall inflation rate?

Mr. BERGSTEN. The Japanese Consumer Price Index lags the Wholesale Price Index. There the difference with the United States has been narrowing.

Representative ROUSSELOT. It's not as great as ours?

Mr. BERGSTEN. Not for consumer prices, but more on wholesale prices.

Representative ROUSSELOT. How do we account for that? They import more oil? Pay higher prices?

Mr. BERGSTEN. I think part of the answer is that the change in the situation caused for us is much more dramatic than for them. They have always been 100 percent dependent on imported energy. Therefore, they have had much tighter use of energy than we have had.

Until recently, we were used to living on cheap, domestically produced oil. As I said, as recently as 1970, our oil import bill was less than $3 billion, a minuscule percentage of our demand.

Representative ROUSSELOT. In 1970, we had all kinds of rules and regulations, too, that impacted on the domestic situation?

Mr. BERGSTEN. I am sure that is a part of the problem.

Representative ROUSSELOT. Small item?

Mr. BERGSTEN. Not so small, necessarily. We got hit by a double whammy. Everybody got hit by the OPEC price increase. We also got hit——

Representative ROUSSELOT. They survived it a little better?

Mr. BERGSTEN. We got hit by the leveling off and the decline, actually, in our domestic production.

It really was a double whammy. We faced not only the higher prices from OPEC oil, which is a 10-fold rise over the last decade, but also a big increase in the volume of our imports, because imports had to meet all of our increasing demand, a situation we were not used to. So for us, the change in the situation was much greater than for Japan, Germany, or any other country. In a sense, therefore, we were caught unprepared, whereas the other countries, based on their wartime experience, their postwar reconstruction experience, and their traditional dependence on imports for energy, had much tighter energy programs than we did.

We are in a sense, therefore, having to catch up with the rest of the world. The fact is often stated——

Representative ROUSSELOT. Catch up in the price we pay?

Mr. BERGSTEN. In the price we pay. Catch up on our policies to conserve and use oil more efficiently. It's well known we consume twice, or more than twice, as much energy per capita as the other major industrial countries. It's a reflection of this historical structural situation.

So we face a much tougher change. I think that's why we have probably been impacted more in this first 5 to 10 years of a new energy era than other countries have been.

Representative ROUSSELOT. Now, all of these countries save and invest more of their income than the United States. Consequently, they grow faster, so they add more new plants. They have more modern plants than we do. I don't have to go through that litany with you because you are well aware of that, especially as it relates to our steel plants.

As a result, they are able to produce and sell cheaper than we can. They have a more favorable tax and regulatory climate. It attracts more money from abroad.

So it seems to some of us that growth isn't all that bad, and that the balance of payments in their case isn't quite as severe. Oil imports then seem to have just become an excuse for our bad performance. It seems that if we had a decent domestic policy of encouraging incentives to save, invest, produce—as our report pointed out last year—we would have a greater improvement both in our domestic economy and our international situation.

Do you disagree with that then?

Mr. BERGSTEN. You notice in my comments I did not use oil as an excuse for our external situation.

Representative ROUSSELOT. I was happy to see that.

Mr. BERGSTEN. I did point out it was a major factor in the overall picture but that we have to do better than we have been doing recently, in order to pay that bill.

Representative ROUSSELOT. And also to produce better here?

Mr. BERGSTEN. Right.

Again I take some encouragement from the fact that over the last couple of years, our share of world markets has been increasing. Our export volumes have been rising at a very impressive rate.

Representative ROUSSELOT. Mostly in the agricultural field?

Mr. BERGSTEN. No. I carefully used nonagriculture export figures. The volume of our nonagriculture exports grew over 8 percent in 1978, 12 percent last year.

Representative ROUSSELOT. Eight percent is a good increase. In dollar volume, our agricultural products have done awfully well.

Mr. BERGSTEN. They have done awfully well, there is no question. Both are essential parts of our overall trade performance.

At the end of the day, I agree with your basic point that we have to do better in terms of productivity growth, incentives to capital formation, the productive strength of the economy without which all the things we do on the directly international side, Export-Import Bank, measures of that type, can have only a marginal effect. You are quite right. The issues of productivity and investment capital lie at the heart of whether we can compete effectively in the world.

