

# THE 1967 ECONOMIC REPORT OF THE PRESIDENT

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HEARINGS  
BEFORE THE  
JOINT ECONOMIC COMMITTEE  
CONGRESS OF THE UNITED STATES  
NINETIETH CONGRESS  
FIRST SESSION

FEBRUARY 20, 21, AND 23, 1967

PART 4

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# CONTENTS

## STATEMENTS

### FEBRUARY 20, 1967

	<b>Page</b>
Reuther, Walter P., president, Industrial Union Department, AFL-CIO, and United Automobile Workers (UAW), accompanied by Nat Weinberg, director of special projects department, United, Automobile Workers.....	717
Hagedorn, George G., vice president and chief economist, National Association of Manufacturers (NAM).....	792
Roosa, Robert V., general partner, Brown Bros., Harriman & Co.....	830
Kindleberger, Charles P., Department of Economics, Massachusetts Institute of Technology.....	833

### FEBRUARY 21, 1967

Wallich, Henry C., Department of Economics, Yale University.....	875
Colm, Gerhard, chief economist, National Planning Association.....	883
Lekachman, Robert, professor of economics, State University of New York at Stony Brook.....	895

### FEBRUARY 23, 1967

Auerbach, Carl A., professor of law, University of Minnesota.....	928
Backman, Jules, professor of economics, New York University.....	957

## ADDITIONAL INFORMATION AND SUBMISSIONS

Reuther, Walter P.:	
Article from Wall Street Journal, February 7, 1967, re gasoline price rise.....	722
Article from Wall Street Journal, February 8, 1967, re asphalt price raise.....	723
Data comparing changes in income, requested by Representative Widnall.....	730
Information relating to UAW profit sharing plan, requested by Representative Reuss.....	732
Outline of provisions of bill to require hearings on administered price increases in order to make private economic decisions more responsive to public need, requested by Senator Miller.....	738
Excerpt from "Technology and the American Economy," report of the National Commission on Technology, Automation, and Economic Progress, February 1966, requested by Representative Rumsfeld.....	743
Excerpt from BLS publication "Labor Development Abroad," requested by Representative Rumsfeld.....	745
Questions and answers:	
Senator Miller to Mr. Reuther.....	752
Senator Proxmire to Mr. Reuther.....	753
Representative Widnall to Mr. Reuther.....	755
Prepared statement.....	756

## ADDITIONAL INFORMATION AND SUBMISSIONS—continued

Reuther, Walter P.—Continued	
Charts:	Page
Unit labor costs in manufacturing since 1948.....	721
Employee compensation lagged far behind nonlabor income.....	724
U.S. unemployment still high compared with other countries.....	729
General Motors hourly rated worker and General Motors stockholder.....	734
Ford hourly rated worker and Ford stockholder.....	735
Hagedorn, George C.:	
Prepared statement.....	792
Study: Report on the Federal budget for 1968.....	808
Roosa, Robert V.:	
Prepared statement.....	832
Comment on Aschinger article submitted by Senator Symington.....	862
Responses to questions by Representative Brock.....	870
Symington, Senator Stuart:	
Article: The Building of an International Money Machine, by F. E. Aschinger.....	859
Kindleberger, Charles P.:	
Comment on Aschinger article submitted by Senator Symington.....	863
Responses to questions by Representative Brock.....	870
Colm, Gerhard:	
Prepared statement.....	887
Letter responding, to question by Senator Javits.....	913
LeKachman, Robert:	
Prepare statement.....	898
Wallich, Henry C.:	
Response to Senator Javits' question on tax rate change discretionary power.....	912
Auerbach, Carl A.:	
Prepared statement.....	933
Backman, Jules:	
Prepared statement.....	966
Percy, Senator Charles H.:	
Statement by Dr. Paul W. McCracken, excerpted from Joint Economic Committee hearings, February 23, 1966.....	948
Proxmire, Senator William:	
Letter from Seymour Harris, chairman of the Department of Economics of the University of California at San Diego.....	1002

# THE 1967 ECONOMIC REPORT OF THE PRESIDENT

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MONDAY, FEBRUARY 20, 1967

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

The joint committee met at 10 a.m., pursuant to recess, in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Symington, Jordan, Miller, and Percy; and Representatives Reuss, Moorhead, Rumsfeld, and Brock.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Donald A. Webster, minority economist.

Chairman PROXMIRE. The committee will come to order.

At this time of the year the committee faces an extremely difficult problem. For the period of about a month we have had to examine the entire range of economic issues. We have had many witnesses, and the next very brief period we have nine witnesses before us, so I am going to ask members of the committee this morning to limit their questioning to 5 minutes. We can take whatever turns time permits.

I am going to ask our witnesses to limit their statements to 20 minutes. We hope we can cover more ground by doing this.

Our witness this morning is a very distinguished, eloquent, able spokesman for the labor movement. We are very proud and happy to have Mr. Walter Reuther appear before us. Mr. Reuther has a detailed statement, and without objection that statement will be printed in the record as if read.

Mr. Reuther, go right ahead.

## TESTIMONY OF WALTER P. REUTHER, PRESIDENT OF THE INDUSTRIAL UNION DEPARTMENT, AFL-CIO, AND OF THE UNITED AUTOMOBILE WORKERS (UAW); ACCOMPANIED BY NAT WEINBERG, DIRECTOR OF SPECIAL PROJECTS DEPARTMENT, UNITED AUTOMOBILE WORKERS

Mr. REUTHER. Thank you, Mr. Chairman. You have been more than generous.

Members of the committee, I want first to express my very sincere appreciation for the opportunity of appearing before your committee and being given the chance to discuss the general state of the American economy.

I appear this morning in a dual capacity, first as the president of the United Automobile Workers Union, representing roughly one and a half million members, and also as president of the Industrial Union

Department of the AFL-CIO, representing roughly 7 million members. With respect to broad economic policy questions I will be speaking for both organizations, but with respect to more specific collective bargaining questions I will be speaking only for the UAW.

As one American I share the view that the American economy is freedom's greatest material asset. I believe that how effectively we mobilize its economic potential, how responsibly and rationally we allocate resources to meet our private and public needs, and how equitably we share the increasing abundance that the tools of science and technology give us, are the keys to the improvement of the quality of our society at home and will determine our success in meeting our responsibilities whenever freedom is challenged in the world.

That is why I put great emphasis upon the importance of what we do in the American economy and how intelligently we use the new tools of science and technology.

I am disturbed by the fact that we are the richest Nation in the world, yet have permitted many basic and urgent human needs to go unmet. We all realize that more than 30 million Americans live in poverty in a land of plenty, that our urban centers have become social cesspools, scarred with decay and blight; that our educational system is inadequate; that while we have achieved high levels of medical competence, America, the richest Nation in the world, ranks 11th in the rate of infant mortality.

Our cities are paralyzed with congestion. We are polluting our air and our water, and we are destroying our living environment. I share the view, Mr. Chairman, that we have the know-how and the resources to solve these problems, and that what we need is the sense of national purpose, and the will to commit ourselves and our resources in a measure equal to the dimensions of these problems.

I believe that what we need to do is to work out a list of priorities in which we put first things first, and then allocate our resources to the practical implementation of those priorities.

I would put very high on the list of those priorities the achievement of the purposes of the Employment Act of 1946. For 20 years we have failed to achieve the purposes of that act. We have averaged more than 5 percent unemployment throughout those 20 years. We have had a higher rate of unemployment than any democratic industrial nation in the world.

Now I am encouraged by the fact that under the Kennedy and Johnson administrations we have made meaningful progress in reducing the levels of unemployment. We are now down to 3.9 percent. But that is not good enough.

In 1962, when Mr. Heller was the Chairman of the Council of Economic Advisers, the Council came out with an interim unemployment goal of 4 percent. We raised at that time a warning, saying we wanted to be certain that this 4-percent interim goal did not become a definition for full employment. And we believe that our fears were well founded, because in Mr. Ackley's most recent report—and this deeply disturbed us—he now takes the 3.9-percent unemployment rate, and describes it as “substantially full employment.” And he projects it into 1967, saying that it will mean substantially full employment.

We reject this concept vigorously, because it will continue to deny a great many Americans the opportunity for meaningful employment

and it will place a disproportionate burden of the tragic cost of unemployment upon the youth of America and on minority groups.

We believe that we must move forward with courage and with deep national commitment to provide every American able and willing to work a socially meaningful and rewarding job. Until that is possible, until every American has that opportunity, this goal ought to be one of the top priority items on our agenda.

I would like to urge Congress to give serious consideration to the unanimous recommendation of the Automation Commission, which I had the privilege of serving on. That commission, composed of industry representatives, labor, and people from the academic community, after a year of intensive study, recommended that the Federal Government be the employer of last resort, if market forces fail to create employment opportunity for all who are able and willing to work.

We pointed out that there were more than 5 million potential jobs available in public service employment, if we were to do the things that need doing in American society.

As we come together this morning, I am deeply concerned about what we believe to be some very serious soft spots developing in the American economy. We all know that the housing industry has been in a depression. There are serious layoffs in the automotive industry. Capital expenditures are tapering off. The decline in durable goods orders is very significant. And there is an excessive inventory buildup. I think it has increased approximately \$16 billion during the last quarter, and in the face of these uncertainties, it is our judgment, Mr. Chairman, that a tax increase at this time would not be justified.

We have no assurance that a tax increase, in the face of these economic developments, will yield greater revenue. In the 1958-59 fiscal period, Mr. George Humphrey was so obsessed with balancing the budget that he unbalanced both the economy and the budget and we wound up in that period with a \$12.4 billion deficit, the largest peacetime deficit in the history of America, with unemployment as high as 7.5 percent and averaging 6.2 percent for the fiscal years.

And so we have no assurance that a tax increase will yield greater revenue, if it compounds negative forces that may reduce the overall level of economic activity.

We would recommend instead that the Congress give the President discretionary authority on the tax front, and that the President then use that authority based upon the economic developments as they evolve. If the economy grows stronger and these weak spots are overcome, then one course of action may be justified. If, on the other hand, you have a compounding of these weaknesses, then another course of action would be suggested.

We have not yet found a satisfactory answer to the basic question: How does a free society go about achieving the purposes of the Employment Act of 1946, achieving maximum employment, maximum production, and maximum purchasing power within the framework of a stable price structure?

In Europe they have done a better job on the employment front, at the cost of a great degree of price instability. We have had the greatest stability in our price structure, but we have paid a tragic price in intolerable levels of unemployment.

We believe that in broad outline the philosophy behind the wage-price guidelines is sound. The idea is that if the overall level of increase in productivity is  $x$  percent, the worker can share proportionately in that general overall increase in productivity. In those industries where the tools of production are not as efficient, such wage increases may require price increases. These price increases would be offset by price decreases in industries where the increase in productivity is abnormally high. That is the theory of it.

It is a sound theory, but it breaks down in practice, not on the wage front, but on the pricing policy front, because giant corporations which are immune to the forces of the marketplace, which really have an administered price structure, have been keeping a disproportionate share of the increase in productivity and both wage earners and consumers have been shortchanged.

This is where it has broken down. Now if you take the automotive industry, with which I am very familiar, we are using the fantastic tools of automation and the new technology. Labor productivity has gone up very fast, much faster than the average in the whole economy. But what has happened to that tremendous increase in productivity?

The workers have gotten some of that increase, but they have not gotten their equity, and the consumers have not gotten their equity. We believe that what we need to do to achieve the dynamic qualities of expansion and growth and full employment is to establish equity among investors, workers, and consumers. When any group is shortchanged, you begin to feed the forces of imbalance into the economy.

If you look at the Big Three as an example, in 1965, which was our peak production year, the Big Three together had an earning rate after taxes of 24.1 percent on net worth or almost double the earning rate for industry generally. General Motors made 28-percent return on its net investment after taxes. Ford made 17.5 percent. Chrysler made 20.8 percent.

We have advocated, and continue to advocate, that corporations enjoying an abnormally high increase in productivity, because of the tools of science and technology, share their gains with American consumers by meaningful price reductions. We advocated a \$100-per-car-price reduction in the auto industry. This would have made a tremendous contribution toward the stabilization of our price structure. It would have helped to offset the upward price pressures in the service industries, where technology has not improved productivity as much. And we pointed out that the General Motors Corp. could have cut the price of every U.S.-made car in 1965 by \$100, and still would have made a profit of \$3.6 billion before taxes, or \$1.9 billion after taxes, after the \$100 price reduction.

General Motors profits in 1966 have come down slightly, but they were still the second highest profits in the history of the corporation, and they yielded a return on investment after taxes of 21.8 percent.

We will be sitting at the bargaining table, Mr. Chairman, in a few months. In 1967, I, along with my colleagues in the leadership of the UAW, will be representing at the bargaining table roughly 850,000 to 900,000 wage earners and their families, and we say now, not for public relations purposes, but because we believe American consumers have been shortchanged, we now urge the automobile industry to cut the price of its cars. We have written the Chairman of the Council of Economic Advisers urging him to spend more of his time trying

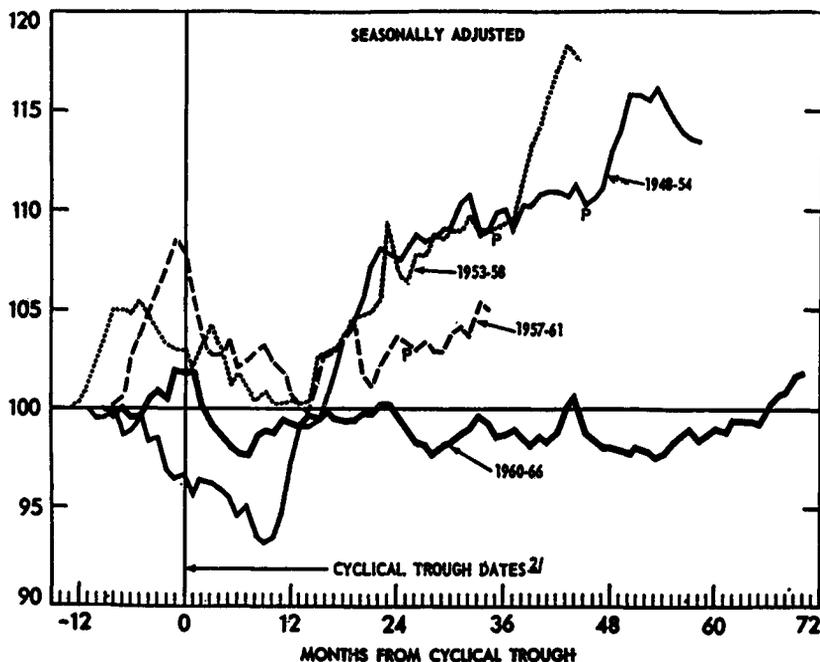
to get the industry to cut prices, and we are prepared to bargain in 1967 within the economic framework of what results from a meaningful price reduction in the prices of cars and trucks.

I think if we are going to try to make sense about how we go about achieving a more stable price structure, we need to get away from propaganda and look at the basic economic facts. We are in trouble not because wage earners are exerting tremendous pressure on the price structure. We are in trouble because large corporations have been getting a disproportionate share of the increase in productivity.

This chart, which we think is a very significant chart, indicates that starting at the peak of the last business cycle and projecting unit labor cost for the period of this cycle—the 72 months of the present business cycle—you find, as this heavy line indicates, that unit labor cost, excepting at the very end, has been lower. It was lower in 1961 and 1962 and 1963 and 1964 and 1965 and in the largest part of 1966 than it was in 1960 when this cycle began. So the pressure on prices did not derive from wage increases that exceeded the increase in productivity, because the unit labor cost was actually going down in that period. And we did not break above the line until workers began the fight to catch up with the increase in the cost of living. Now this is the Council of Economic Advisers' chart.

### Unit Labor Costs in Manufacturing Since 1948

PREVIOUS PEAK = 100 1/2



P—CYCLICAL PEAK: JULY 1953, JULY 1957, AND MAY 1960.

1/2 PREVIOUS PEAKS ARE NOVEMBER 1948, JULY 1953, JULY 1957, AND MAY 1960.

2/2 CYCLICAL TROUGHS ARE OCTOBER 1949, AUGUST 1954, APRIL 1958, AND FEBRUARY 1961.

NOTE.—PERIODS COVERED ARE NOVEMBER 1948—AUGUST 1954, JULY 1953—APRIL 1958, JULY 1957—FEBRUARY 1961, AND MAY 1960—DECEMBER 1966 (LATEST DATA AVAILABLE).

SOURCES: DEPARTMENT OF COMMERCE AND BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

Here are the real culprits in this situation. This is the story from the Wall Street Journal dated February 7, 1967, and the headline says "Gasoline Prices Rise Unseasonably" and it talks about "Standard of Indiana" boosting prices. On February 8, another story in the Wall Street Journal, "Standard of Indiana Raises Asphalt Prices." And then in the Wall Street Journal on February 13 is a full page ad by Standard of Indiana, and it says "1966 earnings break all records at Standard Oil Co. of Indiana. Profits rise 17 percent 8th straight year."

(Items referred to are reprinted herein :)

[From the Wall Street Journal, Feb. 7, 1967]

**GASOLINE PRICES RISE UNSEASONALLY AS DEMAND GROWS—INDIANA STANDARD UNIT LIFTS DEALER AND JOBBER QUOTES, FOLLOWING OTHER PRODUCERS**

GENERAL RETAIL BOOST SOUGHT

(A Wall Street Journal *News Roundup*)

Prices of gasoline are increasing unseasonably in the wake of rising demand. In Chicago, American Oil Co., a subsidiary of Standard Oil Co. (Indiana), announced it is increasing gasoline prices to dealers by 0.6 cent a gallon and to jobbers by  $\frac{1}{4}$  cent a gallon, effective today. American said it also is suggesting to its dealers that pump prices in the states affected be increased by one cent a gallon from previous suggested retail price levels.

The action by American in boosting tank wagon prices to both dealers and jobbers follows similar moves by several other companies, including Phillips Petroleum Co., Sunray DX Oil Co. and Continental Oil Co.

"There's a lot of skirmishing among the major companies who are trying to put into effect a one-cent increase in the retail price of gasoline," said one Midwestern marketer of motor fuel, "but the increases can't be termed general until most of the major companies succeed in getting dealers to go along."

Midcontinent petroleum refiners also are apparently readying a general boost in the wholesale prices of gasoline processed for shipment to the North by pipeline. Some marketers reported the refinery price for 92-octane (regular grade) branded gasoline is fluctuating at least  $\frac{1}{4}$  cent above the posted quote of  $12\frac{3}{4}$  cents a gallon. Some suppliers are said to be advancing wholesale prices by as much as  $\frac{1}{2}$  cent a gallon. A year ago, the refinery quote for gasoline processed in the Midcontinent area was generally 12 cents a gallon.

NORMAL PATTERN IS DOWN

Gasoline prices at this time of the year normally go down instead of up. Wintry weather slows driving, and this leads to a buildup of inventories of motor fuel.

According to the American Petroleum Institute, stocks advanced seasonally some three million barrels in the week ended Jan. 27 and now are about 10 million barrels above year-ago inventories. But demand has been climbing. One industry source puts consumption of gasoline at more than 4.6 million barrels daily, or more than 4.5% above a year ago.

Oil companies also insist that gasoline prices both at tank wagon and wholesale levels are below those of the late 1950s.

"Price increases at this time will bring the price of gasoline—which has lagged behind rising prices for other commodities for some time—a little more into line with the economy as a whole," an American spokesman said. "In addition, they will reflect recent wage increases in the petroleum industry."

In view of the increase in dealer and jobber operating costs, which have risen significantly in the past year, he added, the suggested increase in pump prices will enable dealers and jobbers to maintain adequate manpower and station operating hours and provide the service the public expects and should receive.

VARYING BY AREA

In Michigan, tank-wagon price adjustments will vary by area, although the Detroit tank-wagon price will be increased by the 0.6 cent figure. In Alabama,

the established dealer tank-wagon price will be 17.5 cents a gallon, statewide; in Mississippi, established dealer tank-wagon price will be 17.4 cents a gallon, statewide; and in Georgia, established dealer tank-wagon prices will be 17.3 cents a gallon, statewide.

Consumer tank-wagon prices will be increased or adjusted by the same amounts as the dealer prices.

Temporary dealer tank-wagon prices will be removed in all of the above mentioned states except Florida, where current discounts will remain in effect.

"While we believe the increase is justified because of increasing costs, it is recognized that the duration of the more realistic price level will be contingent upon the action taken by the industry as a whole as well as the overall economic condition of the petroleum industry," the American Oil spokesman said. Further, he said, "if this increase doesn't hold, we'll have no choice except to revert to previous price levels."

[From the Wall Street Journal, Feb. 8, 1967]

#### INDIANA STANDARD UNIT RAISES ASPHALT PRICES

AMERICAN OIL SAYS RISE REFLECTS HIGHER COSTS FROM CUTBACKS OF CRUDE OIL IMPORT QUOTAS

(By a Wall Street Journal Staff Reporter)

CHICAGO.—American Oil Co. increased the price of paving asphalt at four East Coast shipping points to reflect "increased costs resulting from government cutbacks of crude oil import quotas," W. C. Marquis, marketing manager said. American is a subsidiary of Standard Oil Co. (Indiana).

The increase involves a price rise of about 25 cents a ton and an elimination of discounts which have been running between \$1.50 to \$2 a ton, he said.

The new prices become effective today and apply to sales at refineries in Baltimore and Savannah and terminals in Norfolk and Wilmington, N.C.

A price revision, Mr. Marquis said is needed "to justify using reduced quotas for the importation of heavier asphalt crudes compared with importing lighter crudes for the manufacture of gasolines, jet fuels and similar higher value light products."

[From the Wall Street Journal, Feb. 13, 1967]

#### 1966 EARNINGS BREAK ALL RECORDS AT STANDARD OIL CO. (INDIANA)

PROFITS RISE 17 PERCENT; 5TH STRAIGHT YEAR OF INCREASE; DIVIDEND RAISED

Consolidated net earnings for the year reached \$225,900,000. This was up 17% from the \$219,300,000 earned in 1965.

Per share earnings increased to \$3.62 per share, based on 70,646,823 shares outstanding at year-end. This compares with \$3.10 per share on 70,794,742 shares at the end of 1965.

Total revenues rose to \$3,351,000,000 compared with \$3,063,000,000 a year earlier.

Per share dividends were again increased. They totaled \$1.70 compared with \$1.55 the preceding year.

#### PRODUCTION AND SALES CONTINUE TO CLIMB

John E. Swearingen, Chairman and Chief Executive Officer, attributed the record results to new peaks in the production of crude oil and natural gas liquids, natural gas, and in refined product sales, and sales of chemicals.

Production of crude oil and natural gas liquids averaged 491,000 barrels a day, up 8%. Refined product sales averaged 895,000 barrels a day, an increase of 7%. Sales of gasoline rose 9% at generally steady prices for the year. Refinery runs, at 829,000 barrels a day, were up 7%. Natural gas sales increased 8% to average 2.4 billion cubic feet a day. Chemical sales rose 23% to \$158,000,000.

#### OUTLOOK BRIGHT FOR 1967

Mr. Swearingen looked ahead to a further earnings increase in 1967, despite a rise in wages and suspension of the investment tax credit.

Our annual report will be available in March 1967. If you would like a copy, please write.

STANDARD OIL COMPANY (INDIANA)  
910 S. Michigan Ave.,  
Chicago, Illinois 60680

Mr. REUTHER. This company since 1960 has increased its dividends 16 percent per year on the average, and yet they turn around and raise the price of gasoline and other petroleum products to the American consumer. Why? Not because unit costs have gone up, but because they want to inflate their profits so that they can continue to increase dividends 16 percent a year.

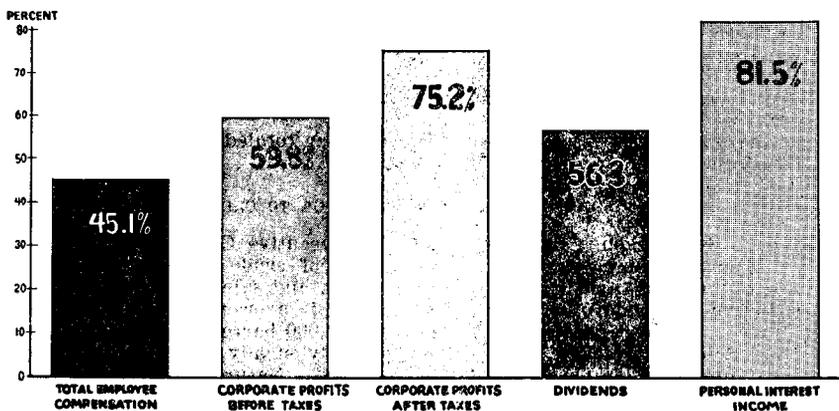
Now you measure a 16 percent yearly dividend increase against the 3.2 wage formula, and you begin to understand where the basic inequity comes in. I should like to suggest respectfully that this is the front on which the Council Chairman ought to be expending his time and his energy, rather than trying to put the burden of higher prices upon the backs of the American wage earners.

When you look at what has been happening to the relative compensation of various economic groups in America, you can see that the wage earner has been on the short end of it, and here again these are from the Department of Commerce records. Total employee compensation—wages, fringe benefits, social security payments, salaries, everything—went up in this period 45.1 percent. Corporate profits before taxes went up 59.8 percent. Corporate profits after taxes went up 75.2 percent. Dividends went up 56.3 percent. And personal interest income went up 81.5 percent. So the wage earner has gotten the short end of the distribution of the national income during this period.

(The following chart was later supplied by the witness:)

## EMPLOYEE COMPENSATION LAGGED FAR BEHIND NONLABOR INCOME

( PERCENT INCREASES, SECOND QUARTER 1960 TO SECOND QUARTER 1966 )



DATA: DEPT. OF COMMERCE

Chairman PROXMIER. If I could interrupt just for a minute, Mr. Reuther, you have had almost 20 minutes and I would appreciate it if

you could summarize in a minute or so and then we will start with our 5-minute period of questions.

Mr. REUTHER. Very good. I would just like to say that in a free society you cannot achieve harmonious labor-management relations on the same basis that you can in a totalitarian society. There you can get it in the absence of justice, but in a free society it can only rest upon the foundation of economic and social justice. We believe that what we need in America is not a decimal point guidepost system, but a national income policy through which we can place the burden of stability upon all forms of income, and not just upon that one sector, that of the American wage earners' income.

We in the UAW have also suggested the creation of a public price-wage review board. We believe that this represents a rational approach to a middle ground. If we rely upon the irresponsible forces of the marketplace, and Standard Oil of Indiana and other corporations behave as irresponsibly as they have, that puts us in jeopardy. On the other hand, we don't think anybody in Washington has the wisdom to be able to make all of these economic decisions. We have therefore proposed the creation of a public review board in which only the major corporations in the price-administered industries, which determine the general price trends, would be obligated to defend the economics behind their contemplated price adjustments.

And if their demands were such that they would necessitate a price increase, a labor union would be obligated to defend the economics of its demands before the same public review board.

We believe that this would bring to bear upon the private decision-making process, both in the pricing area and in the collective-bargaining area, the leverage of enlightened public opinion, and make private decisions more publicly responsible.

One other point; I will take a minute and then I will conclude. I have sat at bargaining tables now, Mr. Chairman, for some 32 years. There are many things on which I cannot speak with authority, but I do know something about the collective-bargaining process. And what is the basic problem? It has bothered me for a long time.

I believe when I sit at the bargaining table representing UAW members that I obviously have a responsibility to them. And the management people who face me across the bargaining table have a responsibility to the stockholders. But I believe that together we share a joint responsibility which transcends our separate responsibilities, and that joint responsibility is to all of the people of this Nation.

Now the basic problem is that too often economic decisions at the bargaining table are based upon economic power and not economic facts, because we bargain in the absence of the facts. If, when I sit down next July with the General Motors Corp., and they expect us to sign a 3-year contract—and we don't know what the term of the contract is going to be—we are not talking about 1965 or 1966. We are talking about 1968, 1969, and 1970. How can we rationally determine, 3 years in advance of the fact, what the relative equity of a worker and a stockholder and a consumer is? We are only guessing. And since we are guessing, what happens is that the economic facts do not determine the decisions, but rather you get a play of economic power.

I believe that what we need to do at the collective bargaining table is to bring in some fundamental new concepts. We ought to work it out so that a wage earner would get his basic wage as the first part of his equity. We would say to that wage earner, "That is all we can give you now" and that basic wage ought to reflect along with other relevant factors, the general level of increase in productivity, because that we can measure in advance.

But also say to him:

If we have a good year, and if the economic pie that our joint effort makes possible is large, then you will get a second, supplementary increment of your equity based upon your right to share in the profits of the company.

Now this is not a revolutionary idea that we dreamed up. This is exactly how GM has done it for their executives all these years. They get their basic salary. That is the first increment of their equity. And at the end of the year, when the profit pie is baked, they get a very healthy slice of that profit pie in bonuses, and in most cases bonuses for the top executives are bigger than their salaries. And so what we say is that that makes a lot of sense for corporation executives because they get then their full equity after the facts and not before the facts.

The same ought to apply to wage earners. It applies to stockholders. They get their basic dividend and they get a special dividend based upon the size of the pie. We believe that it is this kind of idea that we have got to begin to introduce into the collective bargaining process to make it more rational, so that these decisions can be more publicly responsible because they reflect economic facts after the facts become available and are not essentially the result of the play of economic power.

Chairman PROXMIRE. Thank you very, very much, Mr. Reuther, for a forceful, vigorous, and extremely interesting statement. I would like to ask you this. Our overall program calls, as I understand it, for no tax increase, although the Congress might see fit in your view to give the President some discretion in this area. You didn't mention any reduction in spending, although presumably you have not advocated that, as I understand it, in your statement.

You favor an easier money policy than we have had in the past, and you would favor as far as wages are concerned, as I see it, increased pay for productivity plus a cost-of-living escalator. In other words, an income policy. And in addition to this, you would compensate workers in those areas where profits are high with some profit sharing.

Now in order to hold down inflation you would rely primarily upon wage boards who work in the administered price industries. My reaction to this is that I am still very much concerned about the possibility of inflation for these reasons: (1) The increase in prices has not primarily been in the administered price industries in the last 3 or 4 years. Steel prices didn't go up very much. Automobile prices went up some but certainly not as much as many other prices did. The prices in these other nonadministered areas would be subject to the kind of fiscal and monetary inflation we might suffer under these circumstances. I would feel we might get an unbalanced situation

without the kind of control of inflation that we would need if we are going to prevent a maldistribution of income.

Mr. REUTHER. To begin with, I think we need to treat the inflationary pressures for what they are. They are not classical inflationary pressures that would grow out of an excessive demand over supply capability. We are utilizing our productive capabilities somewhere around 88 percent, so that there is an underutilization situation. We have a great deal of unemployment. And we do not, therefore, have the classical pressures that normally create inflation when the demand exceeds supply.

What we have got is a selective kind of inflationary pressures and they have to be dealt with as such. Now if you are to be able to offset the pressures of wage and price increases in the service industries, for example, where productivity may not have gone up as much as in the automotive industry, if you are to be able to offset that so you can maintain a stable price situation, then it is not enough to say to the automobile industry "Well, you have not been so irresponsible, you haven't raised prices."

The auto industry has to cut prices. The Standard Oil Co. has to cut prices. If the industries where abnormally high productivity increases are possible just maintain a stable price situation, and do not cut their prices, then you are going to have inflationary pressures. But if they offset the pressures in other sectors of the economy by meaningful price reductions, then I believe you can have a stable price situation.

This is where the wage-price review board comes in. In a free society, what are the leverages that influence the private decision-making processes? And I want to keep it as broad and as free of Government control as possible.

Chairman PROXMIER. Would you go as far under these circumstances as providing a tax penalty for price increases, for example, and some kind of a tax incentive for a price cut? That kind of a proposal has been made in the Senate, suggested by the staff of the Antitrust and Monopoly Subcommittee of the Judiciary Committee.

You see, the thing is we have never had a situation, to my knowledge, where we actually directed an industry to cut their prices. We have had a policy—theoretically we have had it, we haven't really tried it—we have attempted to keep them from raising their prices, but to require them to reduce their prices is something else.

Mr. REUTHER. I believe we have got to develop a lot of new tools, if we are going to find the answers to these problems. This is why we came up with a price-wage review board.

Just take General Motors. General Motors, I think, today perhaps is more sensitive to public reaction than they have ever been. They had some very bad experiences in the last year in this town. And I would think that if the General Motors Corp. knew that ultimately it would face the day when it would have to make an accounting to the American people on economic justification of its price policy, GM would behave much more responsibly on the price front than if it didn't have to make that public accounting; and what is true of industry is true of labor.

I don't ask the General Motors Corp. to be obligated to do anything in terms of their public accounting that I am not willing to do as the President of the UAW, because I think we both must be publicly responsible and our decisions must first reflect the needs of the American people.

This idea of a tax penalty, I think, is worth exploring, because when an industry operating in terms of market forces puts the whole economy in jeopardy, the American people have a right to protect themselves against that kind of irresponsible action by any legal procedure that they choose, and the tax penalty certainly ought to be explored.

Chairman PROXMIER. My time is up.

I might say for the members that just came in, we are following a 5-minute rule this morning. We are going to have another witness coming up.

Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Thank you, Mr. Reuther, for coming before us again today and giving us some very substantial testimony on a subject that is of great interest to all of us.

In your statement you say :

Nevertheless, as a Nation we cannot escape the fact that the United States still has the highest rate of unemployment of any democratic industrialized nation in the world.

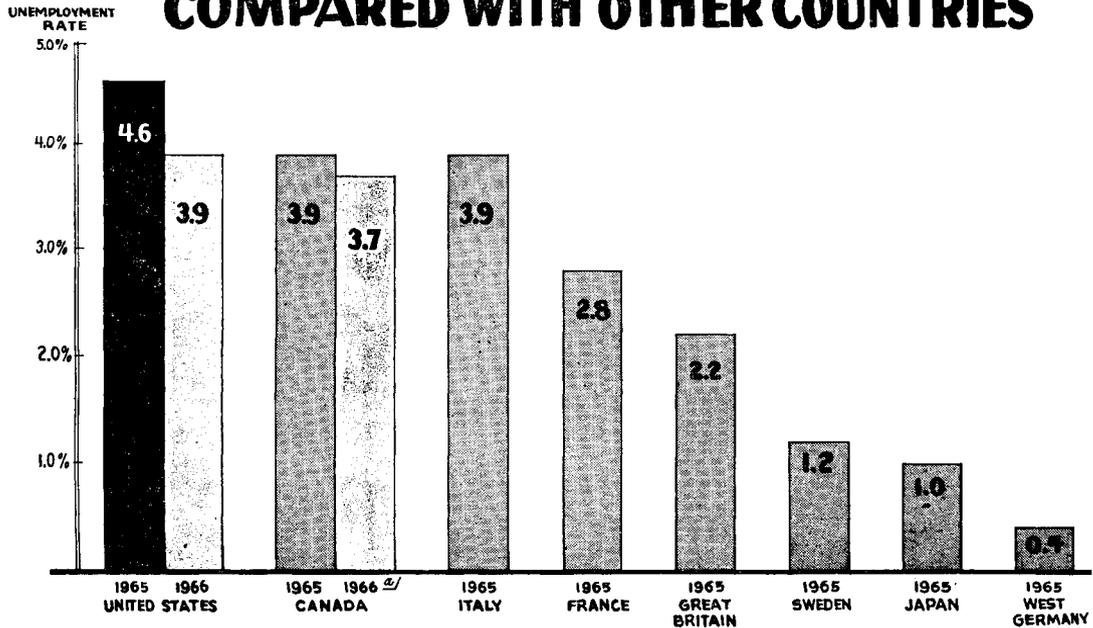
We had some testimony last week that indicated that other nations compile their unemployment figures on a different basis than we do. Has this been taken into account by you?

Mr. REUTHER. Yes. I serve, Mr. Charman, as a member of the President's Labor-Management Advisory Committee. This was set up originally under President Kennedy, and Mr. Goldberg was the Secretary of Labor, and when we were wrestling with these comparative figures of the rate of unemployment in the United States and the European countries and Japan, the question came up: Are they using the same measuring sticks; are we talking about the same thing? And a study was made, and the result was that when unemployment was measured by our definition in some of these other countries, the discrepancy was even greater.

Here is a chart based upon the most reliable Government figures that we can get, the BLS, and the comparable agency in the Dominion of Canada, which indicates unemployment here in the United States in 1965, and you can see its relationship to Canada, Italy, France, Great Britain, Sweden, Japan, and West Germany. So that there is no question about it that by any definition of what constitutes unemployment, the United States has had a level of unemployment much higher than any other democratic industrial nation in the free world.

(Chart referred to follows:)

# U.S. UNEMPLOYMENT STILL HIGH COMPARED WITH OTHER COUNTRIES



<sup>a/</sup> 11 months.  
 Note: Data for countries except U.S. and Canada are preliminary and are adjusted to U.S. definitions of unemployment.  
 DATA: Bureau of Labor Statistics except Canada, Dominion Bureau of Statistics

Representative WIDNALL. The question was raised in my mind by Professor Hansen, I believe, who was testifying before us last week. He said that in Great Britain a 2-percent unemployment figure would be the same as a 3- to 4-percent figure here in the United States. This certainly is at variance with what you have just said.

Mr. REUTHER. But in this chart, the adjustment that he was referring to is already reflected.

Representative WIDNALL. Now, you had another chart which referred to the imbalance between the rise in wage and fringe benefits as against price increases and other increases within the economy. Do you have any figures for the years 1955 to 1960? It is my recollection that at that time the wage and fringe benefits were increasing by a greater percentage than the other components.

Do you have any figures on that?

Mr. REUTHER. I don't have them at hand, but this chart was chosen for this period, the second quarter of 1960 to the second quarter of 1966 because we thought we were starting at a point that was comparable to the point where we were ending up, from the peak of one cycle to the peak of another cycle. We think, therefore, that this is a valid comparison of the movement of the compensation of these groups.

Representative WIDNALL. Could you furnish for the record the prior 5 years?

Mr. REUTHER. Yes; we would be happy to provide the committee with any specific information that we may not have with us today.

(Information requested by Representative Widnall and later supplied by Mr. Reuther, appears below:)

In the course of my testimony, Congressman Widnall asked for data comparing changes in various forms of income from 1955 to 1960. The figures are presented below for whatever they may be worth; however, I do not believe they are worth very much. The period is a wholly inappropriate one for comparison because 1955 was a year of extraordinarily high profits and the second half of 1960 was a period of recession. Total corporate profits before taxes in 1955 had jumped 26.9 percent over the preceding year to a new all-time record and were 14.0 percent higher than the up-to-then record level of 1950 when profits were ballooned by the speculative, inflationary boom arising out of the Korean War. In consequence, use of 1955 as a base period for comparison of the movement of profits with that of wages obviously distorts the results—especially when the other end of the comparison is a year that was half recession. It would therefore be misleading to present the figures requested without first putting them into perspective. They follow:

	<i>Percent change</i>
Total employee compensation.....	31.0
Corporate profits before taxes.....	2.3
Corporate profits after taxes.....	1.1
Dividends .....	27.6
Interest .....	64.8

Representative WIDNALL. How would you evaluate the contribution of public training programs toward reducing unemployment?

Mr. REUTHER. I am very much in support of public training programs that are directed toward improving skills and upgrading workers, so that they cannot only qualify for a higher paying job, but can make a greater economic contribution to the overall community.

I do believe, however, that training programs in themselves will not create more employment. It will only determine who is unemployed and who is employed.

I think the history of the period since 1960 indicates that the expansion of aggregate demand, accompanied by job training, is the most effective means of providing work for the unemployed.

Representative WIDNALL. Would you look with favor on a tax credit for business investment in additional worker training?

Mr. REUTHER. No. First of all, American industry throughout its history has taken on the task of training people on the job to meet their own job requirements, and they do a very effective job of that.

I believe that industry does not need tax relief to carry on that normal function and responsibility. I would favor the approach that the British have made.

The British have established what they call an Industrial Training Act. Every employer is obligated to make a small tax contribution to the funds that finance that training program, and then there are very high standards of training performance worked out, and if an employer meets those high standards, he gets his taxpayment as a rebate. If an employer is not making a contribution to training or doing a mediocre job, then he doesn't get his rebate. I think that approach would give you the highest possible standards of training. Those standards are not just giving a worker a limited skill doing a specific, limited job for a single employer, but trying to elevate the broader skills and competence of that worker so that he has greater flexibility, greater mobility in the total work force, and so that he is a more useful economic citizen in terms of the overall economic needs of the economy.

This is, I think, a much sounder approach than just giving a tax credit to an employer without standards, without any knowledge of what kind of a job he is doing.

I can tell you from firsthand experience that we have a relationship with employers who are doing really a first-class training job, and we have other employers who couldn't care less about training workers, and I don't want to put them all in the same boat. I think the British approach says to an employer, "If you do a creditable job, if you meet these high standards, you get your tax rebated," and somebody else, who is doing a mediocre job, pays for it.

Representative WIDNALL. Thank you, Mr. Reuther. My time is up. Chairman PROXMIER. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Mr. Reuther, you recently resigned from the executive board of the AFL-CIO. Do your economic views as presented here this morning differ in any particular from those of the AFL-CIO?

Mr. REUTHER. I am really not in a position to give you a definitive answer. I think in general, certainly with respect to the question of putting emphasis upon the need to continue to move forward in reducing the levels of unemployment and these kinds of broad economic questions, there is no fundamental difference in the American labor movement.

The difference that I have with the AFL-CIO is in a different area. I happen to share the view that the labor movement cannot act as a narrow pressure group, that it has to take on broader social responsibilities in terms of the whole community, and it is in this broad area that I think the American labor movement is failing to meet its responsibilities. But this is neither the time nor the place to discuss that.

Representative REUSS. In your discussion of income policy, you indicated that you thought labor should get not only the productivity increase trend adjustment, but some sort of profit sharing. In that event, what happens to the consumer in terms of his price?

Mr. REUTHER. In 1958 the UAW made a serious collective-bargaining proposal to General Motors and the other auto corporations for profit sharing. We proposed in that document that the General Motors Corp., after it had met all of its fixed operating costs, its payroll, its taxes, et cetera, and had paid its investors a certain fixed amount, which would have been a very liberal amount in terms of their basic dividend, would then share the excess profits beyond that basic dividend with the stockholders through a special dividend, with the workers through shares in the profits, either in stock or a combination of stock and cash payments, and, through a rebate, with the American consumer.

Representative REUSS. On a one-third, one-third, one-third basis?

Mr. REUTHER. I don't recall the exact details, but at the breaking point it was on a one-third basis. I don't recall, specifically, the exact breaking point where we would draw the line of demarcation, but we can get that information for you.

Representative REUSS. I would appreciate it if you could.

Mr. REUTHER. We will get that.

(The information referred to was subsequently furnished by the witness and follows:)

The profit sharing plan proposed to the major automotive corporations by the UAW in 1958 was, in part, an adaptation of the bonus plans provided by those corporations for their executives. The Ford Motor Company, for example, provided (and still provides) that 6 percent of all profits before taxes in excess of an amount equivalent to 10 percent on net capital would be available for payment of bonuses to executives. (The General Motors bonus formula was calculated on an after-tax basis but yielded essentially the same results.)

The UAW proposal, similarly, provided that a basic 10 percent of net capital must be earned for stockholders before others would share in the profits. Profits in excess of 10 percent on net capital were to be shared three ways. Half of that excess was to be retained by the corporation for the benefit of its stockholders and managers; it would be available for additional dividends, executives' bonuses, and reinvestment in any proportions decided upon by the corporation. One-fourth would go to wage and salary workers employed by the corporation (excluding salaried personnel covered by the executives' bonus plan) to be used for wage increases and fringe benefits. UAW members were to decide by democratic vote on the allocation of their share of the profits as among wage increases and various types of fringe benefits. The remaining fourth was to go to consumers who had bought the corporation's products during the year in the form of a rebate on the prices they had paid. (The first Henry Ford had once paid profit sharing rebates to buyers of Ford cars.)

The share of the corporation in the excess of profits over 10 percent on net capital was fixed at 50 percent, as compared to 25 percent for workers and consumers, respectively, in recognition of the fact that amounts paid out in dividends or reinvested (but not the amount paid in executives' bonuses) would be subject to the corporate profits tax which was then 52 percent. Thus, the end result would have been approximately an equal three-way sharing among stockholders, workers and consumers.

Representative REUSS. Is that your proposal today? This was true in 1958. Is that what you mean by profit sharing today?

Mr. REUTHER. No. I raised the profit-sharing concept in this testimony this morning not as it relates to that specific proposal that we made in 1958. I raise it with respect to a broader consideration.

I am disturbed about the collective bargaining process. I think it has to be a responsible and rational process, but I don't see how it can be responsible and rational except as it works within the framework of the known facts, and when you are making a contract 3 years in advance of the fact, how can anyone know? All the wisdom of a thousand Solomons can't tell me or the president of the General Motors Corp. what the equity of a GM worker will be in 1970 when we are sitting together in 1967.

The genius of America is that we are always looking and searching for new ideas and new concepts, new tools, to solve new problems. You can't solve tomorrow's problems with yesterday's tools and yesterday's concepts. And so with the profit-sharing idea. Historically it was opposed by the labor movement, because of a narrow class struggle concept. You know, the employers over here, and the workers over here. I think that this is all a part of ancient history.

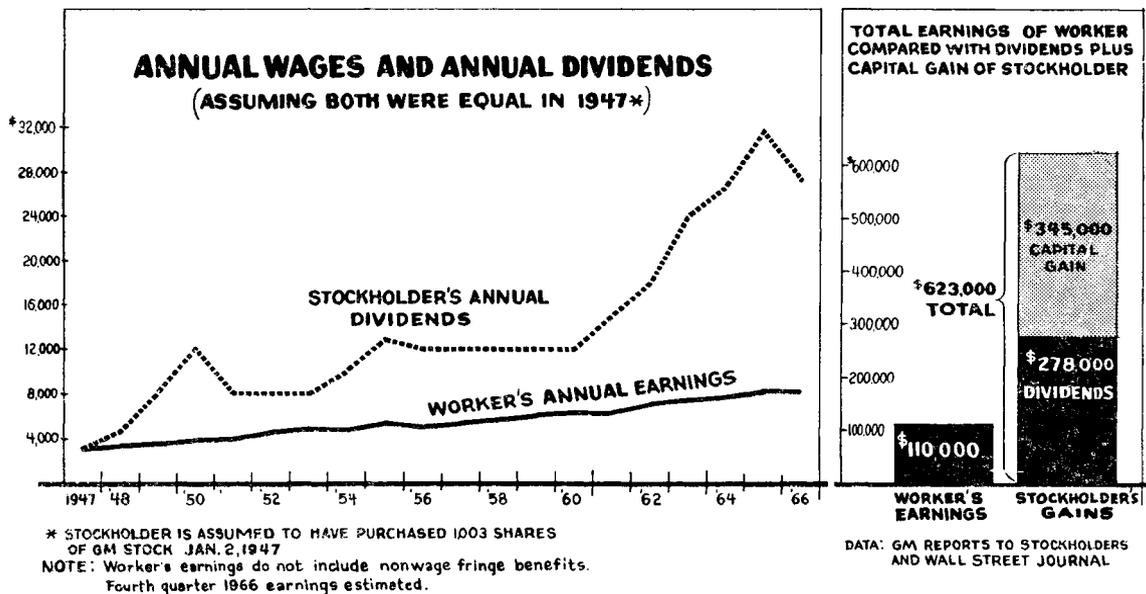
I think that the basic interests of workers and employers and the public are so interwoven that the only answers are total answers. The problem is to find these common answers. There are no isolated answers in little pigeonholes.

We believe that the profit-sharing concept brings into the bargaining process a means to give the worker equity. Just look at these charts. You can understand what the problem is.

This is the chart of the relative incomes of a General Motors hourly rated worker as compared to a GM stockholder, starting in 1947, projected through December 1955. The average GM worker, if he worked 2,000 hours, earned roughly \$3,000 in 1947, if he worked every year without layoffs—and he didn't because there were so many layoffs. We assumed a stockholder who owned sufficient stock to have received in dividends from General Motors in 1947 an amount equal to the worker's wage. What happened? Well, the worker moved up, and he got a total in that period of \$110,000 by working 2,000 hours every year. But the stockholder who started out with a comparable income got \$623,000, a 6-to-1 ratio.

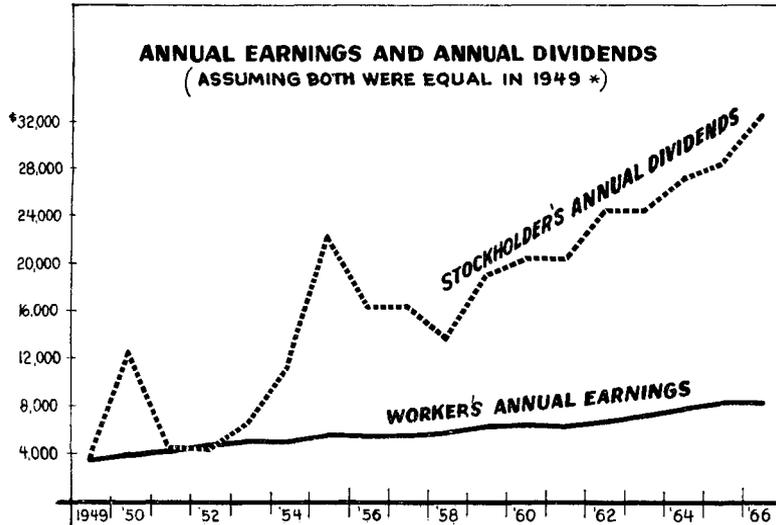
(Chart referred to above follows:)

# GENERAL MOTORS HOURLY RATED WORKER AND GENERAL MOTORS STOCKHOLDER JANUARY 2, 1947 - DECEMBER 31, 1966

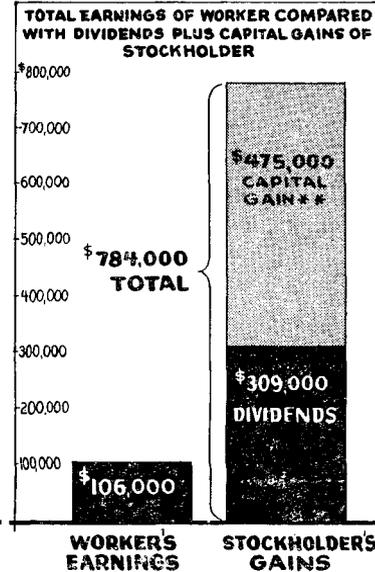


# FORD HOURLY RATED WORKER AND FORD STOCKHOLDER

JANUARY 1, 1949 - DECEMBER 31, 1966



\* STOCKHOLDER IS ASSUMED TO HAVE HELD 6,800 SHARES OF FORD STOCK JAN. 1, 1949.  
 \*\* CAPITAL GAIN BASED ON INCREASE IN STOCKHOLDER'S EQUITY PER SHARE.  
 NOTE: Worker's earnings do not include nonwage fringe benefits.  
 1966 Earnings estimated.



DATA: FORD ANNUAL REPORTS AND PRESS RELEASES

When you take the Ford Motor Co., the comparison is for a shorter period, because the Ford Motor Co. didn't become a publicly owned stock company and its figures weren't published until more recently. From 1949 through 1966, you find that a Ford worker earned \$106,000, but a stockholder who started out with the same equity in 1949 got \$784,000.

Now, this is what is happening, and this is why it is not just a propaganda slogan to say that the rich are getting richer and the poor are getting poorer. If you look at the income distribution, you see that it is being distorted very dangerously. This is not just a matter of economic justice. The economy won't work, it will break down, if we don't find a more equitable way to share the abundance of our new technology.

The lowest 40 percent of family groups in 1960 had 16 percent of the national family income, and in 1964 it dropped to 14 percent, a drastic shift. The highest 10 percent got 27 percent in 1960 and in 1964 they got 30 percent.