Representative ROUSSELOT. Our tax policy is related very much to that, isn't it? We learned that overseas.

Mr. BERGSTEN. That's right.

Representative ROUSSELOT. Ambassador.

Mr. OWEN. I wanted to add that you are absolutely right. The rate of saving investment is higher in a number of industrial countries than here. What is interesting is that it is declining in these countries just as it is here. All the industrial countries are facing the same problem, which is a decline in investment and a decline in the rate of productivity.

Representative ROUSSELOT. For a longer period of time, if I can interrupt, they have been much better at it than we have?

Mr. OWEN. It depends how far back you go. Before the war we were doing better. After the war they caught up and did better.

Representative ROUSSELOT. Which war are we talking about?

Mr. OWEN. World War II.

Representative ROUSSELOT. Fine. [Laughter.] We had so many, you understand.

Mr. OWEN. The one I was in.

Representative ROUSSELOT. The big war?

Mr. OWEN. Exactly.

Now all of them, we as well as they, are declining. One of the things that strikes me is when the heads of government get together at summits, they are all clearly in the same box. They talk about it. I think they are puzzled as to what is producing the decline in investment and productivity.

You identified an area which I think is extremely important: The area of overregulation. This is an area which all these countries in varying ways are trying to do something about. As you know, the President has a program for screening Government regulations much more carefully.

Representative ROUSSELOT. I just hope he screens more out.

Mr. OWEN. That's the objective of the exercise, Congressman, to introduce fewer regulations and to screen out some of the ones that already exist.

Even when you take an account of that, a colleague of Fred's and mine at Brookings, Ed Dennison, probably the leading student of productivity, says it's not easy to explain all the reasons why simultaneously in the industrial world you have a decline in productivity.

I couldn't agree with you more. One of the major tasks of U.S. economic policy is to try to find the answers through tax policy, through deregulation, and otherwise to produce a climate which is more congenial to investment and hence to increased productivity. This is a major purpose of the President's program.

In his economic message, he said that if and when the fiscal conditions changed so as to make a tax cut advisable, one of the primary purposes——

Representative ROUSSELOT. If and when. That's the big problem now. We have had a ream of testimony in the last week before Ways and Means, on which I serve, explaining in great detail how our tax policies are an absolute disincentive to the whole thing you are talking about. That isn't all—it's also regulatory policy, yet, yesterday we had administrative policymakers up here telling us we just have no way of having a tax cut of any kind. We were told that the timing was bad.

Mr. BERGSTEN. I would like to explain why that is.

Representative ROUSSELOT. We would like that again.

Mr. BERGSTEN. That goes back to your fundamental question. One of the greatest disincentives to investment and savings is inflation.

Representative ROUSSELOT. No doubt about that.

Mr. BERGSTEN. The savings rate, as you know, has fallen.

Representative ROUSSELOT. Our congressional policies haven't done much to help.

Mr. BERGSTEN. Right. Glad to hear you say that.

Representative ROUSSELOT. We are one of the scapegoats. There are a couple of others involved.

Mr. BERGSTEN. The administration's stance is based on the view that inflation has to be the priority issue, both in terms of consumer needs but also because it is central to getting again a solid base for economic growth and productive investment. Because of the inflation we have now, and the inflationary expectations built into the economy, the savings rate has dropped to just over 3 percent, an unheard of level.

Representative ROUSSELOT. It certainly isn't that low in the other countries.

Mr. BERGSTEN. It's falling there too.

Representative ROUSSELOT. Nowhere near to the degree it has here. For many years they have been up much higher.

Mr. BERGSTEN. I think one lesson we have to draw——

Representative ROUSSELOT. What have they done right and what have we done wrong?

Mr. BERGSTEN. That's a long story. One thing some of them have done is have lower inflation rates than we have. Traditionally Germany and Japan have had lower inflation rates, more incentive to save, more productive investment.

Representative ROUSSELOT. That's certainly a good piece of the reason.

Mr. BERGSTEN. That is why the President has at this point made the judgment that reducing inflation has to be the overriding priority. We said again and again as soon as the time is right, meaning inflation is down substantially—and that issue is on the way to being dealt with—then we are prepared and eager to support tax changes which would provide new incentive to productive investment. The President's 1978 tax bill did that: It increased the rate of the investment tax credit or rate of percent.