I sit across the bargaining table with the highest paid corporation executives in the world, and I keep saying to them, "I don't understand what mental and moral gymnastics you go through to tell us that if you are getting \$500,000 a year and you are working to get \$600,000 as an executive, that that is a reward for individual initiative and incentive, it is not inflationary, it is superpatriotic. But if you are getting \$5,000 a year and you are trying to get \$6,000 a year that is dangerous economics, it is highly inflationary, and it is a little bit subversive."

This is nonsense, and it is incompatible with the values of a free society.

Representative REUSS. My time is up.

Chairman PROXMIRE. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Reuther, in connection with the guideposts for the full employment—or the Employment Act of 1946, is this concept of purchasing power. I take it from what you have been saying, that you would say that the stability of the price structure is an inseparable part of that concept, is that correct?

Mr. REUTHER. Obviously the important thing when you are dealing with purchasing power is not the number of dollars you take home. It is what you can buy, and this is our whole argument with Mr. Ackley.

American wage earners are not concerned with the number of dollars they take home in their pay envelope. They are concerned about their real wages.

Senator MILLER. I couldn't more thoroughly agree with you. In other words, the stability of the purchasing power of the dollar would be a part of this concept of economic and social justice, would it not?

Mr. REUTHER. Exactly.

Senator MILLER. All right. Now, in your statement you say that we have become unduly alarmed "by exaggerated fears of inflation." I would like to point out to you that I am advised that last year real wages in this country were down over the year before. That we had \$29 billion of inflation last year representing taking the purchasing power away from the people more than half what the Federal income tax does.

My own State's share of that \$29 billion was the same as a 10-percent sales tax. My guess is that the people of Michigan had the equivalent loss of purchasing power of around a 10-percent, possibly a 12-percent sales tax.

Inflation last year amounted to 47 percent of our increased gross national product. You stated here that the workers had been fighting to keep up with the increased cost of living. It must say that I don't understand why, in the light of that, you would refer to exaggerated fears of inflation.

Mr. REUTHER. What I was trying to say was that I believe that the fear of both the problem of inflation and the balance-of-payments problem is exaggerating. They are both very real problems. I think we have to deal with them.

I think we have to take steps to try to counteract the pressures that create these problems. But I don't believe that they ought to influence us to the point where we forget about the fact that reducing the levels of unemployment ought to be a priority item.

I think that if unemployment is allowed to continue at the present level, because you think that that is the way to fight inflation, then you are putting the burdens of inflation upon the very income groups who are least able to carry them.

What we are trying to say is that we think that there is a problem of inflation. It is selective in character. It is not classical, as I said earlier, and therefore it has to be approached in a different way than it is being approached. We have to deal with it on a selective basis rather than on a broad basis.

Mr. Ackley, for example, is against the worker getting an escalator clause, and I suppose he thinks that that is because it will feed the fires of inflation, as he says.

Well, a lot of people had something to do with escalator clauses before Mr. Ackley came to Washington; Mr. C. E. Wilson, for example. I had the privilege of working with Mr. Wilson for many years when he was the president of the General Motors Corp.

He made a great contribution to elevating the whole concept of collective bargaining of how a worker in a free society gets his equity. Mr. Wilson was one of the pioneers in developing the escalator clause, which protects the GM worker, if the cost of living goes up. And he was attacked by other people saying "well, doesn't this give you a mechanism to build in inflation, if you get an adjustment?"

He wrote an article in the Reader's Digest, September 1952 issue, in which he said, and I quote:

I contend that we should not say the *wage-price spiral*. We should say the *price-wage spiral*, for it is not primarily wages that push up prices. It is primarily prices that *pull up* wages.

And so what we say is don't try to find the answer by riding the back of the wage earner. Deal with the problem of pricing policy, where the culprits really are.

This is the fundamental difference we have with Mr. Ackley.

Senator MILLER. May I say that I happen to agree with that statement. However, I feel that you have not told us what should be done to stop inflation. What should Congress do to stop inflation. You have talked about cutting prices somewhere along the line. We can't cut prices here. What can the Congress do to stop inflation?

Mr. REUTHER. Well, I would like first of all to suggest that you give consideration to the establishment of the wage-price review board, and I would like to put a more detailed description of that into the record if I may.

Chairman PROXMIRE. Without objection, that will be printed in the record.

(The material referred to was subsequently filed for the record and follows:)

**OUTLINE OF PROVISIONS OF BILL TO REQUIRE HEARINGS ON ADMINISTERED PRICE INCREASES IN ORDER TO MAKE PRIVATE ECONOMIC DECISIONS MORE RESPONSIVE TO PUBLIC NEED**

**1. Purpose**

To bring an informed public opinion to bear upon price policy in administered price industries as a substitute for the price-restraining influence of competition which is lacking in such industries.

**2. Administrative machinery**

(a) A Price-Wage Board of Review to conduct hearings on price increases proposed by certain corporations.

(b) A Consumer Counsel to represent the consumer and public interest in such hearings.

The relationship between the Board and the Consumer Counsel might be similar to that between the National Labor Relations Board and the General Counsel of the NLRB.

**3. Coverage**

The legislation should apply permanently to corporations in a position to act as "price leaders" in their respective industries. Specific and objective criteria should be devised to determine the corporations that fall into the "price leader" category. Total coverage should be limited to the minimum number of corporations required to accomplish the basic purposes of the bill. One possible criterion for coverage could be: all corporations accounting for 25 percent or more of total sales in a major industry. (Such corporations could be identified from data in the files of the Census Bureau, the SEC and FTC.) Under this criterion, only a limited number of giant corporations in major industries would be covered on a permanent basis. In addition, the President should be authorized to extend application of the legislation temporarily to other firms if he believes that a price action taken or about to be taken by such firms threatens over-all price stability.

**4. Advance notification of proposed price increases**

Covered corporations should be required to notify the Price-Wage Board of Review of intention to increase a price, and should be prohibited from putting such a price increase into effect for a specified minimum period (perhaps 60 or 90 days) sufficiently long to permit the Board to hold hearings on the proposed price increase and to issue its findings concerning such increase. The corporations should be required to supply to the Board, simultaneously with their filing of the notice, all data which they consider pertinent to the proposed price increase. The Board should publish the fact that notice has been received and make available for examination by groups listed below under "Other Appearances" the data filed with such notice.

**5. Waiver of hearings**

Upon analysis of the data submitted with the notice, and after a reasonable time has been allowed for examination of the data by all interested parties, the Board, with the consent of the Consumer Counsel, should be empowered to waive hearings and permit the proposed price increase to go into effect immediately. In such cases, however, the Board should be required to publish promptly a report setting forth the reasons for so doing.

**6. Emergency price increase**

Upon a claim that an increase in production costs creates an emergency requiring the corporation to raise its prices prior to expiration of the notice period,

the corporation should be permitted to raise its prices within that period. In such case, however, the Board, in addition to its other findings, would be required to make a finding as to whether or not such an emergency in fact existed and whether or not the price increase exceeded the amount required to meet increased production costs.

If it found that the claim of emergency was not supported by the facts, the corporation would be required to rebate to every customer who paid the price increase damages equal to three times the amount of such price increase for products shipped during the notice period. In the event the ultimate purchaser of the products in question could not be ascertained, the corporation would be subject to a fine equal to the triple damages specified above. If an emergency were found to exist but it was also found that the price increase exceeded the cost increase, the triple damages rebate or fine would apply to the excess.

#### *7. Price reduction hearings*

The Consumer Counsel should be empowered to initiate hearings when, in his judgment, there is reason to believe that a corporation permanently or temporarily subject to the legislation should reduce the price of any of its products. This procedure is essential in order to assure the price reductions in high-productivity industries which are essential to offset unavoidable price increases in low-productivity industries. If a corporation responded to the notice of a hearing with an acceptable price reduction, the hearing could, of course, be cancelled.

#### *8. Subpoena power*

The Consumer Counsel would have power to subpoena witnesses, to examine them fully, and to require production of all pertinent books and records.

#### *9. Involvement of unions*

If a corporation claims that its proposed price increase would be required as a result of granting union demands, the Consumer Counsel would be empowered to subpoena and examine representatives of the union. Union and corporation representatives would be permitted to cross-examine each other.

#### *10. Other appearances*

Representatives of unions, of consumer organizations, of corporations purchasing products affected by the proposed price increase, and of interested government agencies (federal, state, or local) should be allowed to participate in the hearings voluntarily, subject to permission granted by the Board. Such voluntary witnesses would be required to submit to cross-examination and would be permitted to cross-examine corporation witnesses. All testimony taken at the hearings would be under oath.

#### *11. Open hearings*

All hearings should be open to the public, the press, and radio and television. (The matter of possible "confidentiality" of certain types of data should be considered in drafting the proposed legislation. It should be kept in mind in this connection, however, that the legislation is premised on the absence of price competition in the industries affected; that, therefore, there are not apt to be genuine "competitive secrets" related to costs and prices; and that the public interest is as deeply involved as in public utility rate hearings in which all pertinent facts are publicly available. If, nevertheless, it should be decided that certain types of information required for purposes of the hearings should be treated as "confidential" the Board might be empowered to go into executive session while such information was being presented and considered with the participants in such executive sessions subject to penalties for public disclosure of such information.)

#### *12. Findings and recommendations*

After obtaining all the pertinent facts, the Board should publish a report of its findings and recommendations, together with the facts supporting such recommendations. To assist the Board in this task, each party to the hearings—the corporation, the Consumer Counsel, and the union, customer corporations, consumer organizations and government agencies, if any are involved—might submit to the Board at the conclusion of the hearings a list of proposed findings and recommendations which the Board would consider in framing its own findings and recommendations. The Board's findings and recommendations should be published before the expiration of the notice period.

*13. Standards for recommendations*

In framing its recommendations, the Board would be required to apply standards carefully devised to assure both equity to all parties concerned and reasonable stability of the over-all price level. The President's Advisory Committee on Labor-Management Policy might be called upon to develop and propose the standards to be included in the legislation initially. The standards should be subject to review at regular and frequent intervals by the appropriate Congressional Committees with a view to making such amendments as experience may show to be necessary.

*14. Penalties*

Penalties should be provided for failure to give the required notice of a proposed price increase, for failure to respond to subpoenas, for taking reprisals against any person who testifies, and for perjury. The penalties should be severe enough (particularly in the case of failure to give notice) to deter violations. In the event of failure to respond promptly to subpoenas or to requests for production of books, records, etc., or if the corporation is found to be engaging in other dilatory tactics, the Board should be empowered to extend the period during which no change in prices would be permitted.

*15. No price or wage control*

Regardless of any finding or recommendation that the Board may make, upon expiration of the notice period (or any extension of it), the corporation would be free to determine its own prices (to the extent specified in its original notice or to any lesser extent), and the union would be free to pursue its demands. The only restraint on the corporation and the union would be the restraint of enlightened public opinion.

This procedure, of course, would not rule out the possibility of Presidential intervention in a case where a corporation insisted on imposing a price increase which the hearings had shown to be clearly unjustifiable. In that case, the President would then be in the position of having a fully informed public opinion from which to mobilize support.

In the great majority of cases, however, it can be anticipated that no company would be prepared to face the unfavorable publicity bound to rise from such an action. In most cases a price increase would not even be proposed, when the company knew a public hearing was likely to result, unless it was sure that the economic facts did justify an increase.

Mr. REUTHER. Now we think that that is a very meaningful step, because, in a free society, what is the pressure that can persuade people to make their private decisions more responsible to the public need? The only pressure is government pressure, which is coercion, which is compulsion, and we are trying to avoid that. The fundamental distinction between a totalitarian society and a free society, is that in the former the government makes all the decisions, and then dictates to its citizens, and we want to have the broadest area in which private decisions can function freely.

We believe that public opinion can be an effective disciplinary force under these circumstances. This is an attempt to bring that to bear upon pricing and wage policies. We think that would be very important.

We also believe that there are monetary and fiscal policies on a selective basis that ought to be carried out. If the Government does these various things, we believe that while there will always be, perhaps inescapably some slight edging up in terms of the price structure, we can maintain price movements within manageable bounds, and we can meet the problems within that framework.

Chairman PROXMIRE. Congressman Rumsfeld?

Representative RUMSFELD. Mr. Reuther, you made the statement that aggregate demand and improved job training must go together, if we are going to solve the problems of unemployment. In your pre-

pared statement you urge this committee to recommend that the Government coordinate and utilize all of its plans, functions, and resources to reduce unemployment to no more than 3 percent by the end of this year or by mid-1968 at the least. Obviously you are not satisfied with the Council of Economic Advisers' apparent acceptance of a higher rate.

You also indicated your support and approval of public job training programs, such as vocational education and manpower training and development, which I also support.

Yet in your response to Mr. Widnall, you seem to indicate that you did not favor the concept he mentioned of a tax credit for job training, and instead you referred to your proposal for a fund for assisting displaced workers. I think this is the same proposal you wrote Chairman Mills about last year when a suspension of the tax credit was under discussion.

Possibly we are having some language difficulties, but your proposal as I understand it, is in fact a tax credit for partial costs of job training, is it not? As I understood your letter to Chairman Mills and your response to Mr. Widnall, it would go into a fund, and in the event they met the standards and in the event the job training was performed, they would, in fact, receive this money back. Is this correct?

Mr. REUTHER. That is correct. I think there is a fundamental difference between a general tax credit—a windfall which everyone gets, unrelated to their past performance—and one that says if you do a good job and meet the standards, then you would get the tax rebate. I think that is the fundamental difference.

Representative RUMSFELD. Well, I don't believe that Mr. Widnall's approach or the so-called Human Investment Act, would necessarily not require standards. This is apparently an assumption in your part.

Mr. REUTHER. I am only stating that if you make the proposal of a general tax credit without standards, then I think that you are giving employers help who haven't earned the right to get help, whereas if there were standards, then I wouldn't have any argument.

Representative RUMSFELD. In other words, if there were standards, you would agree with the Human Investment Act tax credit approach to solving some of the job training problems.

Mr. REUTHER. If it had the basic standards that an employer had to perform, and that meant not just training a fellow to do one little limited job to meet his own production requirements, but to try to make a contribution in raising and upgrading the overall skills of that worker so that he would be a more useful economic citizen, then it seems to me that I would not have a great disagreement with that proposal.

Representative RUMSFELD. In your statement a minute ago to Mr. Widnall, as I recall, you said that you didn't feel that business needed the tax credit that he was suggesting.

Mr. REUTHER. I personally think that most of the corporations really don't need that kind of help. But I do believe that the concept that the British Industrial Training Act implements is a sound one, and it does make a contribution towards increasing and improving skills, and I would be in favor of that approach, or any other approach which in effect made a comparable contribution. I am not familiar

with the details of the bill that you are referring to, but if it were in this direction, and it set adequate standards, then I would think that it would be a constructive approach.

Representative RUMSFELD. Mr. Chairman, I ask permission to insert a summary of the Human Investment Act in the record at this point.

Chairman PROXMIRE. Without objection.

(The material referred to follows:)

#### THE HUMAN INVESTMENT ACT, 90TH CONGRESS

*Purpose.*—"To provide an incentive to American business to invest in the improvement of the Nation's human resources by hiring, training, and employing presently unemployed workers lacking needed job skills, and by upgrading the job skills of and providing new job opportunities for workers presently employed."

*Method.*—The Act offers employers a tax credit toward certain specified expenses of programs designed to train prospective employees for jobs with the company or retrain current employees for more demanding jobs with the company.

*Amount of tax credit.*—10% of the allowable employee training expenses with a maximum of \$25,000 plus 50% of the taxpayer's tax liability in excess of \$25,000. This credit would be in addition to credits provided for by other sections of the tax code, and in addition to the regular deduction as a trade or business expense under section 162 of the code.

#### *Allowable employee training expenses:*

1. Wages and salaries of registered apprentices.
2. Wages and salaries of enrollees in On-the-Job Training programs under the Manpower Development and Training Act.
3. Wages and salaries of employees participating in cooperative education programs.
4. Tuition and course fees paid or reimbursed by the taxpayer to a college, business, trade or vocational school.
5. Home study course fees paid to or reimbursed by the taxpayer to a college or an accredited home study school.
6. Expenses to the taxpayer of his organized job training programs.
7. Expenses to the taxpayer of organized job training programs contracted by him to another taxpayer.
8. Expenses to the taxpayer of organized job training programs conducted by a trade association, joint labor-management apprenticeship committee, or other similar group.

#### *Other provisions:*

1. Allowable expenses must be tax deductible under section 162 of the Tax Code.
2. The tax credit may be carried back three years and carried forward seven years.
3. No credit is allowed for the training of managerial, professional, or advanced scientific employees; or for reimbursable expenses; or for avocational or recreational courses.

The intent of the Act is to help workers advance up the "skill ladder", thus opening vacancies at the bottom for the presently unskilled and unemployed. Its major premise is that private business has, over the years, learned how to obtain the most results per training dollar, and should now be encouraged to expand its training programs to meet the national demand for labor skills. In addition, the Act seeks to encourage training by business because, unlike so much institutional training, training by business leads directly to a better job for the trainee.

*Legislative history.*—The original Human Investment Act was introduced on February 17, 1965 by Senator Winston Prouty (R.-Vt.) The second-generation version was introduced by Senator Prouty and Rep. Thomas B. Curtis (R.-Mo.) on September 9, 1965, and eventually claimed 109 Congressional sponsors. The present bill is a refined third-generation version, a product of over a year of research and consultation with businessmen, labor leaders, economists, and tax lawyers.

Representative RUMSFELD. The point that bothers me about this is that your proposal to Chairman Mills and to Mr. Widnall is a more modest one than than the Human Investment Act. We have been going along for a great many years with a high level of unemployment, not really coming to grips with the problem of structural unemployment, and not really helping to see that the skills that the hard-core unemployed lack are in fact provided. I would like to see the Congress of the United States and this Government go beyond vocational education, go beyond manpower training and development, and see that if we can't possibly do better than the Council of Economic Advisers' 4-percent level of unemployment. You have been talking about new concepts and new approaches. Here is one. Here is a chance for us to do more in this area and try to solve it, and it disappoints me to have Mr. Goldfinger of the AFL-CIO come before this committee last week and oppose it, and have you in your response to Mr. Widnall not be enthusiastic.

Mr. REUTHER. As I say, if it meets these standards, I can be enthusiastic. But the thing you are referring to that we proposed to Congressman Mills is a different matter. That proposal was a more limited thing to take care of people who were displaced for technological reasons or other reasons, to tide them over until they got other employment.

Representative RUMSFELD. Wasn't job training included in that?

Mr. REUTHER. No. Well, only in a very limited way. It was primarily an income maintenance program for laid-off workers, a different thing. But I think the most valuable resources we have are human resources. I am for doing everything humanly possible to facilitate the maximum growth and development of every human potential we have.

Representative RUMSFELD. Mr. Reuther, my time is up. Am I correct that you are going to include some specific information about the proposal you mentioned to Mr. Widnall in the record?

Mr. REUTHER. Yes.

(Material in reference to above was later supplied for the record and is reprinted herein:)

[Source: "Adjusting to Change," Appendix Volume III of *Technology and the American Economy*, the Report of the National Commission on Technology, Automation, and Economic Progress—February 1966.]

#### USE OF INVESTMENT TAX CREDIT TO FACILITATE ADJUSTMENT

##### BASIS FOR PROPOSAL

There is universal agreement that management, labor, and government should cooperate in an effort to assure that technological progress is achieved without sacrificing human values. The President's Advisory Committee on Labor-Management Policy, for example, in its report on automation dated January 11, 1962, said:

There is unanimous agreement among the members on these fundamental points:

1. Automation and technological progress are essential to the general welfare, the economic strength, and the defense of the Nation.
2. This progress can and must be achieved without the sacrifice of human values.
3. Achievement of technological progress without sacrifice of human values requires a combination of private and governmental action consonant with the principles of a free society.

While there is agreement on these fundamental points, no working mechanism has yet been created to implement them.

The report of the Commission states in still more specific terms the principle involved. Thus the report includes among the "basic requirements" for individual adjustment situations that:

\* \* \* the displaced individual must have adequate financial security while searching for an alternative job or while undertaking training, and that:

\* \* \* the displaced person should not have to suffer the loss of earned security rights such as vacation, retirement, insurance, and related credits to his total worklife account.

Such a forthright statement of principle deserves to be backed up by concrete proposals for its implementation. The following proposal is put forward with that end in view.

#### PROPOSAL

The investment tax credit under the Internal Revenue Act would be an appropriate vehicle for implementing the principle, since it is designed to stimulate modernization, and to the extent that it serves that end, it also adds to the human problems resulting from technological change. The investment credit can be used both to provide the incentive for employers to establish programs to meet the problems of workers dislocated from their jobs by reason of technological change, and to provide the necessary resources.

#### *Financing*

It is proposed that in each year, one-half of the investment credit to which each firm is entitled would be paid to it directly, and the other half would be placed in reserve in a Government trust fund where it would be held available for a period of 5 years to meet the needs resulting from disemployment of the employees of that firm resulting from technological change. At the end of 5 years, any amounts not so used would be returned to the firm.

If there is any fear that temporary diversion of part of the investment credit in this manner might weaken its effectiveness in serving the basic purpose of stimulating new investment, this problem could be met by raising the credit figure from the present 7 percent to, say 10 percent. The suggested figures are illustrative only. The purpose of this proposal is not to reduce the stimulus to investment, but to incorporate with it an additional stimulus to meet the human problems of employees which may result from that investment. There is no reason why the program cannot be so devised that an average firm which does meet such problems would end up in the same financial position as it would be under the present investment credit provision—and the company which by constructive and imaginative measures succeeds in finding means of meeting the human problem with less than average costs would end up in an improved situation.

#### *Benefits to displaced workers*

The funds set aside with respect to any given firm could be used to provide the following forms of assistance to laid-off employees of that firm (the details as to amounts, periods of time, etc., are purely illustrative):

1. They would supplement unemployment compensation or retraining allowances up to 80 percent of the displaced worker's wages, for a length of time equal to his period of employment with the firm (time-for-time) up to a maximum of, say, 5 years.
2. If the worker accepted a new job at lower wages, his earnings would be supplemented up to 100 percent of his former earnings on the same time-for-time, 5-year maximum basis.
3. If the worker accepted a job with inferior protection in the areas of health services and life insurance—or with none—such protection would be supplemented up to the level of that on his former job on the same time-for-time basis.
4. Starting on a new job, the worker's vacation pay entitlement would probably be less than on his former job. The funds would supplement his vacation pay on the same time-for-time basis up to the level to which he would have been entitled if he had kept his former job.
5. If he had not been employed on the former job long enough to vest his pension credits, or if there were no vesting provision, the fund would purchase an annuity equivalent to the value of the service credits he has lost.

If he finds employment on a new job which provides no pension, or an inferior pension, an additional annuity could provide an appropriate equivalent on the same time-for-time basis indicated above.

6. If the worker obtained a new job in another community during the same time-for-time period, the funds would pay his costs of relocation.

#### *Eligibility requirements*

Appropriate eligibility qualifications would have to be worked out. For example, the worker might be required to have had at least 1 year of employment with the responsible employer.

Since it would be impracticable administratively to distinguish in individual cases between loss of employment caused by technology and that caused by other factors, objective criteria would have to be developed which would roughly accomplish the purpose. For example, all permanent separations (e.g., resulting from a plant closing, or where the employer certifies that a laid-off worker's recall was improbable) would be covered. In addition, continuous layoffs or short-time work for specified periods would establish eligibility for benefits retroactively to the beginning of the period. These periods should not be too long. Otherwise, loss of income, even if retroactively made up, would defeat the purpose of safeguarding the worker and his family against harm. In this connection, the layoff and short-time provisions of the new British Redundancy Payments Act, which provides for separation pay (also in the context of stimulating modernization of industry) may be relevant. The act provides that a worker becomes eligible if he is laid off or on short time (i.e., receives less than one-half of his normal weekly pay) "either (a) for 4 consecutive weeks, or (b) for a series of 6 weeks (of which not more than 3 are consecutive) within a period of 13 weeks."

#### *Operation of trust fund*

The monies in the trust fund would be invested in Government bonds, in the same way as with the Social Security Trust Fund. The interest would be pooled to pay the excess of the costs charged to any one company over the amount of investment credit reserved with respect to that company. If at any time the total sum of such excess costs was in excess of the amount of interest available, the difference would be made up by the Treasury out of general revenues. In no event would an amount in the fund reserved with respect to one employer be used to pay costs attributable to another employer. For reasons shown below, such costs to the Treasury would probably be small.

Where a company has established programs to pay any of the benefits provided under the plan, the amount reserved from its investment credit would be reduced by the lesser of the amounts actually paid to its employees under such programs, or the amounts paid by it during the year into a trust fund to provide for such payments. (Benefits paid under such programs would be taken into account in computing benefits under this proposal.) This provision would encourage employers to establish such programs, since they would then benefit by the interest on the amounts by which their investment credit reservation would be decreased.

#### *Effect of proposal*

The effect of this proposal would be to encourage firms to minimize dislocations resulting from technological change. The company would have a strong financial incentive to plan its changes so as to avoid dislocations, to find alternative jobs for workers disemployed, to train them for other jobs it may have to offer, and so on, since success in such efforts would increase the amount of reserved funds that would eventually be returnable to it. This encouragement to keep the costs attributable to technological change at a minimum would in turn minimize the possibility that there would be excess costs chargeable to the Treasury.

(The following summary description of the British Industrial Training Act, excerpted from the June 1964 issue of the BLS publication "Labor Development Abroad," is submitted in response to Congressman Rumsfeld's request:)

The Industrial Training Act of March 12, 1964, is intended to improve existing arrangements for the industrial and commercial training of persons over the compulsory school age . . . and to overcome the shortage of skilled manpower which has prevailed since World War II in the United Kingdom. *By imposing a*

*levy on firms having no training program of their own, the legislation represents the first Government effort to spread more equitably the cost of training workers.*

The planning and direction of individual industrial plans has now become the responsibility of the Government—through Industrial Training Boards to be set up under the law. In addition, the new law provides for the formation of a Central Training Council and Appeal Tribunals . . .

Before this act, industrial training was chiefly the responsibility of individual firms . . .

Under the 1964 act, Industrial Training Boards are to be created by order of the Minister of Labour after consultation with representative organizations of employers and employees. Each board will be composed of a chairman, educational personnel, *and an equal number of employer and employee representatives*, all appointed by the Minister. Industry jurisdiction will also be defined in the order establishing a board . . .

The Minister of Labour has general direction over the boards, which must periodically submit a general plan of operation for his approval. The duties of a board are (1) to determine the job skills needed by industry and the nature and length of training to provide these skills, and (2) to make provisions for courses and other facilities (including residential accommodations) for the training of persons now employed or planning to be employed in the industry. The boards must also determine the qualifications of trainees and their instructors and *publish recommendations concerning both standards to be attained through training and methods of ascertaining whether the standards have been met.*

For these purposes, a board may not only establish industrial training centers but may also approve the courses and facilities provided by other agencies and firms within its jurisdiction. *It may subsidize the training programs of these firms by extending them: loans and grants.*

*Firms without training programs of their own will be penalized; they are subject—with the right of appeal—to orders issued by the Labour Minister at a board's initiation to pay a levy.*

Individuals become trainees either by entering into a contract of service or apprenticeship with a board or working with a firm having a board-approved plan. Trainees will be entitled to maintenance and traveling allowances and may also be subsidized if they take more advanced training given or approved by a board.

The boards will operate under grants and loans made to them by the Minister of Labour and approved by the Treasury. Initially, the law set aside £50 million (US \$140 million) for this purpose. The boards will also be permitted, with the Minister's consent, to borrow from other sources.

The Central Training Council, an advisory body to the Minister of Labour, has yet to be formed. Of its 32 members, *6 each will be appointed from employers and employees by the Minister of Labour*, 2 from nationalized industries, not more than 6 chairmen of Industrial Training Boards, and 12 other members, 6 of whom will be appointed after consultation with the Minister of Education and the Secretary of State for Scotland. The Council must submit an annual report on its activities to the Minister, who will present it to Parliament.

The act provides that any firm may appeal the levy order imposed on it for lack of a training program to special tribunals established by the Ministry of Labour for that purpose. A tribunal will have the power to rescind a levy order or to reduce the amount levied. *{Emphasis added.}*

#### Chairman PROXMIER. Senator Percy?

Senator PERCY. Mr. Reuther, may I say I have found this morning at least one case of what is good for General Motors would be good for the country? I share your enthusiasm for profit sharing, and I like your term "democratization of industry." My own experience in seeing over 15 years of profit sharing build up for a company indicates that people become enthusiastic about capitalism when they are capitalists, and not just in theory but in actual practice.

In your prepared statement at the beginning, you declare: "Our urban cities are blighted by decay and spreading slums."

I would like to ask you whether we could not democratize our cities by seeing that more ownership of property is made available

to low-income families. Do you not think that the pride taken in property ownership in the suburbs contributes to their beautification as opposed to the deterioration in our slum areas, where low-income families have allegiance only to the slumowners, the landlord, or perhaps the public housing project, but with no feeling of ownership themselves in the city itself?

Mr. REUTHER. I want to thank you, first of all, for saying these kind things about profit sharing. I think American industry ought to recognize that, if we are going to have something that can be called people's capitalism, then we have to do something about the fact that 1 percent of American families own 70 percent of the stock of America. Profit sharing would give you a broad democratic base of ownership and participation in American industries, and that is the way to make the American people be enthusiastically in support of our free-enterprise system.

With respect to American cities, I think that the point you make is well taken, and I share that point. I believe that the more American families we can have owning their own homes, the sooner we will change the basic character of our cities. I think, whether it is an absentee slum owner or whether it is the Federal Government, the relationship is bad, and I believe that the key to this is to come up with some bright new ideas of how we can apply modern technology to the total rebuilding of our cities.

We have got to get the cost of decent housing down so that millions of American families who live in slums can afford decent housing. I think if you can apply the most advanced technology to the auto industry and to the space industry, there ought to be enough courage and ingenuity to apply it to the housing industry.

Senator PERCY. If we have a softness in our economy this year, would you say, in your judgment, that rehabilitation of existing housing structures could develop into a growth industry?

Mr. REUTHER. I think that there is no question about it, that any time this country thinks it is running out of work, the housing field, education, medical facilities, and many other areas of need offer enough work to keep America busy for a long time.

Let me say, as one labor leader, at the risk that I may be criticized and that a lot of people may think I am soft, that I have never gotten very excited about the fight for the short workweek, because I think we have got too much work to do in America.

When we get all of these slums cleared so that every family has a decent house and every child has the kind of education opportunities to facilitate its maximum growth and development, when we have enough hospitals and all these other things, then I think a shorter workweek will make a lot of sense, because then the question will be, "Do you want more leisure or more gadgets?" and I would vote for more leisure.

But that is not our problem now, and the building of America and housing of America, I think, is a tremendous challenge and a good opportunity in terms of employment in the future.

Senator PERCY. Mr. Reuther, last year I proposed the establishment by the Congress of a national homeownership foundation.

You proposed in your testimony before the Ribicoff committee a national nonprofit housing corporation.

There may be some differences between them; there may be some similarities. Would you think the Congress this year should place high priority on working out a practical means to get the private enterprise system deeply involved in rehabilitation of existing housing?

Mr. REUTHER. I very much favor that, and I would hope that the Congress would act on it at a very early date.

Senator PERCY. Mr. Reuther, I understand you have created a citizens' crusade against poverty. I am also trying to find a way to get poor people involved in this process.

Do you think the involvement of the poor in the rehabilitation of the city, in their own neighborhood, and in their own housing units, is important?

Mr. REUTHER. I think it is absolutely essential. I do not believe that you can change the basic character of a community without involving the active participation of the people who make up that community. In our Citizens' Crusade, of which I have the privilege of being the national chairman, we are working to develop that active participation. We have set up two training centers and the UAW has put money into it, the Ford Foundation has given us a grant, and we are going to try to train a thousand community leaders from the slums to go into their neighborhoods and to help mobilize and generate the forces to do exactly what you are talking about—to involve the people themselves.

This can't be something from above that you hand down. They need economic help, they need guidance, they need leadership training, they need all this kind of assistance, but you have to give these people a sense of participating, in shaping their own lives, in rebuilding their own communities. This is not only a democratic idea, it is an essential idea if the job is going to be done.

Senator PERCY. Mr. Chairman, may I have permission to ask one more question?

Chairman PROXMIRE. Yes, indeed.

Senator PERCY. I will precede this question, Mr. Reuther, with a statement, that discrimination within industry by management has, in the past, contributed to the "nonemployment" of members of minority groups.

Do you feel that there can be a real involvement of the poor, a large part of the poor being nonwhite, until such time as we tear down the racial barriers that exist within certain craft unions?

How can you expand rehabilitation into a growth industry, if you can't get the very people who are now unemployed into the craft unions, and train them to become members of the working force in the great rebuilding job we face today?

Mr. REUTHER. I might say that, in 11 years of the AFL-CIO merger, there have been many disappointments that I have shared, but among the most important of those disappointments is the failure of the American labor movement to demonstrate both the courage and the compassion to do something more meaningful about the problem that you pose.

I think that our democratic credentials will be in question as long as we try to hide behind pious declarations on paper. People are going to evaluate our commitment in terms of what we do to implement our

belief in the equality of everyone in the right to share equal employment opportunities; not by convention declarations and eloquence but by what we do about the practical job of tearing down the barriers that deny millions of Americans the right to have access to job opportunities in certain areas of American industry.

Senator PERCY. Thank you, sir. I will join that crusade.

Mr. REUTHER. We will be very happy to have you.

Chairman PROXMIRE. Congressman Brock?

Representative BROCK. I share the feelings of the Senator from Illinois but I can't help but say I am not sure which one has changed the most, but I find in the area at present we are in more areas of agreement than disagreement today, and I appreciate that.

I, as Senator Percy, am particularly interested in profit sharing. I can't think of anything that is more important to maintaining or expanding that concept of participating in democracy than this idea. I have one question along this line.

In your idea of profit sharing I find myself in some disagreement in that I don't see ownership tied in, and I wonder if you in your proposal have included some way in which the Federal Government can give greater incentive toward stock ownership on the part of wage earners?

Mr. REUTHER. You see, the stock ownership thing arises out of the fact that a large percentage of the earnings of American industry is being invested, plowed back in, and this is part of a whole growth process of American industry, which gives the stockholder a share of a bigger and growing corporation. We don't want to slow down that process of growth and expansion.

We want the worker to share in it. If a company says, "We are going to put X percent of our earnings this year into capital expansion, new factories and new capacity," then they may say, "If we have to give the worker a cash payment, then we won't be able to do that." We want the worker to share in that expansion. It can be done by giving him stock.

We would work out the creation of a fund, so that under certain emergency circumstances the worker could cash in his stock equity and realize it in cash, but I believe that, overwhelmingly, the American workers would like to share in the ownership of the corporations that they work for, share in the growth of those corporations, have a sense that they don't just have a timeclock-card relationship, that there is a different relationship.

I think industry has to make up its mind. Ten years from now, what kind of workers do you think GM will be employing? They aren't going to be immigrants out of Ellis Island coming over here with a loaf of pumpernickel bread stuffed in their jeans. They are going to be fellows with a 2- and 3-year college education. Their whole relationship with their employer is going to be quite different. We keep looking backward when we talk about tomorrow. We have to look ahead.

This is why, in 1967, we are going to abolish the hourly rate system in the automobile industry. This idea of paying the worker by the 10th of the hour is an old concept that came out of the early beginnings of the industrial revolution. We are going to put everybody

on a salary, because dignity demands it, the whole relationship has got to change, and we are going to do it.

Profit-sharing is a part of that whole evolution in the status and dignity of the worker and in his relationship with the employer.

Representative Brock. I think I agree in looking ahead, but what I am concerned about is that if you have just a pure profit-sharing program, that you are still piecemeal, that it is still on the profits of a given year for a given worker, and I am concerned that we expand the opportunity for workers to themselves invest in this growth, and you can't have a share of the growth, long-term growth, unless you own the stock itself.

And today your Federal income tax precludes the purchase of stock at less than 85 percent of the value. Is this an area that we might address ourselves to in the Congress, to give a greater inducement or opportunity for workers, with the assistance of management, to participate in stock ownership programs?

Mr. Reuther. I am encouraging that wherever possible, so I would be in favor of Congress doing anything that would encourage it.

Some years ago the General Motors Corp. proposed a stock purchase plan. We rejected it because the lowest income worker with the largest family would in effect have been excluded, and we thought that that would have compounded inequity. Our approach would give each worker his proportionate equity, quite unrelated to whether or not his family situation enabled him to save.

If a worker had eight kids and he was having a hard time sending them to school and he couldn't accumulate anything, we wouldn't want him to be deprived of the right to share in the profits, hence our approach. Now, we should be most happy to furnish the committee the specific collective bargaining profit-sharing plan that we submitted to General Motors in 1958. At the present time we have no detailed proposal that we are submitting to any employer. I raise this only as a broad concept.

(See p. 732 for material referred to above.)

Representative Brock. I personally feel that a human being, worker or management, has a greater sense of involvement if he has to invest something in, if he has to participate. I am trying to encourage this from our end as you are from yours.

One final question. On this question you said you weren't concerned, and that we shouldn't make it a major crisis. I am interested in what you suggested about the wage-price committee. Then you say "selective and monetary fiscal policies ought to be adopted."

Now, there aren't very many monetary and fiscal policies that haven't been tried. We can have a higher interest rate. You have already said you don't like that. We could have higher taxes. You have opposed that. Or we could reduce spending. That is the third category. As I understand it, you oppose that category. I don't see what specific suggestions you have proposed to us to combat this reduction in the real worth of wages for the workers.

Mr. Reuther. Well, to begin with, as I say, I think that we must understand that the basic problem flows from the pricing policies of certain corporations who have failed to share their abnormally high increase in productivity with consumers through meaningful price reductions.

If we had gotten those price reductions there would be no inflationary problem of any magnitude in the American economy, and we wouldn't be worried about it. If you put all the pressure on the wage front, you are working on the wrong end of the problem. You won't find the answer until we get those price reductions. This is why Mr. Ackley is unrealistic and why his whole attitude on the escalator clause is unworkable.

He doesn't have to sit at any bargaining table. He is very fortunate in that respect. He leads a very cloistered, sheltered life. But I can tell him that wage earners are not going to say, "It is too bad, we are going to have to take a 50-percent loss in our real wage position because of inflation."

They are going to fight to make it up. That is what happened in the airline strike. The fight there was about catchup money. It is unrealistic to believe that wage earners are going to look at the distribution of national income and see everybody else going through the stratosphere and then settle for only 50 percent of their catchup money through escalation.

The Federal Reserve Board has got to be more responsible when they tell the banks around the country the conditions upon which they are prepared to give them access to new money. The Federal Reserve Board has got to act as though it is a part of the American system instead of something apart from the American system.

There are many other things we can do on a selective basis. But the main point we try to make is that we should not let the problem of inflation and the balance-of-payments problem, both of which are real problems, unduly influence us with respect to continuing to do those things which are necessary to reduce the levels of unemployment. That is the point I am trying to make.

Chairman PROXMIRE. Thank you very, very much, Mr. Reuther, for an excellent performance and for a great deal of most useful information. I think maybe some people are surprised at the consensus here, but it indicates that when men of good will get together on the facts we find a very, very wide area of agreement. You have done a splendid job. We are mighty grateful to you, Mr. Reuther.

Thank you.

Senator MILLER. Mr. Chairman, I have a few questions.

Chairman PROXMIRE. Fine. I think with Mr. Reuther's permission we can put those in the record.

Senator MILLER. I will submit them and ask that Mr. Reuther supply the answers for the record, because I know we have a time problem.

Chairman PROXMIRE. Yes, indeed; and I have a few questions myself.

Mr. REUTHER. I should be most happy to try to cooperate in responding to any questions.

Representative WIDNALL. Mr. Chairman, may I have that privilege?

Chairman PROXMIRE. It will apply to all members; yes, indeed.

Thank you very much.

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

(The questions of Senator Miller, Chairman Proxmire and Representative Widnall and answers supplied by Mr. Reuther were subsequently received for the record and appear on the following pages:)

## QUESTIONS BY SENATOR MILLER

**Question.** In your testimony, you criticized former Treasury Secretary Humphrey for his "obsession with a balanced budget," which resulted in unbalancing the economy to the extent of a \$12 billion deficit for 1959.

Does this statement mean that you fail to recognize that it was the Democratically controlled Congress which had the power to pass the revenue, appropriations, and other laws needed to prevent an unbalanced economy?

**Answer.** I was attempting to make an economic rather than a political point: namely, that misguided attempts to achieve balance in the budget can unbalance the economy with the result that the actual budget deficit can be vastly greater than the deficit sought to be avoided or reduced. It is pertinent to note, however, that under our system of government the leadership in budget-making is in the hands of the Executive and that Congress tends to follow that lead fairly closely regardless of whether the majority of its members are from the same Party as the President or from a different Party.

**Question.** Do you believe it is more fair for the Federal Government to take purchasing power away from the people by increased income taxes than by inflation?

**Answer.** Inflation is inequitable in its impact, disadvantaging some and benefiting others. In general, the disadvantages tend to fall most heavily on those least able to bear them, while the advantages tend to accrue to those who least need them. (This point is documented by some of the data in my prepared statement.) Unlike inflation, taxes on incomes based upon ability to pay can promote rather than impede equity and social justice.

**Question.** I invite your attention to the close relationship between deficits of the Federal Government and inflation. It has now reached the point that for every \$1 billion of deficit under the Administrative Budget, there will be an accompanying inflation of \$2 billion or more. Would you not therefore favor reduction, if not elimination, of these budget deficits—and, if so, what specific action by Congress should be taken to do so? (E.g., specific taxes to be increased or Federal expenditures to be reduced.)

**Answer.** As my prepared statement shows, there is no general excess of demand which needs to be soaked up either through tax increases or reduced government spending in order to avoid inflation. There is a substantial unused margin of idle human and physical resources which a budget deficit can help to employ productively. Such inflationary pressures as exist are selective and sectoral and should be combated by selective measures rather than by the blunt instrument of an overall fiscal policy aimed at reducing demand at a time when the objectives of the Employment Act call for increased demand.

**Question.** What is your definition of "living in poverty" in the context of your statement that 32.5 million Americans continue to live in poverty?

**Answer.** The definitions are those developed by the Social Security Administration after careful and detailed study. A household is classified as poor if its total money income falls below \$1,570 for an unrelated individual, \$2,030 for a couple, \$3,200 for a family of four, and comparable figures for families of other sizes. In 1965, there were 32.7 million persons in households having incomes below those levels. They certainly fit within any reasonable definition of poverty since, in the words of the Council of Economic Advisers, their incomes clearly are "inadequate to provide even the basic essentials of a decent life in our society."

**Question.** Of the 800,000 members of the U.A.W., how many are covered by escalation clauses covering increases in the cost of living?

**Answer.** There are currently approximately 1,400,000 employed members of the UAW. Of these, we estimate that 85 to 90 percent are covered by cost-of-living escalator clauses. The 800,000 figure refers, in round numbers, to those who will be involved in negotiations with major automotive, agricultural implement, and parts supplier corporations this year.

**Question.** Of those covered, how much have these clauses meant in increased wages during *each* of the last five years?

**Answer.** While there are some variations, most UAW escalator clauses are the same as or closely similar to those in our contracts with the major automotive

corporations. Under these contracts, increases in the cost-of-living allowance during each of the last 5 years have been as follows :

Year:	Cents per hour
1962.....	3
1963.....	3
1964.....	3
1965.....	4
1966.....	11

It is important to keep in mind that the above adjustments in the cost-of-living allowance (a) came in response to *prior* increases in the price level, and (b) did not increase the buying power of the workers' wages but merely helped to protect their families' living standards against erosion by higher prices.

**Question.** In connection with wage-price guidelines, should there not be some account given in wage increase patterns between plants having different increases in productivity? For example, if Plant A has increased productivity of 1% in a given year, should the workers be given an increase of 3%?

**Answer.** Since advances in productivity are socially generated, all members of society should share equitably in their fruits. Moreover, to relate wage increases directly to the rate of productivity advance in individual industries would have highly undesirable consequences. It would tend to make second-class citizens, suffering relatively depressed living standards, of those workers unfortunate enough to be employed in industries whose productivity increased slowly. It would also distort the national wage structure in an economically unworkable direction by confining skilled workers in slowly advancing industries to wages lower than those paid to unskilled workers in industries whose productivity rises rapidly. In general, the basic philosophical approach of the guideposts to this problem is sound. Under that philosophy, price increases required in slowly advancing industries to pay for wage increases related to national productivity gains should be offset by price decreases in industries with above-average productivity progress, thus preserving the stability of the general price level. In practice, the price decreases have not been forthcoming. Corporations with rapid productivity increases have tended instead to monopolize the resultant gains for the exclusive benefit of their stockholders and managers rather than to share them with consumers in price reductions. That failure to pass on cost savings in lower prices generates excessive profits. Workers employed by such corporations will inevitably insist on wage and fringe benefit gains commensurate with the profits. After all, as the Council has noted :

“ . . . there is no justification, on either economic or equity grounds, for distributing above-average gains in productivity exclusively through the profits channel.”

**Question.** I have long favored a stepped-up program of federally assisted trade and technical schools to give underprivileged young people a skill with a future. Would you comment on this proposal?

**Answer.** The UAW has been an active supported of legislative and private programs aimed at providing the disadvantaged with skills that would enable them to compete more effectively in the labor market. We initiated and are operating a number of training programs with government financial assistance. Among them are on-the-job training programs and a program to enable members of minority groups to meet the requirements for entrance into formal apprenticeship in the skilled trades. In addition, we have pressed and continue to press the corporations with which we bargain to improve their training programs.

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QUESTIONS BY SENATOR PROXMIRE

**Question.** In your statement you criticized the guidelines as inadequate and unfair and you recommend instead an incomes policy, pointing out that all European countries have moved to that approach. However, isn't it true that Britain, when faced with emergency conditions, reverted again to wage limitations. Isn't this indicative of weakness in incomes policy when the chips are down?

Answer. As noted in the question, Britain acted in response to emergency conditions. The emergency may reasonably be attributed, in part, to failure to adopt an incomes policy earlier. Because of the seriousness of the situation that Britain faced last summer, the government was unable to rely on the voluntary incomes policy that it had previously contemplated and that is still intended for the long run. As of July 20, 1966, a "prices and incomes standstill" was imposed which took the form of a "freeze" until the end of 1966, followed by the current 6-month "period of severe restraint". The standstill, however, is *not confined to wage limitations*, as the question suggests. It is far broader in its application to incomes than the U.S. guideposts which cover only wages fixed through collective bargaining. The approach taken, in fact, is that of an incomes policy. The White Paper on the "freeze" (Cmnd. 3073), for example, deals not only with wages and prices but also with rents for both housing and business premises, "scales of charges and fees for self-employed persons, including all sorts of professional fees", salaries and other forms of remuneration not fixed by collective bargaining "including that of company directors and executives", and "all company distributions, including dividends paid by companies". In addition, the White Paper notes, "The Government have already pledged themselves to use their fiscal powers or other means to prevent any excessive growth in aggregate profits."

Question. The incomes policy that you favor concentrates, as I understand it, on the relative shares of real income that go to labor and the other factors of production. Elsewhere in your statement you indicated that labor and capital should be free to bargain over the shares of income that each shall receive. Aren't these contradictory? Doesn't an income policy tend to stabilize the share of income going to labor? We would be interested in hearing how you reconcile these two.

Answer. Perhaps the best way to answer this question is to quote from the British White Paper on "Prices and Incomes Policy" issued in April 1965 (Cmnd. 2639). (This White Paper later was attached to the Prices and Incomes Act adopted in August 1966 as a "schedule" setting forth the considerations to be taken into account in the administration of that Act.) The pertinent paragraph says: "The requirement that total money incomes should rise in line with the growth of real national output *does not mean that all forms of income should increase at the same rate. It is necessary not only to create the conditions in which essential structural readjustments can be carried out smoothly but also to promote social justice.* The general review of money incomes of all kinds to be carried out by the National Economic Development Council will involve not only the assembly of the facts about the movement of the main categories of income—wages, salaries, income from self-employment, profits (distributed and undistributed) and rent—but also an appraisal of the way the distribution of the national income is developing under the impact of the prices and incomes policy. The Government have pledged themselves to use their fiscal powers or other appropriate means to correct any excessive growth in aggregate profits as compared with the growth of total wages and salaries, after allowing for short-term fluctuations." [Italic added.]

One of the problems with the guideposts is that the Council, in applying them, has tended to forget its own statement that:

"... there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes."

The Council, in practice, has attempted to apply its wage guidepost in a manner that would freeze the labor income share in the unlikely event of an absolutely stable price level and that reduces the labor share when prices increase.

There are important economic considerations, as well as equity and social justice considerations, for not freezing the shares going to labor and nonlabor incomes. The increasing productivity of capital, noted in my prepared statement, calls for a long-term increase in the labor share. Other factors that should be taken into account have been summarized by Professor Neil Chamberlain of Yale University as follows:

"... the distribution of income affects the balance between consumption and investment. Under changing circumstances this balance too may have to change if the economy is to make full use of its assets. The balance may have to swing more toward savings and away from consumption when more private investment is needed to satisfy rising household demand; more toward private

consumer expenditure when investment goods become more productive and less saving is required to keep pace with wants; more toward public expenditure with higher tax rates when private demand is still strong but needs balancing with more 'infrastructure'; and more toward public expenditure with lower tax rates when private demand is weak and social investment can lay the basis for future expansion. An 'incomes policy' becomes a significant element in economic planning by helping to steer GNP into the channels appropriate to the given circumstances."

An incomes policy is therefore thoroughly consistent with changing income shares. It can help to assure that the changes that do take place are in the direction of equity, social justice, and the requirements of the economy as a whole. Collective bargaining over income shares has a vital role to play in that process.

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#### QUESTIONS BY REPRESENTATIVE WIDNALL

*Question.* Do you foresee an increase in unemployment this year?

*Answer.* The many signs of weakness already apparent in the economy suggest at least a strong possibility that unemployment will increase this year. My prepared statement mentions some of the reasons for concern. The discussion under the subhead "Signs of Weakness" is particularly pertinent.

*Question.* How do you stand on pushing forward with the development of a new statistical series on job vacancies? Would such a series help in the placement of the unemployed and in tailoring our training programs for actual job openings? Why has organized labor opposed this in the past?

*Answer.* A complete answer to this question would require much more space than I can reasonably take. Permit me to note, however, that comprehensive quantitative and qualitative data on job vacancies would be available if a measure long urged by the UAW were now in effect. We have proposed repeatedly that employers be required to list job vacancies to be filled by new hires with the public Employment Service as a condition for eligibility for so-called "experience rating" reductions in their unemployment compensation contributions. Comprehensive listing of job vacancies with the Employment Service would provide direct help in the placement of the unemployed, whereas purely statistical surveys of vacancies would have, at best, only a remote relationship to placement. Many employers, including some of the largest in the country, presently refuse to list their vacancies with the Employment Service.

If there were a financial penalty on such refusal, the Employment Service would have a far more complete listing of and far more detailed information on the nature of actual job vacancies (information usable not only for placement but also for statistical, analytical, administrative and policy purposes) than could possibly be obtained by the kind of job vacancy surveys that have been proposed.

While some who propose such surveys do so in good faith, others who advocate them are obviously hoping to develop propaganda rather than factual information. It is evident from expressions by the latter group that they seek global figures on job vacancies to set alongside the unemployment figures in order to minimize the seriousness of the unemployment problem. They would obviously like to buttress their callous charges—proved baseless every time demand rose high enough to provide work opportunities for the jobless—that "the unemployed do not want to work." To blame unemployment on the unemployed is both easy on the conscience and a useful argument against effective government action to reduce unemployment.