Representative ROUSSELOT. With a little resistance. When we wanted to reduce the capital gains tax, we had all kinds of crises. It will be interesting to see in July how much the reduction of that capital gains tax has in fact contributed to investments. We won't be able to tell everything. I remember all the hues and cries from Treasury.

Mr. BERGSTEN. I know.

Representative ROUSSELOT. I hope you didn't participate in writing some of that.

Mr. BERGSTEN. A number of tax cuts for business were put into that bill.

Representative ROUSSELOT. Yes. Right.

Mr. BERGSTEN. Also the reduction in the corporate tax rate. A number of steps were taken in the last tax bill to try to improve productive investment, provide an incentive for it. We are prepared to do more as soon as the time is right.

Representative ROUSSELOT. We notice in some of those countries that money supplies are going up. Whatever the President can do, I hope we can increase the money supply at a rapid rate. The argument has been that interest rates should be encouraged to go up. Interest rates alone don't stop the heavy flow of new fresh money into the supply which very much creates the inflation problem that we face.

Some of us feel that had the priorities been right, we would have made room in this budget for saving—encouragements to saving, faster depreciation, and also a little better lid on spending. Government spending on the demand side clearly does help contribute to inflationary pressures.

Mr. BERGSTEN. As I am sure you heard in some of the earlier testimony, the high-employment budget measure of fiscal restraint increases by about $52 billion in the proposed fiscal year 1981 Federal Government budget as compared with fiscal year 1980. It's a big swing in a restrictive direction after a swing of about $17 billion in that direction, fiscal 1980 over fiscal 1979. The Federal Government budget is a major force in reducing inflationary pressure on the economy.

One can always say you could go further.

Representative ROUSSELOT. If in fact it has restricted increases on the spending side to some degree. You and I know that the deficit in 1981 is going to be far more than $15 million. The Federal Government has to go out and borrow to make up the deficit, putting additional pressure on the market system. I realize part of the problem is Congress.

Mr. BERGSTEN. Right; but even aside from that, the net Federal borrowing requirement on the fiscal year 1981 budget as we see it is no greater than the fiscal year 1980 budget.

Representative ROUSSELOT. That doesn't make it very good.

Mr. BERGSTEN. It could be tighter.

Representative ROUSSELOT. It certainly could.

Does the administration have any coordinated domestic and international economic policy? I know you have described some of it. By anybody who understands the line, between domestic and foreign trade?

Mr. OWEN. Let me speak to that. There is a body called the Economic Policy Group which is chaired by Bill Miller which includes in it the major domestic policymakers such as Fred Kahn and Charlie Schultze, also, on the foreign side, Dick Cooper from the State Department and myself. We meet at least once a week, sometimes twice a week. The object of the exercise is to do exactly what you have in mind.

Representative ROUSSELOT. Are you doing it?

Mr. OWEN. Procedurally we are doing it by making sure every time we take a domestic decision we look at the foreign consequences. Every time we take a foreign decision, we look at the domestic consequences. Substantively we are doing it, as I say, by focusing primarily on two issues: One, the question of macroeconomic policy in trying to make sure that there is some coordination between the macroeconomic policies in the main industrial countries; and two, on energy by making sure the main industrial countries are acting together, one, to reduce the consumption of energy, and two, to increase the production of alternative energy sources.

Representative ROUSSELOT. How are we doing with our domestic effort to increase production, other than decontrol?

Mr. BERGSTEN. As you know——

Representative ROUSSELOT. Reducing some of the restrictions?

Mr. BERGSTEN. That's right. Before the Congress, as you know, are two major proposals to that end, the proposed Energy Security Corporation and the proposed Energy Mobilization Board, the second of which would have as its purpose——

Representative ROUSSELOT. Some of us had problems with that. It looked like more bureaucracy.

Mr. BERGSTEN. The objective was very much as you stated, to try to cut through a lot of the regulatory and bureaucratic hindrance to increase production that now exists.

Representative ROUSSELOT. Wouldn't it be easier to amend those?

Mr. BERGSTEN. In some cases it would; in some cases that's been done.