Job vacancy data can properly be matched up with unemployment data only if there is enough detailed information on the vacancies to compare with similarly detailed information on the characteristics and geographical location of the unemployed. A statistical survey of job vacancies based upon a sample sufficiently large to provide the detailed information required for that purpose would be impossibly expensive. Moreover, employers would be unwilling to accept the burden of the clerical work that would be involved.

Among those who urge job vacancy surveys in good faith, there is confusion as to the purpose which they should be designed to serve. Vacancy surveys have been proposed, among other reasons, in order to provide information (a) for placement, (b) for training, (c) to serve as an overall economic indicator, and (d) to make labor market supply-demand comparisons either on an overall

basis or by occupation, by area, or both. Each of these purposes would require a different survey design and sample size.

All of the purposes could be served, and served better, on the basis of the data the Employment Service would be able to generate if employers were induced to list their job vacancies with it.

Question. What is your position on Federal revenue sharing with the states and localities?

Answer. My position on this matter is spelled out in my prepared statement under the heading "Tax Sharing and Social Responsibility."

(The prepared statement of Mr. Reuther, submitted to the Joint Economic Committee in advance of his appearance, follows:)

#### PREPARED STATEMENT OF WALTER P. REUTHER

The fundamental question to which our nation has not as yet found a satisfactory or acceptable answer is: What is the purpose of a free society and how does it intend to harness the full potential of the Twentieth Century Technological Revolution and commit this potential to the advancement of human and democratic values.

Our nation is more richly blessed than any other nation in the world. We possess tremendous economic resources, a highly developed technology, a skilled and industrious work force. Yet, despite all these advantages, we are still failing to satisfy many urgent and basic human needs. Thirty-two and a half million Americans continue to live in poverty in a land of plenty. Our urban centers are blighted by decay and spreading slums. Our education and medical facilities are inadequate; we are polluting our air and our water; we are strangled in traffic congestion; we are destroying the beauty which was our great national heritage and are creating a living environment unworthy of citizens in a free society.

We have the resources and we have the technical know-how to overcome all these problems. We have lacked the will, however, to match these resources and this know-how to our needs.

We must make up our mind as to what we feel is important within the framework of our value system, declare a list of national priorities, and commit ourselves and our resources to the achievement of those national priorities.

Achieving and maintaining full employment and the maximum utilization of our human resources must continue to be at the top of our list of national priorities. The Employment Act of 1946 committed our nation to the achievement of maximum employment, production, and purchasing power. Twenty years after the enactment of this legislation we are still short of achieving these objectives.

Since 1960 we have made steady and meaningful progress in reducing unemployment, moving from 5.6 percent to 3.9 percent. Presidents Kennedy and Johnson deserve enormous credit for pursuing policies and programs that made this progress possible. Nevertheless, as a nation we cannot escape the fact that the United States still has the highest rate of unemployment of any democratic, industrialized nation in the world.

During the Eisenhower Administration, the obsession with balancing the budget unbalanced both the economy and the budget. In recent years we have also been unduly alarmed by exaggerated fears of the balance of payments deficit and of inflation, and have permitted our concern over these two problems to prevent fulfillment of the mandate of the Employment Act of 1946, to which our nation is and must be committed.

Today I would like to discuss steps which can be taken to further reduce unemployment and ameliorate the hardships and economic losses that flow from it, and to discuss ways and means to contain inflation.

In that connection, I will discuss such subjects as:

- the mandate of the Employment Act;
- the balance of payments;
- the guideposts and the manner in which they have fostered inequities at the expense of workers;
- cost-of-living wage escalator provisions;
- bargaining over income shares, with particular reference to the automobile industry;
- the need for a comprehensive incomes policy applying equitably to all forms of income;

profit sharing and its relationship to incomes policy, to democratization of the ownership of industry, and to collective bargaining;  
 a proposed price-wage review procedure both for immediate implementation and as an instrument of incomes policy;  
 the proposed tax increase in relation to the state of the economy, inflation, monetary policy and selective credit controls;  
 an employment target for 1967; and  
 the proposal that the government act as "employer of last resort."

In addition, I will discuss a number of other matters—poverty, guaranteed minimum incomes, proposals to share federal revenues with the states, and Great Society goals.

#### THE MANDATE OF THE EMPLOYMENT ACT

In his first Economic Report in 1962, President John F. Kennedy emphasized the importance of the principles of the Employment Act, under which is Report and that of the Council of Economic Advisers were made. He said:

"My first Economic Report is an appropriate occasion to re-emphasize my dedication to the principles of the Employment Act. As a declaration of national purpose and as a recognition of Federal responsibility, the Act has few parallels in the Nation's history. In passing the Act by heavy bipartisan majorities, the Congress registered the consensus of the American people that this Nation will not countenance the suffering, frustration, and injustice of unemployment, or let the vast potential of the world's leading economy run to waste in idle manpower, silent machinery, and empty plants.

"The framers of the Employment Act were wise to choose the promotion of 'maximum employment, production, and purchasing power' as the keystone of national economic policy. They were confident that these objectives can be effectively promoted 'in a manner calculated to foster and promote free competitive enterprise and the general welfare.' They knew that our pursuit of maximum employment and production would be tempered with compassion, with justice, and with a concern for the future. But they knew also that the other standards we set for our economy are easier to meet when it is operating at capacity. A full employment economy provides opportunities for useful and satisfying work. It rewards enterprise with profit. It generates saving for the future and transforms it into productive investment. It opens doors for the unskilled and underprivileged and closes them against want and frustration. The conquest of unemployment is not the sole end of economic policy, but it is surely an indispensable beginning."

#### *Four-percent unemployment was an interim target*

The Council of Economic Advisers in its 1962 Report set 4 percent unemployment as an "interim" target, to be achieved by mid-1963. The temporary nature of this goal, however, was strongly emphasized. The Council said:

"We must not forget, however, that any practical unemployment goal is only a temporary compromise, and its attainment must never be an occasion for relaxation, but rather an incentive to search out ways to achieve a still lower rate."

Even more specifically, the Council forecast that if structural obstacles were removed, unemployment could be reduced well below 4 percent. It said:

"If we move firmly to reduce the impact of structural unemployment, we will be able to move the unemployment target steadily from 4 percent to successively lower rates."

As it turned out, the structural obstacles which so deeply concerned some economists in 1961 and 1962 proved in large part illusory. Gardner Ackley, Chairman of the Council, emphasized that point in testimony before this committee last year.

He pointed out, for example, that in 1961 there were only 160,000 technical and professional workers unemployed, yet in the four succeeding years employment of such workers increased by 1,178,000—the difference being represented by new entrants into the labor force and by formerly unemployed or employed workers who had been trained or upgraded into technical and professional jobs. Mr. Ackley continued:

"In September 1961, 25 major labor market areas had unemployment rates of 7.0 percent or more. *Many seemed to be areas of permanent distress, which no amount of general prosperity could erase.* By September 1965, only two areas (both in Puerto Rico) had rates in excess of seven percent. . . .

*"The lesson seems clear. The millions of excess unemployed were indeed employable, and the great flexibility and mobility of our labor force, and the ingenu-*

*ity of our employers permitted their reemployment without severe strains or bottlenecks.*" [emphasis added]

*The Council rejects its mandate*

The structural obstacles to full employment having been to such an extent dissolved, we might have expected the Council this year to have come forward with programs designed to "move the unemployment target steadily from 4 percent to successively lower rates." Unfortunately, the Council has chosen another course. It has rejected the mandate imposed upon it by the Employment Act to "use all practicable means" to promote "maximum employment, production and purchasing power." It has done so in the face of clear evidence that the mandate is still far from having been carried out. At the end of 1966, manufacturing industry was operating, according to McGraw-Hill, at only 88 percent of capacity.<sup>1</sup> This compares with 89½ percent a year earlier, because capacity has grown faster than output, and was well below the preferred rate of 93 percent. There were still nearly three million unemployed, nearly two million more working only part-time for economic reasons, and an estimated 500,000 to a million "discouraged workers" who are not even counted in the labor force because they are not actively seeking work. Yet in the face of these shortfalls from the goal of "maximum employment, production and purchasing power," the Council of Economic Advisers announces that full employment has been achieved, and advises us that in the light of the programs it recommends we cannot expect any further reduction in the average unemployment rate this year.

Just to make sure that its position will be understood, the Council states it in the opening words of its Report. It commences:

"The United States in 1966 enjoyed the benefits of the fullest employment in more than a decade. The unemployment rate reached a 13-year low of 3.9 percent. At that level, demand finally matched supply in most labor markets, a situation which most economists define as essentially 'full employment'."

Subsequently, in discussing the economic outlook for 1967, the Council said: "Finally and most important, the Nation should continue to experience substantially full employment in 1967. The unemployment rate should be essentially the same as in 1966, when it averaged 3.9 percent."

This attitude of complacent self-satisfaction must be rejected by the Congress and by the Administration. For what does it mean? If there is to be no decline in the unemployment rate, there will continue to be 1.2 million unemployed workers below the age of 25. If there is to be no drop in total unemployment, then there will continue to be 625,000 Negroes unemployed.

On the basis of the new definitions of unemployment adopted by BLS, unemployment rates in 1966 averaged 7.6 percent for Negroes, and 11.7 percent for teen-agers (aged 16-19). Similar figures based on the new definitions are not available for Negro teen-agers separately, but on the basis of the old definitions their unemployment averaged 21.2 and 31.1 percent for Negro boys and girls respectively (aged 14-19). We must put an end to the human wastage of our young people and the continuing denial of real equality of opportunity for Negroes which these figures indicate. To permit them to continue would be an act of immoral and dangerous folly. Yet if the employment forecasts of the Council are realized on the basis of the programs which the Council recommends, then there is no realistic hope that the jobless rates of either teen-agers or Negroes can be substantially reduced.

In fact, if the employment forecasts of the Council prove overoptimistic, then these groups will be among the first to suffer rising unemployment.

#### BALANCE OF PAYMENTS

The pressure for restrictive fiscal and monetary policies in the face of continued high unemployment and serious signs of weakness in the economy arises out of an unwarranted concern with the deficit in the balance of payments and fear that it may be worsened by inflation.

No one would be foolish enough to argue that either inflation or persistent payments deficits are desirable. But the fear of both, and the panicky retreat into repressive economic measures which it inspires, is in strange contrast to the refusal to apply more direct solutions less costly in human hardship and economic

<sup>1</sup>The McGraw-Hill figures are used here rather than the FRB figures used elsewhere in this statement because the McGraw-Hill utilization figure is comparable with the "preferred rate" figure.

waste than unemployment, and less inequitable than policies that seek to hold the rise in real wages below the increase in productivity.

Until relatively recently, the main reason usually advanced in support of price stabilization policies was that inflation is inequitable in its impact, unfairly enriching some groups in the population at the expense of others. For some years now, equity has been receding into the background and the adverse effects of price increases on the balance of payments have replaced it as the main reason for combating inflation. In fact, there has been an increasing tendency to sacrifice equity in order to protect the balance of payments. The tendency is evident in the promulgation of and adherence to a wage guidepost applied to money rather than real wages which, in the face of rising prices, disadvantages workers and benefits other groups at their expense. The sacrifice of equity is even more starkly evident in the adoption of restrictive fiscal and monetary policies to curb inflation which inflicts the ultimate economic inequity—unemployment—on the least favored groups in the population.

That these sacrifices are wholly unnecessary should be readily apparent to anyone who takes the trouble to look at the facts. To begin with, it must be remembered that wages have relevance to the balance of payments only insofar as they may affect prices; and prices, in turn, are relevant only to the trade component of the balance of payments. The facts show that wage movements in this country, relative to those of the other industrialized countries with which we compete on the world market, far from being adverse, have been favorable to the competitive position of the United States. A recent BLS study showed that U.S. unit labor costs in manufacturing rose less between 1957 and 1965 than those of all eight other countries examined, except Canada, by a wide margin. Even the comparison with Canada would have been favorable if not for that country's devaluation of its dollar. As BLS said:

"From the standpoint of labor cost per unit of output, American manufacturers in the mid-1960's have achieved a better competitive position relative to foreign producers than they held in the late 1950's. This conclusion emerges clearly from an inspection of the time series indexes in all nine countries, taking account of changes in the exchange rates in four of the countries."

Money wages and fringe benefit costs per hour increased somewhat faster in 1966 than in earlier years because of prior increases in consumer prices, and there was a small increase in unit labor costs in manufacturing. The Council of Economic Advisers noted, however:

"Even so, unit labor costs in manufacturing have risen less rapidly in the United States during 1966 than in most other industrial countries."

Secretary of the Treasury Fowler was able to testify in these hearings that "on the export side, the U.S. competitive position was maintained" in 1966. He pointed out that "unit value of U.S. exports in the second quarter of last year showed a decline from the comparable quarter of 1965, whereas the movement was upward for most advanced countries."

U.S. exports actually rose during 1966. The Council's Report notes that they "were more than 10 percent greater than in 1965, even after adjustment for the effects of the 1965 dock strike." Particularly significant with respect to the influence of labor costs is the fact that exports of *manufactured* goods also rose 10 percent during 1966. The decline in the U.S. trade surplus last year was the result of a number of special and temporary factors which caused a sharp increase in imports which, as Secretary Fowler said "can be expected to taper off." He mentioned a number of those factors in his testimony, including "additional imports resulting from higher defense spending at home."

The Council's Report calls attention to the increase of 50 percent in imports of capital goods which accounted for more than 20 percent of the total increase in imports in 1966. Foreign-made capital goods were in such heavy demand, obviously, because the spectacular rise in profits fueled an investment boom that strained the capacity of U.S. producers of such goods.

Inflated imports of capital goods inspired by and financed out of grossly inflated profits, however, are only one element in the contribution of corporations to the payments deficit—a deficit which workers are called upon to correct by the sacrifice of job opportunities and their equitable share in the fruits of the nation's growing productivity. A far bigger factor is the sizable and continuing export of U.S. capital to already developed countries in total disregard of the payments deficit.

It is possible that the so-called "voluntary controls" program has had some effect on some forms of capital outflows. But there is little statistical evidence of

any effect on direct investment (excluding funds raised abroad) of American capital in other countries. In 1964, direct investment was not quite equal to the total payments deficit (on the liquidity basis). In 1965 and during the first three quarters of 1966 (annual rate), the total payments deficit was less than half as large as in 1964, but direct investment had increased, so that in both years it was more than 2½ times as large as the deficit. The pertinent figures are as follows:

[Dollars in millions]

	Direct Investment of U.S. capital in other countries (net capital outflow)	Balance-of-payments deficits (liquidity basis)	Ratio of direct investment to deficit
1964.....	\$2, 416	\$2, 798	0.86
1965.....	3, 371	1, 337	2.52
1966 <sup>1</sup> .....	3, 151	1, 213	2.60

<sup>1</sup> Average for 1st 3 quarters on a seasonally adjusted annual rate basis.

In other words, had direct investment been reduced by as little as two-fifths in 1965 and 1966—which would have brought it less than one-fifth below the 1964 level—the payments deficit would have been wiped out in each of those years. Such a reduction could have been accomplished without damage to the developing countries since only about one-fifth of all U.S. direct investment goes to such countries—in 1965 the proportion was 21.3 percent.

Other industrial countries protect their international payments positions by various forms of controls over capital exports. The IUD and the UAW have long advocated similar controls over U.S. capital exports to developed countries. Direct controls, with appropriate discretion vested in the controlling agency, would afford an opportunity to consider each proposed investment in the light of the national interest.

Another approach has recently been suggested by a member of the Board of Governors of the Federal Reserve System, Sherman Maisel. He proposed that the principle of the interest equalization tax, enacted to restrain other forms of capital outflow, be adapted to apply to direct investment of American capital in developed countries. According to press reports, Mr. Maisel posed a question very much like that which has long been on the minds of many in the IUD and the UAW. He asked: “. . . are lower incomes, unemployment, and excess capacity justifiable in order to avoid direct fiscal methods of adjusting the balance of payments?”

Whether the proper answer is fiscal methods or direct controls, it should be apparent that an answer must be found and put into effect promptly. The interests of the nation as a whole must be assured priority over the narrow, selfish and irresponsible pursuit of profits by the small number of large corporations engaged in overseas operations. *We urge that this Committee examine the alternatives and recommend action to curb direct investment in developed countries by American corporations so as to eliminate the pressures toward a restrictive economic policy which arise out of the payments deficit.*

#### GUIDEPOSTS

The IUD and the UAW unreservedly support sound, equitable, courageous and vigorous action to achieve price stability. But we refuse to permit a balance of payments deficit created essentially by corporate investment policies in pursuit of maximum profits to panic us into accepting an inequitable wage policy that results in enriching those same corporations at the expense of their workers. That is why we oppose the guideposts and call for their replacement by a comprehensive incomes policy that bears equitably upon all forms of income—property income as well as employment income, managerial and professional income as well as workers' income.

Some of the inequities which developed under the guideposts, and the process by which they developed, are described below. In certain instances, the second quarter of 1960 will be compared with the second quarter of 1966. The second quarter of 1960 was chosen because it represented the peak of the previous business cycle, so that the comparisons are between two periods of relative prosperity. The second quarter of 1966 was chosen because subsequently the pressure of rising living costs finally broke the dams and forced wages up at a faster pace. The essential points are that (a) it was a *prior* increase in living costs for which wage increases were not responsible which finally compelled money wages to begin rising faster than the rate of productivity advance and (b) the faster pace of wage increase was required to correct the income distortions and inequities that had developed.

**1. Compensation per employee man-hour has closely paralleled productivity**

In a statement presented by the Council of Economic Advisers to a Subcommittee of the House on September 12, 1966, productivity in the total private economy was shown to have increased at an annual rate of 3.8 percent from 1960 to 1965 (Table A of the statement) while total compensation per employee man-hour, including overtime, in the private economy was shown to have increased during the same period at an annual rate of 3.7 percent (Table 1 of the same statement)—or less than the increased in productivity.<sup>1</sup>

**2. Thus, increases in employee compensation per man-hour cannot be said to have contributed to upward pressure on the price level**

Since hourly employee compensation rose at approximately the same rate as productivity, it obviously was not the cause of increases in the general price level. Given the fact that corporate market power had been used to maintain some prices at excessive levels at the beginning of the 1960-65 period, the close tracking of productivity by hourly employee compensation would have permitted some reduction of the general price level.

**3. Nevertheless, prices rose**

The Consumer Price Index increased by 6.6 percent from 1960 to 1965, an average rate of 1.3 percent annually.

**4. Real hourly compensation, in consequence, lagged far behind increases in productivity**

The rise in *real* total compensation per employee man-hour from 1960 to 1965 was in the neighborhood of 2.4 percent annually—two-thirds as fast as the increase in productivity. Wage and salary earners were deprived of a third of their proportionate share of the gains from increased productivity.

**5. As a result, the distribution of the national income was distorted in favor of property income to the disadvantage of employment income**

	Percent increase	
	1960 to 1965	II-1960 to II-1966
Employment income:		
Total employee compensation .....	33.5	45.1
Employee compensation in the private economy .....	31.3	42.5
Property income:		
Corporate profits before taxes .....	52.3	59.8
Corporate profits after taxes .....	66.7	75.2
Dividends .....	43.3	56.3
Personal interest income .....	64.1	81.5

<sup>1</sup> The productivity figure was subsequently revised by BLS to 3.6 percent because of an upward adjustment in the man-hours figures; comparable revised employee compensation data have not yet been published. It is evident, however, that hourly employee compensation closely paralleled productivity. Differences between the two sets of data might be accounted for entirely by statistical error. It is known that there are important errors of understatement in the productivity index which probably significantly outweigh the fewer and generally less serious errors in the opposite direction.

6. The distribution of income within the corporate sector, similarly, changed to the disadvantage of wage and salary earners

	Percent increase			
	All corporations		Nonfinancial corporations	
	1960 to 1965	II-1960 to II-1966	1960 to 1965	II-1960 to II-1966
Compensation of corporate employees.....	31.9	42.5	31.6	42.2
Profits before taxes.....	<sup>1</sup> 51.7	<sup>1</sup> 58.9	58.6	65.1
Profits after taxes.....	<sup>1</sup> 66.5	<sup>1</sup> 74.5	75.2	82.9
Dividends.....	<sup>1</sup> 40.5	<sup>1</sup> 54.8	39.7	53.8

<sup>1</sup>“Corporate gross product” data used in this table, unlike data in Pt. 5 above, exclude product originating in the rest of the world.

7. The increase in the property income share was achieved at the expense of lower-income families

From 1960 to 1964 (the latest available), the University of Michigan *Survey of Consumer Finances* shows that the shares of total income going to the lowest-income 40 percent of all families and the highest-income 10 percent changed as follows :

	1960	1964
Lowest income 40 percent.....	16	14
Highest income 10 percent.....	27	30

The highest income received by any of the families in the 40 percent at the bottom of the income structure increased approximately half as fast as the lowest income received by any family in the top income 10 percent :

	1960	1964	Percent increase
Highest income of bottom 40 percent.....	\$4, 599	\$5, 199	13
Lowest income of top 10 percent.....	11, 090	13, 700	24

While other causes may also have been at work in bringing about the above results, the disproportionate growth of property income and the corresponding lag of employment income were undoubtedly major factors. Nearly three-fifths (59 percent) of all income from capital went to families in the top-income tenth in 1964, and only one-eighth (12 percent) to those in the four-tenths of all families at the lower end of the income structure.

Income increases for families headed by managers and officials were far greater than for families of other groups of nonfarm employees, white collar and blue collar.

Occupation of family head	Percent increase from 1960 to 1964 in—	
	Median income	Income at third quartile point <sup>1</sup>
Managers, officials.....	31	88
Clerical, sales.....	14	4
Craftsmen, foremen.....	21	22
Operatives.....	18	25
Laborers, service workers.....	11	15

<sup>1</sup> Lowest income received by any family in the 25 percent of the group with the highest incomes.

Property income undoubtedly played a significant part in the sharp increases in incomes of managers' and officials' families. Disproportionately large increases in their salaries, quite likely, helped to heighten the contrast with the lesser gains of other nonfarm employees.

8. *From December 1965 to December 1966 the Consumer Price Index rose 3.3 percent with the result that workers limited to 3.2 percent guideline wage increases suffered declining living standards in the face of rising productivity.*

During the months from January to August 1966, the Consumer Price Index rose at an annual rate of more than 4 percent. It was only after August that wage rates (as reflected in the index of hourly earnings in manufacturing excluding overtime and inter-industry shifts) began to accelerate their previously creeping rate of increase.

9. *Contrary to widespread impression, prices charged for manufactured goods have contributed substantially to the increase in living costs.*

The Council of Economic Advisers, in its September 12, 1966, statement and elsewhere, has fostered the impression that prices of manufactured goods have had little to do with rising living costs. It has put major emphasis on increases in farm income and on the wage gains of workers in the low-wage service industries and in other nonmanufacturing industries where unions exercised "market power." However, wholesale prices of finished manufactured goods other than foods increased 3.1 percent from the second quarter of 1960 to the same quarter of 1966. This increase in wholesale prices contributed materially to the rise in living costs, directly and indirectly, although increases in retail markups may also bear part of the responsibility. (Consumer prices of all commodities except food, which consist overwhelmingly if not entirely of manufactured goods, increased 4.1 percent during the same period.<sup>1</sup>) Manufactured goods, excluding food, accounted for 43.5 percent of the total weight in the CPI as of December 1963, when the index was last revised.

10. *The increase in wholesale prices of manufactured goods occurred despite a decrease in unit labor costs which, under the guideposts, should have led to price reductions.*

As late as July 1966, unit labor costs in manufacturing industry were still below the 1960 average. Had the decrease in unit labor costs been reflected in price reductions, a significant proportion of the rise in the Consumer Price Index would not have occurred. If, in addition, excessive prices had been reduced, the rise in the CPI would have been even smaller.

11. *Rising prices of manufactured goods in the face of declining unit labor costs raised the ratio of wholesale prices to unit labor costs to the highest level since the speculative inflationary boom set off by the Korean war.*

The index of that ratio (1957-58=100) rose almost steadily from 100.4 in November 1963 to 105.8 in July 1966, the highest level reached since June 1951. This index shows indisputably that labor costs provided no excuse for price increases.

<sup>1</sup> Information obtained by telephone from BLS; the published CPI figures for "Commodities Less Food" include home purchase costs since 1964. Such costs were excluded in computing the above figure.

12. While the index of labor cost per unit in manufacturing declined, profits per unit increased.

As of 1965, profits before taxes per unit were approximately 25 percent higher than in 1960. As of the second quarter of 1966, profits per unit were approximately 20 percent higher than in the second quarter of 1960—the peak of the last business cycle. (These figures are given as approximations because erratic fluctuations in corporate profits per unit suggest that the available data do not permit precision.)

13. The increased ratio of profits to sales confirms the fact shown by estimated profits per unit that costs other than labor costs did not justify the increases that had been made in the prices of manufactured goods.

	Profits as percent of sales <sup>1</sup>	
	Before taxes	After taxes
Year:		
1960.....	8.0	4.4
1965.....	9.4	5.6
Second quarter:		
1960.....	8.4	4.6
1966.....	9.9	5.9

<sup>1</sup> FTC-SEC data.

14. Manufacturing corporations' rates of profits on net worth showed, similarly, that their price increases were not necessitated by higher costs but rather were designed to increase profits.

	Profits as percent of net worth <sup>1</sup>	
	Before taxes	After taxes
Year:		
1960.....	17.2	9.5
1965.....	22.8	13.5
Second quarter (annual rates):		
1960.....	18.5	10.2
1966.....	25.7	15.3

<sup>1</sup> FTC-SEC data; profits divided by net worth as of end of preceding year.

The rate of profit on net worth, after taxes, increased 50 percent from the second quarter of 1960 to the same quarter of 1966.

15. If manufacturing wage and salary earners had been compensated (in addition to their actual gains in wages and fringe benefits) for the increase in the cost of living from the second quarter of 1960 to the second quarter of 1966, manufacturing corporations would still have had a rate of return on net worth significantly higher than in the earlier period.

The Consumer Price Index increased by 9.4 percent from the second quarter of 1960 to the same quarter of 1966. Compensation of manufacturing employees in the latter quarter was at the rate of \$143 billion per year. Adjustment for the 9.4 percent increase in living costs would therefore have cost \$13.4 billion. Manufacturing corporation profits before taxes in the second quarter of 1966 were \$14,014 million—equal to an annual rate of \$56.1 billion. The assumed cost-of-living wage increase would have reduced such before-tax profits to \$42.7 billion. Based upon the 40.2 percent effective tax rate implicit in the FTC-SEC data, profits after taxes would have been \$25.5 billion—56.4 percent higher than in the second quarter of 1960. Profits in that amount would represent a rate of return on net worth (as of the beginning of 1966) of 11.7 percent compared to the 10.2 percent actual rate in the second quarter of 1960.<sup>1</sup>

<sup>1</sup> These calculations are subject to some error since the FTC-SEC profit data used are not seasonally adjusted and are not strictly comparable with the Commerce Department's employee compensation figures. (Quarterly Commerce Department data on manufacturing profits are not available without adjustment for inventory valuation and there are no Commerce Department data on the net worth of manufacturing corporations.) Nevertheless, the calculations undoubtedly present a reasonably good reflection of the facts.

The above calculations on the ability of manufacturing corporations to absorb cost-of-living wage increases were originally made to check the validity of an assertion made by the Council in the statement of September 12, 1966, previously mentioned. At that time, as noted, the Council contended that the increase in the consumer price level was due largely to gains made by farmers and by low-wage service workers which, it argued, were desirable from a policy standpoint, as well as by certain nonmanufacturing workers exerting their "market power." (It mentioned, but played down, the role of price increases by corporations which had no basis in the levels of costs or profits.) The Council argued that the gains of farmers and low-wage workers were desirable from a policy standpoint—which they were<sup>2</sup>—and then, in effect, concluded that higher-wage workers should pay for those gains. (The Council apparently assumed, contrary to some of its own earlier statements, that farmers and low-wage workers can make gains only at the expense of other workers.) It then went on to say:

"The import of all this for the strongly organized workers in manufacturing is clear: *If workers in manufacturing attempt to catch up with the past rise in consumer prices in order to achieve real wage gains equal to the trend in overall productivity, a sharp rise in manufacturing prices can be avoided only by an appreciable squeeze of manufacturing profits, . . .*" [emphasis in the original]

This statement is contradicted by the figures cited above. They show that if manufacturing workers—wage and salary alike—had caught up with the cost of living, profits would have been reduced from extraordinarily high levels resulting from unjustifiable price increases and refusals to reduce excessive prices, but, far from being "squeezed", they would still have represented, in the second quarter of 1966, rates of return significantly higher than in the peak quarter of the last business cycle. Even if that were not the case, there would still be a question as to whether the living standards of manufacturing workers' families or profits should bear the adverse effects of the increase in the price level.

#### *Effect on workers' standards*

As the inequities described above evolved, workers inevitably became more restless with them. The Council notes that wage settlements tended to increase as the year progressed, particularly in the second half of the year. However, all wages changes effective under major collective bargaining agreements in 1966, including those due under contracts negotiated in earlier years, averaged 3.3 percent. This was exactly equal to the increase in consumer prices from December 1965 to December 1966. Obviously, even after allowance is made for increases in fringe benefits that may have been somewhat higher in percentage terms, the average worker's share in the economy's productivity gains last year was negligible, and for many workers the year brought a reduction in living standards.

In four of the five industry divisions for which the Bureau of Labor Statistics produces data on real spendable weekly earnings, the buying power of the average worker's take-home pay, expressed in dollars of 1957-59 buying power, was less than it had been a year earlier. Between December 1965 and December 1966, for a worker with three dependents, real spendable average weekly earnings in mining fell from \$102.32 to \$101.20; in manufacturing they fell from \$89.75 to \$88.13; in wholesale and retail trade, from \$64.63 to \$64.17; and in finance, insurance, and real estate, from \$74.59 to \$73.23. Only in contract construction did real spendable weekly earnings rise a few cents, from \$111.77 in December 1965 to \$112.35 in December 1966.

It is true that take-home pay levels were affected by the increase in the Social Security tax, but even gross real weekly earnings dropped in two of the industry groups, manufacturing and finance, insurance and real estate, and in a third group, wholesale and retail trade, rose by only 24 cents per week.

#### *Cost-of-living escalators*

The year 1966 thus demonstrated to millions of workers the need for cost-of-living wage escalator provisions in their contracts in order to protect their families' living standards against the inequities illustrated above. The evidence is clear—workers' wage and fringe benefit gains did not initiate the rise in prices.

<sup>2</sup> The gains to farmers, however, apparently went disproportionately to those operating large farms rather than to impoverished small farmers.

Workers, rather, were the innocent victims of it. Escalator clauses would have prevented erosion of the buying power of their wages.

In the face of these facts, the Council nevertheless decided this year, for the first time, to make a direct attack on the cost-of-living escalator principle. It said:

Although the Council recognizes that some allowance will frequently be made for higher living costs in 1967 settlements, it continues to believe that arrangements which automatically tie wage rates to changes in consumer price indexes will contribute to inflation. One union may be able to protect its members in this way against any deterioration in its real wage or any real impact from increased indirect taxes. But it does so only by imposing more of the burden on others. And if all unions—and other groups in society—were to succeed in tying compensation to consumer prices, the arrangement would become a vast engine of inflation, which, once it began to roll, would continue to gain speed.

We reject this conclusion for it flies in the face of the economic facts. As has been demonstrated above, manufacturing industries, to give one example, could very well have afforded to compensate their workers out of profits for increases in the cost of living, and would still have had profits at very high levels. All the above-quoted paragraph says is that if the employers had so compensated their workers, but had then used their market power to regain that money from consumers by driving up prices, and so protect their already inflated profits, prices would have gone up further. In short, if groups other than workers achieve gains for themselves by causing inflation, the workers have no right to try to restore equity.

#### *The UAW's position*

The UAW has had provision for quarterly adjustment of wages in accordance with changes in the Consumer Price Index in its contracts with General Motors since 1948, and with other major corporations since 1950. These clauses have provided for UAW members and their families a measure of equity for which those not so protected have all too often had to fight on the picket line. The members of the UAW are of no mind to surrender their escalator clauses and see their living standards eroded.

I tried to make that clear—to the Council, to the auto corporations, and to the nation—on the day the Council released its Report. I said:

"The families of UAW members in the automobile, aerospace and agricultural implement industries have had the protection of cost-of-living escalator clauses for many years—in some cases since 1948. Such clauses are a basic part of the wage structures of the industries involved and an essential precondition for industrial relations stability in those industries. The UAW in the past has successfully resisted all efforts to tamper with cost of living protection for its members and it does not intend to permit any tampering in 1967 by the corporations or by anyone else. We will not depart from the escalator principle in this year's negotiations nor will we tolerate any weakening of its implementation.

"The UAW has consistently followed the policy of negotiating gains for its members out of the rapid technological progress and the profitability of the major corporations for which its members work without causing any necessity for price increases. We have adhered in practice to the principle that UAW members and their families should make progress with the community and not at the expense of the community.

"The major auto corporations have not shared the fruits of their great gains in productivity with consumers in lower prices. The UAW has demonstrated time and time again that these corporations could, at the same time, reduce prices to consumers, provide increased wages and improved benefits to their workers, and still earn more than satisfactory profits for their stockholders.

"The Council of Economic Advisers should remember that escalator clauses remain inoperative—no worker gets a penny out of them—unless prices rise first.

"The Council, therefore, would better serve the interests of the national economy and the American people by focusing its attention upon the price-profit policies of the major corporations in America rather than by seeking to place the major burden of avoiding inflation upon workers and their families."

#### *Escalator is not inflationary*

The Council's position on escalator clauses is not only indefensible from the standpoint of equity; it is poor economics. The economic defense of cost-of-

living wage escalation has been made many times. It is enough for purposes of this statement to quote one leading industrialist and one outstanding economist. The late C. E. Wilson, who subsequently became Secretary of Defense under President Eisenhower, and who, as president of General Motors, pioneered with the UAW in establishing the escalator-improvement factor wage formula, was quite sure that he was not, by so doing, establishing an engine of inflation. Indeed, addressing the National Press Club on June 8, 1950, and discussing the new five-year agreement signed with the UAW he said: "The cost-of-living formula by which wages are adjusted every three months is a continuation of the same principle used in the 1948 agreement, applied in the same way. This provision protects our employees against inflation *but in itself is neither inflationary nor deflationary*, but follows what other pressures have forced on the national economy." (emphasis added)

In much the same vein he wrote in *Reader's Digest* for September 1952: "I contend that we should not say 'wage-price spiral'. We should say 'the price-wage spiral'. For it is not primarily wages that push up prices. It is primarily prices that *pull up wages*." [emphasis in the original]

A much more recent defense of the escalator principle was made by one of America's great economists, Professor Alvin H. Hansen of Harvard University, in the magazine *Challenge*, November-December, 1966.

What he had to say on the subject is well worth quoting at length:

"Inflation-proof arrangements need not necessarily exert an upward push on costs. Escalator wage contracts prevent *immediate* wage demands based on anticipated cost-of-living increases.

"Such arrangements redistribute rather than add to aggregate income. By and large, they take income from the inflation-advantaged group and give it to the inflation-disadvantaged group. But these measures are not inflationary *per se*. And they will become increasingly necessary in a high-pressure, full-employment economy.

"Living, as the whole Western world does, in an age of creeping inflation, the impact of this fact upon expectations becomes obviously a crucial matter. As I have already noted, there appears to be no evidence in advanced countries that creeping inflation necessarily leads to runaway inflation. How can one account for this fact?

"In a perfectly fluid free market we should expect a rapid escalation of any inflationary movement. But the price system, fortunately, is not perfectly fluid. If it were, any movement away from equilibrium would rapidly cumulate. Not only is the system far from being fluid, it is in fact a network of contracts, partly legal and partly behavioristic. Inertia plays a big role. Any movement away from equilibrium makes headway against a sticky mass. The result, fortunately, is a lagged adjustment to change.

"What implications do these considerations have for the commonly held view that cost-of-living escalator clauses in collective bargaining contracts tend to accelerate creeping inflation? In my opinion, this view is a mistaken one.

"Take the recent abortive contract (the one turned down by the membership) between the airlines and the machinists union. Aware of the continuous, though moderate, upward trend of consumer prices throughout the past 18 years, the union demanded a cost-of-living escalator clause. The airlines stood firm against this. The union, fearful that a consumer price rise of, say, 2.5 per cent or more, might largely nullify any intended increase in real wages, demanded, and was granted, still higher wages as compensation for surrendering the escalator clause. The revised (and finally accepted) contract was far more generous than the first. It provided both higher wage rates *and* an escalator clause, and crashed right through the Administration's wage guideposts. Thus, with or without the escalator clause, the expectation of creeping inflation affected the proposed settlement.

"Higher wages, paid in *anticipation* of price increases, come immediately into play, and so at once operate to intensify inflationary pressures. *Future* wage increases, paid in accordance with an escalator clause, come *after* consumer prices have risen. Escalation validates a price increase that has already taken place, but is not the *cause* of the price increase that has already occurred.

"The lag is highly important. Stability in a market economy is largely a function of lagged adjustments. At all events, there is no escape from the perfectly reasonable demand of workers that the Consumer Price Index must somehow be taken account of in wage contracts. It makes more sense to make the adjustment *after* the event than to force the issue before the event.

"Clearly, the modern inflation problem presents many conflicting and often irreconcilable factors. What then? Should we abandon the wage-price guideposts? I think not. We do need a thorough overhaul of the statistical foundations upon which the guideposts rest, and we need to clarify our concepts, and our goals, with respect to price stability. But as broad-gauge directives, the guideposts do point to basic relationships which cannot be ignored. The guideposts should be perfected, not abandoned.

"Improved guideposts, Presidential authority to raise or lower taxes within specified limits and, finally, monetary policy working in tandem with fiscal policy, could give us full employment *and* 'reasonable price stability.' In the meantime, let us not blame our inflationary pressures on the New Economics." [emphasis in the original]

While I would not presume to speak for Professor Hansen, I have a strong feeling that when he refers to "improved guideposts" in the last paragraph of his article, he is thinking of some form of incomes policy rather than anything as inequitable as the guideposts. Earlier in the same article, after mentioning price increases resulting from food shortages, he wrote:

More serious is the recent rapid rise in the prices of manufactured goods despite continued stability in unit labor costs.

The reason for these prices hikes is quite simple. Profits soared in 1966 beyond the wildest dreams. And a guidepost policy is always in deep trouble when profits in relation to wages get out of line.

#### *Bargaining over income shares*

In past years, the Council's Reports have invariably repeated in one form or another a point to which it attached so much importance that it was stated and restated at three separate places in its original 1962 presentation of the guideposts. The 1962 Report said:

On page 186:

"\* \* \* there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes."

On page 188:

"The proportions in which labor and nonlabor incomes share the product of industry have not been immutable throughout American history, nor can they be expected to stand forever where they are today. *It is desirable that labor and management should bargain explicitly about the distribution of the income of particular firms or industries.* It is, however, undesirable that they should bargain implicitly about the general price level." [emphasis added]

On page 190:

"Finally, it must be reiterated that collective bargaining within an industry over the division of the proceeds between labor and nonlabor income is not necessarily disruptive of over-all price stability. The relative shares can change within the bounds of noninflationary price behavior."

That point, which seems to me to spring from the most fundamental principles of a free society, is, for some unaccountable reason, missing from this year's Report. Yet, bargaining over income shares is not only an essential attribute of a free society; it can also serve valuable economic purposes. There has been discussion in these hearings on the question of whether the existing distribution of income in the U.S. economy is consistent with sustained full employment. There are reasons to believe it is not, and that the inconsistency has been worsened by the distortions in income shares resulting from recent price increases. Collective bargaining can be a powerful instrument for dealing with that problem.

From a longer-run standpoint, it is desirable that income shares should change to offset the effect on total demand of the increasing productivity of capital. As was pointed out in a recent Brookings Institution study, with technological progress reducing the capital required per unit of output, business fixed investment demand will tend to be smaller in the future in relation to any given level of output than with today's technology. The resulting deficiency of demand will have to be made up either by increased government spending, or increased consumption, or a combination of both. Collective bargaining over income shares can help to provide the required increases in consumption.

Particular importance attaches to bargaining over income shares in 1967 because, as the Council's Report says:

"To assume [sic; probably intended to be 'assure'] steady movement toward price stability in 1967, the public interest requires that producers *absorb cost*

*increases to the maximum extent feasible, and take advantage of every opportunity to lower prices.*" [Emphasis added.]

Among the cost increases that corporations obviously should absorb, although the Council refrains from saying so explicitly, are the cost of wage increases required to restore equity for workers in the face of rising prices and inflated profits. As the Council says, profits of manufacturing corporations:

"\* \* \* were higher for the entire year [1966]—at least as a percentage of equity—than in any prior year since the highly inflationary year of 1950."

These profits, result, to the extent that they are not the consequence of other forms of abuse of administered pricing power, from the refusal of the corporations to share the gains from rising productivity with consumers and workers. The Council, in this connection, repeats from its 1964 Report a point that is highly pertinent to negotiations this year in the automobile and many other industries:

"\* \* \* there is no justification, on either economic or equity grounds, for distributing above-average gains in productivity exclusively through the profits channel."

If the corporations refuse to share their productivity gains with consumers in reduced prices, and the Council is unable to persuade them to do so, there is no basis in justice or morality to stand in the way of workers who seek to share in them.

The Council laments that extra gains in wage increases and fringe benefits, although legitimate under such circumstances, "might tend to spread to other industries." That is most unlikely if the other industries' profits do no permit absorption of the costs involved. *But one way out of the "unattractive dilemma" which the Council poses—since the other, price reduction, has not materialized—is to encourage profit sharing in such situations.*

#### *The auto industry example .*

The automobile industry is the most persistent and flagrant violator of the principle that there is no justification for "distributing above-average gains in productivity exclusively through the profits channel."

Table B-68 on page 292 of the Council's Report shows ratios of profits after taxes to stockholders' equity for 22 manufacturing industries for the 19 year period 1947 through 1965, inclusive, plus quarterly data for part of 1966. In 13 of those 19 years, the "motor vehicles and equipment" industry, as it is called in the table, showed a higher profit rate than any other industry—often by a substantial margin over the next highest. (The relatively low rate shown for the third quarter of 1966 reflects the prolonged model change shutdowns in that quarter. The industry's third-quarter profits normally dip because of model changes.)

The automobile industry's Big Three—General Motors, Ford and Chrysler—account for 87.6 percent, \$3,064 million out of the \$3,496 million, of the total profits, including those of the auto parts corporations, reported for the industry in 1965 by the Federal Trade and Securities and Exchange Commissions which compile the data on which the Council's table is based. *The Big Three's combined after-tax rate of return in 1965 on their aggregate net worth as of the beginning of the year was 24.1 percent—not far from twice the 12.9 percent average of all U.S. manufacturing corporations other than those in the auto industry.* General Motors' rate was 28.0 percent; Ford's 17.5 percent; and Chrysler's, 20.8 percent.

Time and time again, in meetings and in correspondence, the UAW has urgently pressed the Council to use its influence to persuade the auto industry to reduce car prices, which were and are clearly in violation of the guideposts. All such efforts have been unavailing.

In fact, the Council's Chairman has come close to publicly defending the industry's profits. On a "Face the Nation" program broadcast September 26, 1966, he was asked about the price increases which the auto corporations had just announced. He said, "We are disappointed." But then he went on to add:

"I would point out that the '67 models are different cars from the '66 ones, and that one can't compare the prices directly. In particular there are a lot of new safety items on the new models."

Asked about the possibility that the industry might be able to cut prices and still maintain "a pretty good profit level", Mr. Ackley confined his reply to the following:

"Well, the automobile industry is a highly profitable industry, *although its profits in 1966 are running below those of 1965.*" [emphasis added]

I would hope that the government's economic experts would always be careful to give the public a carefully balanced presentation on all important issues. I submit, however, that Mr. Ackley's statement of the auto industry's side of the case was out of balance with the inadequacy of his statement of the public interest side of the case.

This year, for the first time in any of its Reports, the Council has finally taken public notice of price abuses by the auto corporations. It says:

"It is clear that some significant price reductions which the guidepost would have suggested have not occurred. *Automobile prices are doubles such a case.*" [emphasis added]

*The UAW will welcome and support any action the Council takes to bring about reduction of auto prices.* Reductions of auto prices would not only be a contribution to overall price stability. They would result in increased sales and production of cars and thus in increased employment not only for auto workers but for others in the steel, rubber, glass, electrical, copper, aluminum, plastic and many other industries that supply the auto corporations.

The Council notes also that "automobile wages advanced at a rate much above the guidepost." But, it fails to note that, not only were part of the auto wage increase needed to protect the industry's workers against the rise in the price level; the additional above-guidepost amounts gained by the workers were fully in accord with the Council's own principle that the auto corporations had "no justification on either economic or equity grounds" for distributing their above-average productivity gains "exclusively through the profits channel."

In 1965, the automobile industry, including the parts supplier, *could have increased the wages, salaries and fringe benefits of all its employees by a staggering 29.1 percent and it would still have had profits after taxes equal to the 12.9 percent reported by all U.S. manufacturing corporations other than those in the auto industry.*<sup>1</sup>

The UAW has repeatedly committed itself publicly to take account in negotiations of price reductions that might be put into effect by the auto corporations and to confine its demands to amounts that could be paid without creating any necessity for restoration of such price cuts, and without reducing profits below a reasonable level. That commitment is still in effect.

#### *Income policy*

It is apparent that the guideposts have ceased to be of any practical value. An examination of the causes of their breakdown may be useful in the formulation of a new, sounder, more equitable, and therefore more viable stabilization policy. For a policy there must be. While fears of inflation in the United States have been grossly exaggerated and have led the Nation into unduly restrictive actions, the fact remains that the United States is not immune to the problems that beset all other industrialized nations as they try to reconcile full employment and price stability.

The guideposts broke down, in my opinion, primarily for three reasons:

1. *The manner of their inception was unsound.* Instead of being formulated with the active participation of the parties who were expected voluntarily to comply with them, they were promulgated from on high by the Council of Economic Advisers. Secretary of Labor Wirtz has aptly described them as "stabilization without representation."

2. *The wage guidepost has been interpreted and applied rigidly and inflexibly without regard to the facts of the specific situation.* As the President's Advisory Committee on Labor-Management Policy found it necessary to remind the Council in a statement adopted August 18, 1966, the original presentation of the guideposts included numerous qualifications and exceptions based upon considerations of equity and flexibility. In practice, 3.2 percent became the magic touchstone by which all wage settlements were judged, evoking from the President's Committee the obvious but necessary comment that:

" \* \* \* it is impartial if not impossible to translate the goals reflected in the guideposts into formulae for application to every particular price or wage decision."

<sup>1</sup> The Commerce Department employee compensation data and the FTC-SEC profit and net worth data on which these calculations are based are not strictly comparable but the result shown above is undoubtedly reasonably within range of the facts. Figures for 1966 are not yet available.

(The comment clearly is more applicable to the manner of implementation of the wage than of the price guidepost.)

3. *The guideposts have given rise to intolerable inequities because they were not symmetrical either in concept or in application.* For example:

(a) Only one form of income—wages—is covered directly by the guideposts, and then only when determined through collective bargaining. Wage and salary increases put into effect unilaterally by nonunion employers are not covered. Certain other forms of income—e.g., interest, professional income, capital gains, executives' salaries and bonuses—are completely untouched. The attempt to restrain still other forms of income—profits and dividends—is indirect and based on vague criteria concerning prices.

(b) The wage guidepost has been translated in practice into rigid, decimal-point arithmetic. In contrast, the industry productivity figures which are supposed to guide price decisions are nonexistent for many important industries and are known only to the experts where they do exist. Thus, the public, which is asked, in the language of the Council's 1962 Report, "to judge whether a particular wage-price decision is in the national interest", has been told all to explicitly—and in grossly oversimplified terms—when it should frown upon a wage settlement. But that same public has no basis for judgment with respect to specific price increases or refusals to reduce excessive prices. The Council admits in its 1967 Report that even it—let alone the public—"ordinarily does not have the detailed information which would permit a clear judgment as to the appropriateness of the proposed price change on either the basis of the guidepost standards or other relevant considerations."

(c) Wage-setting through collective bargaining is a bilateral process while price-setting is unilateral. Wage negotiations are often conducted in the glare of publicity, with the employer able to gain public and government support in resisting union demands in excess of the guidepost percentage. Price-setting, on the other hand, is not only unilateral but private, with the consuming public and, in most cases, the government aware of the pricing decision only after it has been made.

(d) The wage guidepost has been interpreted by the Council of Economic Advisers to apply to nominal rather than real wages. The Council's Chairman has said, "The guidepost arithmetic doesn't change simply because prices have been going up." The Council's 1967 Report, as noted, criticizes escalator clauses which protect workers' living standards (after a lag) against the effects of *prior* price increases. In contrast, an escalator clause is explicitly provided for corporations; the price guidepost allows an exception for increases in unit material costs that "significantly impair gross profit margins." Impairment of the living standards of workers' families is apparently considered less serious than impairment of profit margins. The effect of applying guidepost arithmetic to nominal wages is to penalize workers for corporation price decisions that violate the guideposts. During 1966, living costs rose 3.3 percent, which means that workers confined to guidepost wage increases *suffered declining living standards in the face of rising national productivity.* The families of the nation's wage and salary earners were asked to forego their share of the gains from rising productivity while those who violated the price guideposts were permitted to enjoy undisturbed the fruits of their irresponsibility.

(e) The Council has not hesitated to condemn publicly specific collective bargaining settlements alleged to violate the guideposts. While a few price increases have been criticized, and some rolled back, the Council has never singled out for similar public condemnation any corporation whose excessive prices and profits were clearly in violation of the guideposts and should have been reduced. In its 1967 Report the Council states, "In general terms, the greatest failure of observance of the price guidepost lies in the failure to reduce prices on a considerable number of the product lines of a large number of industries." Nevertheless, while the same Report says the Council became involved during 1966 in approximately 50 cases of price *increases*, it makes no mention of any instance in which it has sought *reduction* of an existing price.

The lack of symmetry as between wages and prices and as between income from employment and income from property fostered the development of serious inequities, some of which are documented in an earlier section of this statement. Ironically, as that documentation shows, wages—the only form of income to

which the guideposts directly apply—made no significant contribution to the upsurge of prices that began at the wholesale level in late 1964 and at the consumer level early in 1965. As illustrated by the course of unit labor costs in manufacturing, wages, salaries and fringe benefits began to outpace productivity—in money but not in “real” terms—only in response to *previous* price increases that had deprived workers and their families of their share of the fruits of advancing productivity. The irony is compounded by the fact that the objective is *price* stabilization—wages are covered only as a means to that end.

The foregoing diagnosis of the causes of the breakdown of the guideposts indicates what must be done if a new and workable stabilization policy is to be developed. The parties chiefly responsible for adherence to the policy must be actively involved in formulating it; the policy must be flexible enough to allow reasonably for the almost infinite variety of the specific situations to which it will apply; and, above all, it must deal equitably and impartially with all forms of income. As the President’s Labor-Management Committee said in the August 18, 1966, statement previously mentioned:

“We believe that in a free society any policy to achieve price stability will be acceptable and effective only if it bears equitably on all forms of incomes.”

*From wage policy to incomes policy*

The experience of the United States with the guideposts is by no means unique. Other democratic countries have attempted—and similarly failed—to stabilize their price levels through the application of policies aimed primarily at wages. They have found it necessary to place increasing emphasis on nonwage incomes. They have moved from wage policy toward “incomes policy.” Instead of focusing upon the relationship between wages and productivity, they have come to stress the relationship between *total money incomes and real national output*.