Representative ROUSSELOT. Go ahead.

Mr. BERGSTEN. Those were the two major additions to what we did on the price front to try to stimulate additional production. It's a very concrete, very ambitious goal over the course of the next decade in terms of increasing our production both of fossil fuels and increasingly of alternatives.

Representative ROUSSELOT. In our Joint Economic Committee hearings in East Asia, we heard a great deal from U.S. businessmen about the adverse impact of U.S. antitrust laws in organizing to do business overseas. I am not talking about these laws as they relate to domestic activities. We will have a report on this that I am sure you will both look over with interest.

Do you have any reactions to this? The businessmen are not saying that they are trying to avoid antitrust laws in this country, because they realize there are reasons for that here. However, it becomes extremely difficult aboard, and they don't feel always it should apply in overseas activity because our competition is foreign competitors.

Mr. BERGSTEN. This is an issue, as I am sure you know, that has been raised for many, many years. I must say there has not been a convincing demonstration that our antitrust laws have been an adverse factor in business abroad.

Representative ROUSSELOT. In some cases outright unfair?

Mr. BERGSTEN. We do have, you know, legislation on the books, the Webb-Pomerene Act, which provides an exception to our antitrust laws for export corporations. Senator Stevenson has proposed amendments to that. I testified in support of some areas of that liberalization.

Representative ROUSSELOT. I think some members of this committee, both the House and Senate, are interested.

Mr. BERGSTEN. It's an area we have been looking at—whether Webb-Pomerene, which is the legislative vehicle for exempting export corporations from the antitrust laws, could be improved, updated, liberalized. The history of Webb-Pomerene is not all that brilliant in terms of firms and industries finding it beneficial to them to set up export corporations which are explicitly then exempt from the antitrust laws. Nevertheless, it has been argued that that's because Webb-Pomerene itself is not liberal enough. We are looking at that. We have testified in favor of some changes. We will continue to do so. We will look at your report with interest.

Mr. OWEN. Let me add one point to that, Congressman. We have been making a major effort to increase coal exports from the United States to Europe and Japan. We are starting a series of discussions with seven foreign countries for that purpose. We invited the coal association to reconstitute themselves as a Webb-Pomerene association to meet the problem we have in mind. They met and considered it and concluded that they would prefer to have price competition among themselves and that they would in the long run gain more in the way of export markets by continuing that competition than by going the Webb-Pomerene route, contrary to our suggestion. They decided not to form a Webb-Pomerene association.

At least in some instances antitrust laws can't be an awful lot of hindrance or they wouldn't have made that decision.

Representative ROUSSELOT. We had a lot of discussion in these hearings about the fact that our businesses were not able to compete because we haven't developed a great number of American trading companies. In a lot of cases, our people were competing with foreign trading companies. We don't have the size and effectiveness that they do. Do you want to comment on that?

Mr. BERGSTEN. Again this is an issue we have had under active study and have already testified in favor of some aspects of proposals for trading companies. There are some misunderstandings in this area. One, of course, is that the United States does have huge trading companies; the grain traders are huge trading companies which don't just trade grain but literally trade everything from soup to nuts. We do have some trading companies of very great magnitude and success.

A second is that the Japanese trading companies, the Sogo Shosha people often refer to, are not just trading companies. Indeed more than 50 percent of their business is done domestically within Japan. They are major factors within the economy.

The latest data show that the Japanese trading companies, in aggregate, do not generate a trade surplus for Japan. They import raw materials and other products of value as large as the manufactured goods they export. Furthermore, sales of many of the products in which Japanese export penetration has been so effective—automobiles, steel, and electronics—have expanded wholly without any reference to their trading companies. Those are not the kinds of products Mitsubishi, et cetera, are involved in exporting.

At the same time, we have concluded that, particularly for small- and medium-sized U.S. firms who have not been able to break into the exporting business, there may be something to the idea of trading companies. One of our big efforts, frankly, is to sensitize the U.S. business community and encourage the private sector on a much wider basis than heretofore to get into the exporting business.

We have something like 30,000 U.S. manufacturing corporations engaged in exporting; but 250 of those corporations account for about 70 percent of our total exports of manufactured goods. They are always going to account for the bulk of it because they are the biggest share in value and volume terms of our economy; but if we could mobilize an additional significant fraction of American business firms to get into the exporting busines more effectively, it would do wonders for our export numbers and our competitiveness.

We think a number of those firms could be competitive and we are trying, through a variety of means, including studying the possibility of trading companies, to mobilize them more effectively to get into the exporting business.

Representative ROUSSELOT. As you both are probably aware, our businessmen overseas gave us a very, very long laundry list of laws that make it very difficult to be exporters. There are more disincentives, they feel, than there are incentives to do so. Those that have been doing it awhile have learned to live with it all. For instance, our tax laws, as you know, make it very difficult to keep our own Americans on the payroll. It's 100 percent cheaper almost—not 100 percent, but 50 percent cheaper to hire a foreign national to carry out our overseas activities just because of tax laws, alone.

That's just one area. They go through the antitrust area, the Foreign Corrupt Practice Act and some of the problems it creates. I think both the administration and the Congress are going to have to look at that list. That doesn't mean that they are right in everything they say, but I must say that their substantial list of the tremendous problems created by domestic law was impressive. Maybe there are reasons for these laws being imposed here, but they don't always apply in the international field.

Mr. OWEN. We have a study on that, Congressman, underway, an interagency study in which we are looking at the disincentives.

Representative ROUSSELOT. I hope you will look at our list and testimony.

Mr. OWEN. If you ask one of the staff to send it to us, we will do it.

Representative ROUSSELOT. We will make sure you get the report.

Mr. BERGSTEN. Could I say I think there is a fundamental issue here. The basic principle underlying U.S. tax law, antitrust law, and frankly, practically every law is that what's fair at home is fair, abroad. An American working in the United States should be taxed on the same basis as an American working abroad. The antitrust laws that apply at home should, with that one exception, apply abroad.

That was fully understandable in a period when the United States was basically a self-sufficient economy. Now we have moved into a world where the United States has become dependent on the world economy for many of its economic objectives, and where we are part of an interdependent world economy. The question thus arises whether the fundamental precepts underlying tax, antitrust, regulatory, and other policies, is still the right basis.

If the Treasury or a President or anybody came up here to the Congress and proposed exempting all foreign income from taxation, which is what some other countries do, you know what the screams would be from many quarters.

Representative ROUSSELOT. Yes.

Mr. BERGSTEN. Unfair. If you earn money abroad, why should you be taxed more liberally than if you earn it at home?

Representative ROUSSELOT. I have heard those arguments.

Mr. BERGSTEN. I know you have. That's the fundamental issue being posed. Other countries operate on a different basis than we do. The proposal in all these specific areas you mentioned gets to the fundamental, philosophical, as well as practical question: Should our laws as they apply to foreign activities match what our foreign competitors do? Or should they be consistent with what we do at home?

That's a very big issue; and change in all these areas that you mentioned—fundamental change—would require a basic change in the philosophy that has guided U.S. policy in all those areas for two centuries. It's a big debate. I think it's coming. That's really the underlying issue.

Representative ROUSSELOT. We have been told we better get at it or we are not going to be able to compete. I must say I was impressed. Even though we have a lot of exporters in California, I don't think I would have been so impressed without the trip overseas to see what tremendous disadvantages domestic law creates for our people who export.

The difficulties in selling and competing with Japan, with Germany, Korea, and Taiwan are tremendous.

Mr. OWEN. Congressman, in addition to the problems you cited, there are the obstacles and hindrances which are imposed by policies which the Congress and executive branch both think are very important. Let me just mention four of them.

There's the antitrust boycott legislation. There's the anticorruption legislation. There is the nonproliferation. There is a ceiling on arms sales abroad.

All four of those impose major difficulties for our exporters. What we have to do in each of these cases is to choose priorities among our different policies.

Representative ROUSSELOT. Anybody have any questions?

I am sure many of our members will have additional questions. We will probably submit those to you. I appreciate very much your being here. If you would be kind enough to supplement your views with additional questions, we would appreciate it.

Mr. OWEN. Thank you.

Representative ROUSSELOT. The committee stands adjourned.

[Whereupon, at 11:10 a.m., the committee adjourned, subject to the call of the Chair.]

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