The Organization for Economic Cooperation and Development (OECD), of which the United States is a member, has had a Working Party on Costs of Production and Prices studying stabilization policy in its member nations. One of the Working Party’s principal conclusions is directly pertinent to the current situation in the United States:

“\* \* \* experience shows that whatever may be the mechanism of cost inflation, wage earners will ask for some *quid pro quo* in return for any agreement to accept a more moderate increase in wages. As the Trade Union Advisory Committee has put it:

‘An argument can be made out for planning or guiding incomes; an argument can also be made for leaving them unplanned and unguided; but there it nothing at all to be said for planning or guiding half the incomes and leaving the other half unguided and unplanned and subject to market forces or varying degrees of monopoly control.’

“The existence of a policy for wages clearly gives this argument considerable weight. Those whose incomes are subject to restraint will naturally demand the establishment of criteria by which the inflationary or noninflationary behaviour of other incomes can be clearly established, and the assurance that action will be taken if the assumption that—discounting short period fluctuations—other incomes will follow the development of wages, turns out to be wrong. In other words, it is not enough for justice to be done—it must be seen to be done; and it must be seen that the government has the ability to intervene effectively in cases where intervention would be justified.”

An appropriate representative body—including labor, industry and the public—should undertake the task of developing a sound and equitable incomes policy. I have suggested that the President’s Advisory Committee on Labor-Management Policy set up a special task force of technical experts to explore this matter.

*Incomes policy and profit sharing*

As other democratic nations wrestle, individually and through OECD and the International Labor Organization (ILO), with the problems involved in developing and implementing an incomes policy, they are confronted insistently with the role of profits in the inflationary process. The Chairman of the OECD Working Party mentioned above, in introducing a study prepared for his group, wrote:

“During the preparation of its second report, the Working Party had several discussions on the role of profits in the process of cost inflation. It concluded that ‘While it is difficult to disentangle the role of different elements in total costs, it seems probable that the failure of cost reductions to be re-

flected fully or immediately in prices is an important feature of the process by which costs and prices are levered up under conditions of cost inflation.' *As a result of the work of the Experts, the Working Party feels that it should have been rather more positive about the role of profits.* In this connection, the evidence presented in Chapter VI of the Report suggesting a quite strong relationship between profits and changes in profits, and wage movements, is both interesting and significant. While this evidence is open to alternative interpretations, it seems to provide further support for the view that a successful incomes policy must cover prices, profits, and other non-wage incomes as well as incomes from employment." [Emphasis added.]

When workers see profits soar while they are asked to limit their wage gains, it is inevitable that they will raise questions of equity. The equity problem is aggravated by the heavy reliance of corporations on self-financing of their expansion through retained profits. If there were effective price competition, prices would be held close to costs, profits would be small, and funds for expansion would have to be raised in the capital market. The successful firm would be one whose rate of return on investment was high enough to attract new capital supplied voluntarily by savers, but not so high as to attract new competitors.

In practice, oligopoly and price leadership have replaced price competition, and the entry of new competitors is a virtual impossibility in many modern industries. Thus it becomes possible for corporations to set prices at levels that yield profits so high that resort to the capital market for financing is the exception rather than the rule. The real sources of capital become the consumer who is compelled involuntarily to supply investment capital by paying excessive prices and the worker whose wages are a smaller share of the firm's total revenues than he would have had if prices were competitively determined.

The automobile corporations provide glaring illustrations of this type of involuntary investment. The book value of stockholder equity in the General Motors Corporation, for example, increased by \$7.2 billion from the beginning of 1947 to September 30, 1966. Of this enormous increase, only 10.6 percent was financed through the sale of stock. The remaining 89.4 percent or \$6.4 billion represents profits retained in the business, the involuntary contribution made by consumers and workers. The Ford Motor Company's net worth increased by more than \$3.9 billion in the same period. Only 2.2 percent—less than \$100 million—was financed by the sale of stock. Workers and consumers contributed 97.8 percent of the new investment.

In such circumstances, neither the worker nor the consumer is given any recognition for his investment in the form of an equity in the firm or an income on the funds he has involuntarily provided. The stockholders obtain capital gains based upon the added net worth per share contributed by workers and consumers, and profits from the increased output made possible by that augmented net worth increase their dividend income. This is what makes "growth stocks" so attractive; they grow in value and in the size of dividends they pay based upon monies provided by persons other than their owners. They grow far faster than the wages of the workers employed by the "growth corporations."

Here again the auto industry offers illuminating examples which can be followed by comparing the incomes over a period of years of a stockholder and a worker who start out with equal incomes from the same corporation, the one from dividends and the other from wages. In 1947, at the wages then paid, the average General Motors worker would have received \$3,009 in wages if he were fully employed 52 weeks in the year. A stockholder who held 1,003 shares of GM stock at the beginning of 1947 would have received an identical \$3,009 in dividends that year.

By the end of 1966, the GM worker would have received a total of \$110,000 in wages, assuming that he was fully employed—never laid off—throughout the 20-year period. The investor, on the other hand, would have received \$278,000 in cash dividends, an amount more than two and one-half times as great as the worker's earnings. In addition, the investor would have had a \$345,000 gain in the market value of his investment as of the end of 1966. His total gain would have amounted to \$623,000, nearly six times the amount of the GM worker's earnings.

At Ford, a similar comparison can be made for the period from 1949 through 1966. An investor who at the beginning of 1949 held sufficient shares of Ford stock to yield a dividend income of \$3,536, an amount equal to the earnings of a fully-employed Ford worker in that year, would by the end of 1966 have re-

ceived a total of \$309,000 in dividends on these shares. This would be nearly three times as much as the wages of a fully-employed Ford worker, totaling \$106,000 during the 18-year period. In addition, the investor would have benefited from a \$475,000 increase in the "book" value of his share holdings. (Book value is used in this case because there was no market for Ford stock in 1949.) In all, the investor's gain would have been \$784,000, an amount nearly seven and one-half times as great as the worker's earnings. Inclusion of the value of the hypothetical worker's fringe benefits, which would be difficult to calculate precisely, would change the figures somewhat but not nearly enough to affect the validity of the point involved.

In recognition of the practical facts of modern economic life illustrated by the above examples, increasing attention is being paid in Western Europe, in connection with incomes policy, to the development of some method that would permit workers to participate equitably in the profits and the growing net worth of the corporations that employ them. (It is generally agreed that the theoretic alternative—a return to effective price competition and to reliance upon the capital market for investment funds—is not a realistic possibility.)

A recent publication of the ILO posed the issue as follows:

"\* \* \* precisely in periods of high employment, when the pressures for trade union moderation are strongest, profits are at their highest and may indeed increase further by restraint on the unions' part.

"As noted above these high profits are, of course, used to a large extent for investment and thus contribute to a faster rise in average living standards. But this is not an adequate answer, because *the process of reinvesting undistributed profits entails an increase in private wealth on the part of business owners and managers (but not of workers)* which in several countries has been very fast indeed during the post-war period. In so far as the justification for wage restraint and high profits lies in the need for providing investable resources, *it should be possible to achieve this result without the ownership of all the new capital accruing to shareholders, managers and directors.*" [emphasis added]

After discussing various profit-sharing proposals and problems connected with them, the ILO publication went on to say:

"On the other hand, distribution of profits among both sides of industry would appear less inequitable than their appropriation by one side alone. The existing distribution of income is by no means self-evidently just, and it would seem doubtful that any lasting system of wage policy could be acceptable to the trade union movement if it did not come to grips—whether through collective profit sharing or otherwise—with the grosser existing inequalities."

Profit sharing, in cash, or partly or wholly in the form of investment certificates or shares of stock to be issued to workers, is now beginning to be discussed in the United States as a noninflationary means of responding to the upward pull on wages exerted by inflated profits. Only a few days ago, an eminent American economist, Professor Neil Chamberlain of Yale University, was reported as saying:

"If we seek to hold wage increases to something in the vicinity of the national average increase in productivity, and if we are realistic enough to expect that the most we can expect from business on the price front is no price increases, but not actual price decreases, then we have a sure-fire recipe for above-average profits in those companies where there has been above-average productivity improvement. We can scarcely expect a successful hold-the-line policy on wages in such instances, *and some form of profit share or investment share or savings share may make good sense.*" [emphasis added]

If workers had definite assurance of equitable shares in the profits of the corporations that employ them, they would see less need to seek an equitable balance between their gains and soaring profits through augmented increases in basic wage rates. This would be a desirable result from the standpoint of stabilization policy because profit sharing does not increase costs. Since profits are a residual, after all costs have been met, and since their size is not determinable until after customers have paid the prices charged for the firm's products, profit sharing as such cannot be said to have any inflationary impact upon costs and prices.

#### *Democratization of ownership*

Profit sharing in the form of stock distributions to workers would help to democratize the ownership of America's vast corporate wealth which is today appallingly undemocratic and unhealthy. The Federal Reserve Board recently published data from which it is possible to estimate the degree of concentration in the ownership of publicly traded stock held by individuals and families as of

December 1962. Preliminary analysis of these data indicates that, despite all the talk of a "people's capitalism" in the United States, *little more than 1 percent of all consumer units owned approximately 70 percent of all such stock.* Fewer than 8 percent of all consumer units owned approximately 97 percent—which means, conversely, that the total direct ownership interest of more than 92 percent of America's consumer units in the corporation-operated productive wealth of this country was approximately 3 percent. Profit sharing in a form that would help to correct this shocking maldistribution would be highly desirable for that reason alone.

#### *The UAW and profit sharing*

It may be of interest in this connection that the UAW formally proposed profit sharing to the major automobile corporations as early as 1958. In addition to profit sharing for workers, the proposal included a provision for profit sharing rebates to consumers on the prices they paid for the corporations' products. In essence, the UAW proposed that, after meeting their basic wage costs and basic salary costs, and after paying basic dividends to stockholders, the corporation share the remaining before-tax profits, with one-half to go to stockholders and executives, one-fourth to go to wage and salary workers, and one-fourth to be rebated to consumers.

The UAW pointed out at the time that its proposed method for compensating workers was already being applied to executives and stockholders. The amount available for payment of executives' bonuses, in addition to their basic salaries, was and is determined by applying a percentage figure to profits in excess of a specified basic rate of return on investment. Stockholders received and continue to receive basic "regular" dividends which, in profitable years, are augmented by "extra" dividends.

It is certainly reasonable to ask: *Why should this method of compensation not be applied to workers as well as to stockholders and executives?* Why should not workers receive, in addition to their basic compensation reflecting the factors normally considered in negotiating wages and fringe benefits, a share in the profits that their labor helps to create?

The UAW was unable to persuade the corporations to agree to profit sharing in 1958. Their top management spokesmen reacted to the proposal hysterically and ideologically although they participated lavishly in the profit sharing plans for executives maintained by their respective corporations. General Motors described the UAW proposal as "foreign to the concepts of the American free enterprise system"—which, perhaps, explains why it has for years provided profit sharing for GM blue collar workers in Great Britain but not for those in the Corporation's home country.

The UAW did, however, negotiate a profit-sharing agreement with American Motors Corporation in 1961. Anticipating recent discussions in Europe, that agreement provided for part of the workers' share of the profits to be paid to them in the form of stock in the corporation. That American Motors is currently suffering losses rather than enjoying profits is neither attributable to profit sharing nor a reflection on its merits.

I commend profit sharing to the consideration of this Committee, the Congress, and the public as a potentially valuable feature of a sound and equitable incomes policy. This Committee might want to explore the possibility of developing legislation to encourage the negotiation of collective bargaining agreements providing for profit sharing.

#### *Profit sharing and collective bargaining*

If profit sharing is to be an element in stabilization policy, it will take on that role through collective bargaining.

At the same time, acceptance of the profit-sharing principle could greatly facilitate the collective bargaining process.

One of the most serious problems with which collective bargaining must contend—particularly now that long-term contracts are a common phenomenon—is uncertainty about the future. The parties to negotiations attempt to divide up a pie whose actual size cannot be known until after the end of the two, three or more years during which the contract will be effective.

The economic environment in which negotiations take place may provide a temporary advantage to one side or the other which it feels necessary to press to the limit, knowing the other party would do the same if the situation were reversed. Thus, if a contract is negotiated at the peak of prosperity, the workers

may be able to obtain gains that will impose heavy costs on the firm if the market for its products slackens. Conversely, a contract negotiated at the trough of a recession may saddle the workers for three years with wage and fringe benefit gains far smaller than those the company will actually be able to afford, and should in justice and reason provide, as recovery brings expanded volume, reduced unit costs, and greatly increased profits. Efforts of both sides to maximize long-term gains on the basis of purely temporary factors do not make either for healthy relations between the parties or for economically sound results.

Although not discussing profit sharing, Mr. Henry Ford, in a recent speech, put his finger on the heart of the problem which it would help to solve. He noted that present union contracts in the automobile industry will expire this year and that negotiations will take place in an atmosphere of declining sales accompanied by management expectations of increases in nonlabor costs. He went on to say:

"Management must necessarily focus mainly upon what is likely to happen during the next contract period, rather than the past.

"On the other hand, employee expectations have been formed—so far, at least—in an atmosphere of strong sales, rising employment to the point of labor market shortages, and rising living costs."

Profit sharing would resolve the conflict between management apprehensions and worker expectations on the basis of the solid economic facts as they materialize rather than on the basis of speculation as to what the future might hold. The actual size of the pie, rather than guesses about what its size will turn out to be, would determine how big the slices are that go respectively to stockholders, managers and workers (and, if a rebate feature is included, to consumers). All groups would be assured that none would be unfairly advantaged or disadvantaged for years to come merely because of the purely accidental fact that the economic climate at the time of negotiations happened to favor one or the other.

#### *Price-Wage Review Board*

The Price-Wage Review Board mechanism which the UAW has advocated for many years would be a useful instrument for the implementation of an equitable incomes policy. But its creation need not and should not wait upon the formulation of an incomes policy. There is a great deal of work for such a Board to do right now—as anyone knows who reads newspaper reports of price increases being put into effect by corporations already making record-breaking profits.

Two alternative methods could be considered for bringing such a mechanism into operation—legislation or executive action similar to that which brought about the cooperation of designated corporations in the so-called "voluntary controls" program for capital exports.

#### *Legislative approach*

Under the legislative approach, any corporation holding a dominant position which could be expected to give it price leadership in a key industry—for example, controlling 25 percent or more of the industry's sales—would have to give at least 60 days' notice to the Price-Wage Review Board of any intended price increase. The Board would have authority to call the company before it for a public hearing.

At such a hearing the Board would have the power to subpoena witnesses, company books and other pertinent documents and examine witnesses under oath so as to obtain all the pertinent facts, and following the hearing to publish its findings and recommendations and the facts supporting such recommendations.

The recommendations would be based upon a set of standards carefully designed to assure both equity to all affected parties and reasonable stability of the general price level.

The Board's recommendations would not take the form of binding determinations, however, and once the Board's report was published, the corporation would be free to act as it saw fit. But if the public were informed with facts and figures which made it clear that the price increase was not justified, it is highly doubtful that the corporation would attempt to effectuate such a price increase in the face of enlightened public opinion, which in a free society must more and more be mobilized to discipline voluntary decisions and make them publicly responsible. Indeed, just the knowledge that such an investigation

was probable would deter most large corporations from even proposing price increases unless they could in fact be justified.

The number of corporations that would be subject to such hearings procedures is relatively small, probably less than 100, for it would need to apply only to the one dominant company—the “price leader”—in each major administered price industry. If that company were restrained from raising its prices, the smaller ones would have to follow suit.

#### *Office of Consumer Counsel*

It has been suggested, as an argument against similar proposals, that under such a system corporations would never reduce a price because of the difficulties in the way of restoring the price cut if that should become necessary. And, in any case, a procedure that could be triggered only by a threatened price increase would fail to meet the problem posed by industries with above-average productivity gains which refuse to grant the price cuts they could well afford.

Both of these objections are met by the UAW proposal which calls for establishment also of an Office of Consumer Counsel. The Consumer Counsel would have two main functions. He would represent the interest of consumers in all hearings before the Price-Wage Review Board. And he would be authorized to initiate hearings when he had reason to believe that prices of any corporation subject to the procedure were already too high.

#### *Unions also subject*

Unions would also be subject to the hearings procedure when appropriate. Whenever a corporation subject to the procedure claimed that it would have to raise prices if it gave in to union demands, it could so notify the Board, and both the union and the corporation would then be summoned to a hearing and required to produce the relevant facts.

Account would have to be taken, of course, of circumstances which justify a wage increase even if it does require a price increase. If this were the situation in a given industry, the hearing would reveal it. But if the union's demands were not justified, that would be revealed. If, on the other hand, the company could well afford to grant them without raising prices, that fact would be made apparent. As in the case of a hearing involving a corporation alone, the Board would publish a report containing its findings and recommendations and the supporting facts. Both sides would then go back to the bargaining table free to act as they saw fit, but with the knowledge that the public had the facts, and was equipped to pass an informed judgment on the result of their negotiations. The union and the corporation alike would be subject to the same discipline—the need to accept full public responsibility for private, voluntary decisions which affect the public interest.

#### *Voluntary approach*

Under the voluntary approach, the President would designate existing agencies to perform the roles of Review Board and Consumer Counsel, respectively. Their functions would be the same as under the legislative approach except that they would lack subpoena power.

A list of perhaps a hundred corporations holding positions of price leadership in key industries would be drawn up, and they would be asked to notify the Board of any intention to raise prices. In this connection, it should be noted that the Council of Economic Advisers reports that some large companies have already agreed to give the Council advance notice of their intention to change prices. Or if the Consumer Council presented to the Board sufficient evidence to suggest that an existing price was too high, the corporation affected would be asked to appear at a hearing. If the demands of a union were involved in either case, the union would also be requested to appear. The hearings and report procedures would be the same as those outlined above.

One problem would have to be faced under the volunteer procedure. As previously noted, the Council of Economic Advisers implies in its Report that in the system of private meetings with companies which it has been using, it has experienced some difficulty in getting all the information it needs for evaluation of price decisions.

The difficulties of obtaining adequate information from reluctant and uncooperative witnesses under a voluntary system are obvious. However, the government has succeeded in obtaining pertinent data under the capital exports “voluntary controls” program, and we believe that an Administration which acted with sufficient determination could be equally successful in the area of

price-wage review. If in any individual case it were not, if a corporation simply refused to produce the data which would permit an informed judgment of its price proposals or current price levels, the administering agency would make this refusal known to the public, which would be able to draw its own conclusions as to the reason for such refusal.

#### *Advantages are obvious*

Either system would have obvious advantages over the guidepost approach. It would meet the problem raised by the President's Labor-Management Committee, that "it is impractical if not impossible to translate the goals reflected in the guideposts into formulae for application to every particular price or wage decision." It would permit, instead, a case-by-case approach in which recommendations would be based on the particular facts of each case, and would permit the application of the "subtleties, sophistication, experience, wisdom and responsibility" which, as the Secretary of Labor pointed out in these hearings, are required in making intelligent wage and price decisions.

The procedure would have one other far-reaching benefit insofar as it applied to situations arising out of union bargaining demands. It would go far to restore public confidence in the democratic process of collective bargaining—a confidence that is too often shaken when negotiations are broken by a damaging strike over issues which the public does not clearly understand, or when they end in a settlement that is then denounced as inflationary. In both situations, the public's only information may come through the conflicting claims and arguments of the two parties, with no opportunity to get at the real facts. Given the facts people would be able to pass rational judgment on the actions of both sides—and the knowledge of that would lead to more responsible actions at the bargaining table.

The advantage of this procedure is that it can stabilize prices without the necessity of imposing any form of governmental control. Price and wage actions would still be voluntary; they would be based on the free decisions of free men in a free society. But the privilege of being a free man in a free society is accompanied by the responsibility of making decisions that are compatible with the well-being of society. In the area of prices and wages, the price-wage review procedure would enable an informed public opinion to bring a persuasive influence to bear on those who might otherwise be prepared to disregard their responsibilities in the service of their personal or corporate interests.

#### *Full employment, inflation and taxes*

The Administration has proposed an increase in personal and corporate income taxes to take effect July 1, 1967. The arguments for and against this proposal deserve serious and responsible consideration on their merits; for it arises out of a complex background that presents difficult problems. No one can predict with certainty the precise course of economic activity in the months ahead; yet it is the state of the economy that will determine whether or not it will be advisable to raise taxes. It is our judgment, however, that current weaknesses in the economy could be compounded by a tax increase, causing increased unemployment, an unnecessary slowing down of the economy and, quite possibly, a budget deficit larger than would result if there were no tax increase.

The proposal to increase taxes has evoked a barrage of criticism of the Administration's tax policies past and present. On the one hand, the Administration is attacked for not having raised taxes last year. On the other hand, it is urged not to increase taxes this year but to curtail government spending for civilian purposes. Determination of a sound fiscal course for 1967 requires sober examination of these criticisms and of the pertinent facts in the light of the goals of the Employment Act.

The argument that taxes should have been raised last year ignores the fact that the rise in total demand during 1966 was significantly restrained by a variety of tax actions. Payroll taxes were increased, some excise taxes were restored, graduated withholding was introduced, corporate tax payments were accelerated, and the investment tax credit was suspended. Had fiscal policy in 1966 been more restrictive, one of the greatest economic and social gains of the year, the reduction of unemployment to 3.9 percent from 4.6 percent in 1965, would not have been achieved. In fact, as Secretary Fowler testified in these hearings, additional fiscal restraint would "have involved the risk of a recession in 1966 or early 1967." Higher taxes undoubtedly would have aggravated the many weaknesses that began to appear in the economy during 1966 despite the sharp increases in government spending arising out of the Vietnam War—

weaknesses that must be taken into account in efforts to evaluate the effects of the tax increase proposed for 1967.

The Administration has already cut government civilian spending in several areas. Many of those who now urge further cuts in preference to tax increase argue that higher taxes would cause a serious slowdown in economic growth or even a recession. This argument ignores the fact that the effect of reduced government spending on the level of demand and of economic activity is precisely the same as that of a tax increase. In addition, the proponents of spending cuts seem to overlook the point made by President Johnson in his budget message that only 11 percent of total administrative budget expenditures (14.2 percent if pay increases for government employees and the effect of the sale of assets are excluded) consists of what may be considered "controllable" civilian expenditures. Even among these, the degree of controllability is limited; and although some of the programs involved might be stretched out without social damage, a sharp reduction in the total of such expenditures would retard progress toward the Great Society. It would hit with disproportionate impact the same disadvantaged groups who would be the main sufferers from an economic slowdown or a recession caused by a cut in government spending.

Proposals to increase taxes must be evaluated on the basis of their probable effects on both employment levels and our national goals. We in the IUD and the UAW are prepared to give our enthusiastic support to tax increases designed to reallocate economic resources from less important private uses to more urgent public needs. We would not only support, we would urge, any equitable tax increases that might be required to transfer from the private to the public sector more adequate resources for education, urban redevelopment, elimination of environmental pollution, the poverty program, and similar high-priority purposes. Similarly, we would support selective tax increases designed to rechannel resources within the private sector from low-priority to higher-priority purposes or to diminish sectoral inflationary pressures. Selective taxation, for example, could be used under appropriate circumstances to discourage inventory speculation and an unsustainably high rate of business investment and to encourage diversion of the resources involved into housing. Suspension of the investment tax credit is a form of selective taxation.

#### *Effect on employment*

Tax increases do more than reallocate resources, however. Depending upon the relationship between the amounts of revenue raised by government and the amounts spent, tax increases also affect employment levels. This Committee, functioning as it does under the Employment Act, is obligated to ask: What bearing will a tax increase have on the goals of maximum employment, production and purchasing power? Is there any danger that it will perpetuate or cause an increase in present levels of unemployment? Will it, in combination with government spending, promote or retard fuller use of our productive resources?

The answers are apparent from the Council of Economic Advisers' Report. Basing its projections on the assumption that the proposed tax increase will be enacted, the Council, as previously noted, says that the unemployment rate in 1967 "should be essentially the same as in 1966, when it averaged 3.9 percent." *It follows that, assuming the Council's projection is otherwise valid, the unemployment rate would drop below 3.9 percent if there were to be no tax increase.* The Director of the Bureau of the Budget acknowledged that in these hearings.

It is clear from the Council's Report that the purpose of the proposed tax increase is not primarily to promote a better allocation of resources but rather to restrain the growth of demand. The Council calls for "a shift toward restraint in fiscal policy [as of mid-1967] . . . to assure that demand does not outrun capacity." The premise, obviously, is that by mid-year the economy will be "overheated" and will need "cooling off." In our view, there is serious question about the wisdom of the Council's position for we believe that the result will be to halt further progress on the unemployment front for fear of inflation.

As is evident from the current unemployment rate as well as from the capacity utilization rate noted later in this statement, however, the economy is not now operating at capacity. There are no persuasive reasons to believe that it will be doing so in the second half of 1967, even if there were no tax increase. Certainly, full utilization of capacity would be accompanied by an unemployment rate very substantially below the approximately 4 percent projected by the Council.

The ability of a modern industrial economy to reduce unemployment substantially below 4 percent and keep it consistently below that level has been established by the success of other free world countries in doing so. The table on the

following page shows unemployment rates, adjusted to conform to U.S. definitions of what constitutes unemployment, for seven other countries and the United States since 1959. Of the seven, only Canada has had a rate which even remotely parallels ours, and even it has been below ours for the past four years. France has had a rate below 3 percent for every year but one, when it rose to 3.1. West Germany has kept unemployment substantially below 1 percent since 1960. Unemployment in Great Britain has exceeded 3 percent in only two years out of seven. Italy has had a rate well below ours from 1960 through 1965, the latest year for which data are available. Japan has had a rate below 2 percent throughout, and at or near 1 percent for the latest four years. Sweden has also kept its rate consistently well below 2 percent. Public opinion in all of these countries would undoubtedly be shocked and revolted if it were suggested to them that 4 percent unemployment was acceptable.

*Unemployment rates adjusted to U.S. definitions*

[In percent]

Country	1959	1960	1961	1962	1963	1964	1965 -	1966
United States.....	5.5	5.6	6.7	5.6	5.7	5.2	4.6	3.9
Canada.....	6.0	7.0	7.2	5.9	5.5	4.7	3.9	3.7
France.....	2.8	2.7	2.4	2.5	3.1	2.5	2.8	(*)
West Germany.....	1.6	.7	.4	.4	.5	.4	.4	(*)
Great Britain.....	3.1	2.4	2.3	2.9	3.4	2.5	2.2	(*)
Italy.....	5.7	4.3	3.7	3.2	2.7	2.9	3.9	(*)
Japan.....	1.9	1.4	1.3	1.1	1.1	1.0	1.0	(*)
Sweden.....	(*)	(*)	1.5	1.5	1.7	1.6	1.2	(*)

<sup>1</sup> Data for countries other than United States and Canada are preliminary.

<sup>2</sup> Average, 11 months.

<sup>3</sup> Not available.

Source: Bureau of Labor Statistics; except for 1966 Canadian figure which is from Dominion Bureau of Statistics.

Because the Council calls last year's unemployment rate "substantially full employment" does not alter the fact that it is much too high and, under the mandate of the Employment Act, should be reduced. In our opinion, the Council's failure to chart a path toward a lower unemployment rate is an abdication of its primary responsibility under the Employment Act.

*Monetary policy and a tax increase*

Another argument advanced for a tax increase is that it would facilitate relaxation of monetary restraints. It is pointed out that the impact of tight money and high interest rates is highly uneven, with adverse effects falling most heavily on some of the nation's most urgent unmet needs. Housing, as the current depression in residential construction shows, is particularly vulnerable. The building of schools and of state and local government facilities, which are debt-financed in substantial part, is also made more costly and can be severely restricted by tight money.

While the identification of the victims of a restrictive monetary policy is accurate, the conclusion that a tax increase is the proper remedy is, to say the least, questionable. In the first place, the premise—the need for either monetary or fiscal restraint—is open to challenge so long as we remain as far from full employment as we are.

In the second place, there is no assurance that a tighter fiscal policy will lead to an easier monetary policy. The *Wall Street Journal* headline on the testimony of the Chairman of the Federal Reserve Board in these hearings said, "Easier Credit Wouldn't Necessarily Follow A Tax Boost, Martin Warns". The balance of payments might well serve as an excuse for keeping interest rates high or even raising them.

In the third place, the argument assumes that monetary policy must be used as a blunt instrument—that it cannot be applied selectively in accordance with national priorities.

In the fall of 1966, the Federal Reserve Board demonstrated that its vast powers enable it to control not only the total volume of credit but the directions in which credit flows. In the well-known letter of September 1, 1966, the presidents of the regional Federal Reserve Banks told member banks that they

would get short shrift at the discount window if they failed to "cooperate in the system's efforts to hold down the rate of business loan expansion." The action was taken pursuant to a Board regulation under which lending to member banks is to be made with:

\* \* \* due regard to the purpose of the credit and to its probable effects upon the maintenance of sound credit conditions, both as to the individual institution and the economy generally.

The same power, so far as we have been able to determine, can be applied positively as well as negatively to encourage as well as to discourage the extension of credit for specified purposes. *The Federal Reserve System could have told its member banks, and can still tell them today, that they will be given no consideration at the discount window unless they increase, or attain some target level with respect to, the proportion of their assets held in housing mortgages and in school board, state and municipal bonds.* If the requirements were made stringent enough, the member banks would be impelled to compete for such securities with the result that their interest rates would be markedly reduced.

Protection of national priorities dependent upon credit, therefore, does not require a tax increase but rather steps to assure that the Federal Reserve System will respect those priorities through selective application of its monetary powers. The shibboleth of Federal Reserve Board "independence" must not be permitted to be translated into veto power over national goals or national economic policy as expressed in the Employment Act.

#### *Effect on budget*

It is argued, also, that a tax increase—or a cut in government civilian spending—is necessary to reduce the size of the expected budget deficit. An effort to achieve a greater degree of balance in the budget, however, could unbalance the economy with the result that the actual budget deficit would be vastly greater than the one sought to be reduced. The Eisenhower Administration, ignoring serious weaknesses in the economy, submitted a budget for fiscal 1959 designed to yield a surplus of half a billion dollars. The restrictive nature of that budget retarded recovery from the 1957-58 recession. Unemployment rose as high as 7.5 percent and averaged 6.2 percent for the fiscal year. Reduced revenues and increased expenditures turned the anticipated half-billion surplus into a deficit of \$12.4 billion or approximately 2½ percent of GNP—equivalent to \$20 billion in terms of today's GNP. Current signs of weakness in the economy suggest at least a possibility that a tax increase or a cut in spending could produce a similar result in the period ahead.

#### *Signs of weakness*

It is fortunate that the proposed tax increase is not intended to take effect before the middle of 1967. There are already many signs of weaknesses in the economy that suggest at least a distinct possibility that by mid-year stimulus may be called for rather than restraint. The proposed effective date for the tax increase allows time for careful evaluation of developments to minimize the danger that the wrong remedy may be applied to the wrong ailment at the wrong time.

The danger of an increase in unemployment is very real. Such a development would not require a downturn in the economy to bring it about—a slowing up would be quite sufficient. As the Council points out, about 1¼ million additional job-seekers will be in the labor market this year. On top of that, productivity advance will require the creation of another 2 to 2½ million jobs at least. Thus, any slowdown in the rate of economic growth that would result in the creation of much less than 3¼ to 3¾ million jobs overall would probably mean rising unemployment.

The Council is already planning for a substantially smaller increase in Gross National Product (GNP) for 1967 than in 1966. Taking into effect the consequences of a proposed tax increase, the Council estimates that GNP will rise from \$740 billion in 1966 to \$787 billion in 1967—an increase of just under 6.4 percent. But of that, 2.5 percent or more will be the result of price increases, leaving only about 3.8 percent of real growth. This will be sharply down from last year's real growth rate of 5.4 percent. The Council describes it as "nearly in line with the 4 percent growth of potential" which would be necessary to keep unemployment from rising. Leaving aside the arguable point as to whether the growth in potential is not more than 4 percent, the difference between 3.8 and 4.0 could in itself mean rising unemployment.

The Council's forecast, and its recommendation for a tax increase in the second half of 1967, are based on its belief that overall private demand will be significantly strengthened in the second half of the year. The \$1½ billion increase in payroll taxes which went into effect the first of the year will be nearly offset by the reduction in personal income tax payments to be made in April as a result of the graduated withholding system instituted last year. An increase in Social Security benefits is proposed to take effect at midyear, with no increase in revenue from payroll taxes until 1968. With money less tight, construction should be recovering just as inventory investment starts levelling off. That is in brief the basis of the Council's belief that "A shift toward restraint in fiscal policy is appropriate at that time."

A look at some of the figures gives less reason to believe that the economy by midyear will be receiving as much stimulus as the Council anticipates. Its forecast is based in part, for example, on the assumption that real personal disposable income will increase by as much in 1967 as in 1966. But if it does so, it will be reversing a four-year trend. As the following table shows, real disposable personal income, both in aggregate and per capita, has increased by a smaller amount each year since 1963, in part a reflection of the lag in real wages referred to elsewhere in this statement. With an anticipated GNP growth less than that from 1965 to 1966, there is no strong reason to believe this trend will be reversed.

*Disposable personal income, 1963-66*

	Total <sup>1</sup>		Per capita <sup>2</sup>	
	Amount	Increase from previous year	Amount	Increase from previous year
1963.....	\$381.3	-----	\$2,013	-----
1964.....	406.5	\$25.2	2,116	\$103
1965.....	430.8	24.3	2,214	98
1966.....	451.5	20.7	2,294	80

<sup>1</sup> Billions of 1958 dollars.

<sup>2</sup> 1958 dollars.

Source: Council of Economic Advisers report.

In other respects the consumption picture looks less than bright. Retail sales are lagging. Recent surveys of consumer buying plans also suggest a tapering off in the rise in consumer spending. The rise in the personal savings rate in the fourth quarter of 1966 may be another sign of increasing consumer caution. Automobile sales are at disappointingly low levels. Production schedules have been cut back repeatedly during the past two months, and auto workers have suffered short workweeks and week-long layoffs, yet inventories remain disconcertingly high and may still rise higher, and further cutbacks in production seem not unlikely. Appliance production is also being cut back, and the lowered production of these two industries is beginning to be reflected in faltering demand for steel.

The Council's own figures on investment plans do not justify the optimism it displays for a pickup in the second half of 1967. It estimates that business fixed investment "should show a rise of about \$3 billion from 1966 to 1967." Business fixed investment in 1966 was \$60.56 billion, so the average for 1967 should be about \$63½ billion. But the Commerce-SEC estimates for the first two quarters of 1967 are \$63.45 and \$64.05 billion respectively. If the average for the year is to be \$63½ billion, that leaves no room for any increase in the second half at all.

Another factor may actually tend to reduce the level of business fixed investment in the second half of 1967. The suspension of the investment tax credit last year did not immediately affect the rate of investment to any significant degree, because it did not apply to commitments already made. By the middle of this year, however, the bulk of those investments will probably have been completed, and, in view of the restoration of the investment tax credit in 1968, new commitments will be withheld until after the end of the year whenever possible.

Inventories, according to the Council, are expected to level off in the second half of the year after a decline in the rate of accumulation during the first half. But, if other parts of the economy show unexpected softness, vigorous efforts will undoubtedly be made to reduce inventories in the second half.

Residential construction is expected by the Council to increase by about \$5- to \$6 billion between the fourth quarter of 1966 and the fourth quarter of 1967, but even so it will be about \$1 billion below 1966 for the year as a whole. Some doubt is cast on the reliability of the Council's estimate by a forecast made by the Department of Commerce in its "U.S. Industrial Outlook 1967" to the effect that private housing starts for 1967 as a whole may only be in the 1,050,000 to 1,150,000 unit range. This would allow for little or no growth over the year-end rate, which stood at 1,102,000, seasonally adjusted, in December 1966. The Commerce forecast does admit of some upward trend in the second half of 1967, but not in very encouraging tones. It points out:

"The time factor involved in the translation of a shift of money resources to the housing sector into new housing starts appears under present circumstances to militate against a major change in 1967."

Other signs of softness are apparent. The industrial production index declined in both November and December. In fact, of the 30 "leading indicators" which the Department of Commerce uses as weathervanes in its monthly publication, "Business Cycle Developments", 23 had a downward direction as of the January 1967 issue (representing largely data for November 1966) and 29 of the 30 were below their previous peaks.

In addition, while Vietnam spending is to increase in 1967, barring a much-hoped-for end of hostilities, the rate of increase will be tapering off in the second half of the year.

As noted previously, even on the basis of the Council's forecast, the best the economy will do will be to maintain the 1966 rate of unemployment during 1967. And if, as appears very likely, the amount of stimulus given the economy from nonfiscal sources in the second half of 1967 is less than anticipated, while at the same time a tax increase drains off additional consumer buying power, the rate of unemployment will inevitably rise.

#### *Unemployment too high a price*

Unemployment is too high a price to pay for price stability. As has been noted in these hearings, unemployment is grossly uneven in its impact. The burden falls disproportionately on members of minority groups, teen-agers, displaced older workers, and unskilled blue collar workers. These groups, who are least able to bear it, would be called upon, if taxes are increased, to carry the major burden of the cost of combating inflation.

We in the IUD and the UAW share the view expressed by the National Commission on Technology, Automation, and Economic Progress (Automation Commission) that:

"\* \* \* *the toleration of unnecessary unemployment is a very costly way to police inflation.* It deprives the country of valuable output, and it sacrifices the poorest and least privileged among our citizens. It is preferable to press carefully ahead with the expansion of total production and employment, and simultaneously to redouble private and public efforts in the manpower field to relieve shortages in skilled and trained labor as they arise and develop effective means of combating other causes of inflation." [emphasis added]

In considering fiscal policy for 1967 and the period beyond, full account must be taken of the fact that the dangers flowing from unemployment and a slowdown in Great Society programs are far more serious than the danger of some further increase in the price level.

This nation cannot afford the further aggravation of racial tensions and the detonation of the social dynamite in the nation's ghettos which are inevitable if unemployment is not further reduced and if promised help to the victims of poverty is deferred. With the long-dormant hopes of the disadvantaged at last aroused, we can never again have peace of mind or peace in our cities until assurance is provided of prompt and certain fulfillment of those hopes.

The danger on the price front is of an entirely different order. The price problem, as will be shown, is not generalized but sectoral. It is not the kind of problem that is appropriately dealt with by measures to restrain expansion of total demand. Such measures would block further reduction of unemployment and current weakness in the economy suggest that even moderate restraints on the growth of demand might well increase unemployment sharply and possibly

cause recession. In any case, increases in the price level are decelerating and, as spelled out later in this statement, the remaining sources of upward price pressures are to a large degree manageable.

I therefore believe that fiscal policy in 1967 should :

Be designed to promote economic growth at a rate that will bring about a further significant reduction of unemployment ; and

Assign first priority in nonmilitary government spending to adequate funding of Great Society programs even if that should require stretching out of the space program, highway construction and other activities that do not directly affect human welfare and the quality of life in America.

#### *No general excess of demand*

Measures to reduce total demand, such as a tax increase or a cut in government spending, can be justified as weapons against inflation only when demand is excessive in relation to potential supply. Under those circumstances, unemployment need not result from lowered demand.

Demand, reducing measures are not appropriate, however, to combat price increases which occur while productive resources are not fully utilized. The cause of such price increases may be abuse of administered pricing power or a mismatch between the composition of demand and the goods and services which the unused resources are capable of producing, or a combination of both. Price rises that occur in the face of unemployment and unused physical capacity call for rifle-shot solutions aimed precisely at the particular problems involved rather than the blunderbuss approach of a reduction in the general level of demand. The latter is wasteful, in that it deprives the economy of the goods and services which the unused resources are capable of producing, and it is cruel because it inflicts the hardships of unemployment upon the most vulnerable groups of the population.

Clearly, there is currently no general excess of demand. Secretary Fowler attested to that. In his testimony in these hearings he said :

"Our problem during most of last year was *not primarily one of overall excess demand or insufficient total restraint* . . . Rather the problems were those of *selective imbalance* and the financial strains that can develop with a sharply increasing degree of monetary restraint." [emphasis added]

As will be shown, the imbalances, although very definitely selective, were not all attributable to monetary restraint. The absence of any general excess of demand is apparent from the January 1967, unemployment rate which, although substantially reduced since 1961, was still 3.7 percent (on the new basis)—approximately twice as high as the rest of the industrialized free world has averaged in recent years. Physical resources, as well as workers are available to increase production. According to the Federal Reserve Board, manufacturing output in the fourth quarter of 1966 was only 90 percent of capacity—down from 91 percent in the preceding three quarters. Moreover, capacity is increasing rapidly—at an annual rate of approximately 7 percent.

#### *Price increases not inevitable*

Price increases are by no means inevitable if currently idle resources are put to work. Higher rates of capacity utilization and lower rates of unemployment than those presently prevailing can be compatible with reasonable price stability. That is evident from the experience of the 12-month period from the fourth quarter of 1952 through the third quarter of 1953. Utilization rates during this period ranged between 95 and 96 percent. The unemployment rate during the same period ranged between 2.6 and 3.0 percent. Yet, even the removal of Korean War price controls in March 1953 resulted in no major upsurge in prices. During the entire 12-month period, the increase in the index of wholesale prices, other than farm products and foods, was only 1.3 percent. The Consumer Price Index increased by only 1.0 percent.

There is no danger of generalized inflation until demand presses much more closely on the limits of labor and physical resources than it does at present.

#### *Remaining price pressures manageable*

The remaining major sources of upward pressure on the price level are by no means so serious or unmanageable as to justify (if such a policy can ever be justified) the deliberate maintenance of the present level of unemployment in order to combat them. There are tools available which, even if they do not function perfectly, can be effective in holding the rate of increase in prices well within tolerable limits.

1. It is feared, for example, that corporations may use wage increases as the occasion and excuse for raising prices. But profits generally are at levels high enough to permit absorption, without price increases, of wage increases considerably larger than those likely to be negotiated in 1967. In fact, profits in many industries are at levels which would permit reductions in prices even after meeting the cost of substantial wage increases. Attempts by corporations to pass on the cost of wage increases which they can afford to absorb out of profits, refusals to reduce excessive prices, and other abuses of corporate market power can and should be dealt with by creation of the price-wage review machinery previously discussed. That machinery would also serve to minimize any danger that union demands might adversely affect the Price level.

2. Shortages of skills—which, fortunately, are confined to a very limited number of occupations—can be overcome, with varying degrees of speed, by such measures as stepped-up training and worker relocation programs, tax and other incentives to industry to locate new plants in areas of relatively high unemployment, and the great ingenuity that management has repeatedly displayed in adapting jobs to the qualifications of the available workers. In the longer run, a rounded and equitable incomes policy such as is proposed elsewhere in this statement would serve to restrain increases in the price level resulting from disproportionate increases in the incomes of professionals in short supply. Physicians' fees reflected in the Consumer Price Index rose 7.8 percent between December 1965 and December 1966—more than twice as much as the 3.3 percent increase in the Consumer Price Index as a whole.

3. Selective tax and monetary measures can be used both to rechannel demand away from those areas of the economy where pressures of demand on bottlenecks might give rise to inflationary pressure and to encourage the particular investments and other actions needed to open up the bottlenecks.

#### *Recent price rises sectoral*

Such price increases as we have thus far experienced are clearly not the result of an overall excess of demand but rather can be traced to special factors operating in particular sectors of the economy. For example:

1. Prices of certain agricultural products rose because of shortages.
2. In the service component of the Consumer Price Index, shortages of professional personnel are a significant factor in rising medical care costs; tight money and rising interest rates have raised housing costs.
3. In manufacturing, abuses of market power contribute to the increase in the general price level as corporations (a) raise prices even though their profits are ample and their capacity not fully utilized, and (b) refuse to pass on in reduced prices gains from rapidly rising productivity and increased volume.
4. Excessive profits obtained through such price practices have fueled an investment boom which has given rise to sectoral inflationary pressure and to labor shortages in the capital goods industries.

Some of these upward pressures on prices are now beginning to abate and price decreases are replacing price increases. Prices of farm products and processed foods are already down at the wholesale level and the reductions are starting to be reflected in retail food stores. The industrial crude materials component of the BLS Wholesale Price Index is already down more than 4½ percent from the peak reached in March 1966, and the industrial intermediate materials component has fluctuated within a narrow range since May 1966.

The seasonally adjusted index of wholesale prices except farm products and foods, after rising at an annual rate of 3.7 percent between January and July 1966, remained practically level from July to December.

An easier monetary policy is beginning to be reflected in lower interest charges on home mortgages.

Inflationary pressures in the capital goods industries can be expected to taper off as the expected slowdown in the growth rate of capital investment materializes.

The essential point, to repeat, is that *there is no general excess of demand that must be drained off by a tax increase*. Such inflationary pressures as exist are selective in character and should be attacked selectively. The selective approach would enable us to press forward vigorously on the road toward genuine full employment and the achievement of the Great Society. Measures to reduce total demand—whether they be tax increases or reductions in government civilian spending—would seek to buy price stability with unemployment. They would

be in conflict with the intent of the Employment Act, would inflict needless hardship on the families of the unemployed, would intensify racial friction, and would waste in idleness human and material resources that can help to build the Great Society.

*Employment target for 1967*

At the very least, selective measures of the type urged above would substantially lower the threshold level of unemployment beyond which expansionary fiscal and monetary policies would tend to raise the price level. The degree to which that threshold would be lowered depends upon the imagination and determination brought to bear in devising and applying the selective measures. No precise figure can therefore be suggested as to the unemployment rate that would be attainable with reasonably stable prices within any given time span. But that should not prevent us from setting a target rate and designing policies to achieve it. The 4 percent "interim" goal was determined through something less than rigorous application of scientific method. Comparably rough-and-ready methods can be used now to set the next target.

The economy has now had a year to make the adaptations associated with an unemployment rate averaging less than 4 percent. The recent abatement in the rate of price increases shows that those adaptations have largely been made. The argument that growth was proceeding too fast no longer applies. Real growth from the fourth quarter of 1965 to the same quarter of 1966 was only 4.1 percent. In addition, we now have the benefit of several years' operations—although not on as large a scale as would have been desirable—of the manpower and toher programs that were initiated for the purpose of making it possible to reduce unemployment below 4 percent without generating inflationary pressures. It should therefore be feasible now to move below the 3.7 percent rate reached in January 1967 even without use of selective anti-inflationary tools. It is not unreasonable—in fact, it is probably overly conservative—to suggest that application of even a few of such tools would make a 3 percent unemployment rate consistent with reasonable price stability sometime between the end of this year and mid-1968. It is pertinent in this connection that, when the mid-1963 deadline was set for the 4 percent "interim" goal, the latest unemployment figure available was 6.1 percent, which reflected a sharp reduction from a 6.8 percent rate only two months earlier.

Starting from a higher level, it is true, made reduction of unemployment considerably easier in 1962 than at present. But the 0.7 percentage point further reduction envisioned by the proposed 3 percent goal is only a third as large as the 2.1 percentage point objective set in 1962 and is premised upon the use of more refined, selective measures than the gross fiscal and monetary policies that were sufficient under 1962 conditions.

On behalf of the IUD and the UAW, I strongly urge this Committee, in accordance with the spirit and intent of the Employment Act, to recommend that the government "coordinate and utilize all its plans, functions, and resources" to reduce unemployment to no more than 3 percent by the end of this year or by mid-1968 at the latest.

Tax revenues would obviously be greater with the economy on the road to reasonably prompt attainment of a 3 percent unemployment rate than they would be with unemployment at present levels. The added revenues, of themselves, would provide more funds for financing of Great Society programs—but still short of amounts that should be provided for that purpose. *It is therefore the position of the IUD and the UAW that, within the framework of an overall fiscal policy aimed at further significant reduction of unemployment, we would wholeheartedly support equitable tax increases designed to divert substantial additional resources to Great Society programs.*

EMPLOYER OF LAST RESORT

Even a 3 percent unemployment rate would be only a way station on the road to full employment. It would fall far short of fulfilling the commitment of the Employment Act to provide "useful employment opportunities for all those able, willing, and seeking to work."

As the Automation Commission noted, use of expansionary fiscal and monetary policy to reduce unemployment helps those among the unemployed who are most attractive to employers—in terms of education and training and, all too frequently, also in terms of age, sex, color, and religion. Until we have raised demand sufficiently to push unemployment down to the irreducible frictional

minimum, there will remain the problem of fulfilling the promise of the Employment Act for those least able to compete in the labor market.

Their number will be smaller if we continue the progress thus far made in reducing unemployment; it will be greater if Congress accepts the standstill employment policies advocated by the Council of Economic Advisers. But, in either case, it will be all too large for some time to come. In either case, the individuals involved should not be permitted to suffer the demoralizing hardships of unemployment nor should the nation suffer the loss of their potential contribution to its wealth.

The Automation Commission proposed a way to provide such persons with productive employment without risking the inflationary pressures that might arise if gross fiscal and monetary measures were used for that purpose. It recommended a program of public service employment under which the government would act as "employer of last resort" for those able to work but otherwise unable to find work. The Commission estimated that there was a potential of 5.3 million jobs in six areas of the economy "where important social needs are now inadequately met, if indeed they are met at all." The areas of need covered by the Commission's estimate are medical institutions and health services, educational institutions, national beautification, welfare and home care, public protection, and urban renewal and sanitation. To this list we could add programs to eliminate air and water pollution.

To permit those needs to go unmet while unemployed workers able to meet them search vainly for work is both immoral and senseless.

Jobs can be provided for the unemployed by the government as employer of last resort without generating inflationary pressures. I urge this Committee to give serious consideration to legislation that would implement the unanimous recommendation of the Automation Commission to establish the government as the employer of last resort.

#### TAX SHARING AND SOCIAL RESPONSIBILITY

If we are to move more effectively under our federal system to meet urgent human needs, it will be necessary to give more substance to the flexible, pragmatic, creative Federalism which President Johnson advocates. One of the most urgent problems in this whole area is that of ways and means by which the federal government should assist the states and local units of government, most of which are burdened by social responsibilities which they are far from being able to meet without federal assistance.

The President's approach to this question, as defined in his State of the Union and Budget messages, calls for evolution of the federal system. He emphasizes that the grant-in-aid programs, through which federal assistance to the states and local governments is now channeled, are evolving in order more effectively to meet state and local needs, and that this evolution will continue. This evidence of the adaptability of the grant-in-aid approach and of the Administration's intention to improve such programs deserves more attention than it is getting from advocates of other forms of tax sharing which would involve, as some put it, "a minimum of strings attached" as to how states would spend federal revenues.

The President states in his Budget message:

"At the national level the Federal Government has a responsibility to examine and improve the grant-in-aid system, making it more flexible and responsive to State and local fiscal realities. Last year we began a new partnership in health programs through which numerous separate grant programs are being brought together. The model cities legislation enacted last year will also help to integrate the wide range of Federal aids available to communities. In the coming year we will examine other areas of Federal aid to determine whether additional categorical grants can be combined to form a more effective tool for intergovernmental cooperation."

Here, then, is a primary element neglected by the opponents of grants-in-aid: the flexibility of the grants-in-aid approach.

Another weakness in the case of grant-in-aid opponents is their studied myopia with respect to governmental inefficiencies at the state and local levels, inefficiencies which argue against the proposition that these units of government can at the present time effectively use federal funds in the absence of federal guidelines and standards. In his State of the Union message, President Johnson declares:

"Each State, county and city needs to examine its capacity for government in today's world. Some will need to reorganize and reshape their methods of ad-

ministration—as we are doing. Others will need to revise their constitutions and their laws to bring them up to date—as we are doing. Above all, we must find ways in which the multitudes of small jurisdictions can be brought together more efficiently.”

The President, indeed, courteously understated the magnitude and urgency of these problems of governmental fragmentation and inefficiency. State governors themselves, in recent inaugural addresses, have stressed the degree of obsolescence and disorganization in state after state. (*Time*, January 20, 1967). Governor Harold Hughes of Iowa declared:

“I think we need to pay less attention to states’ rights and more attention to states’ responsibilities.”

Governor Love of Colorado attacked his state’s:

“crazy-quilt development of overlapping, duplicating, and sometimes competing groups of governmental jurisdictions” and warned that future challenges could not be met with the “organizational patterns of the 19th century.”

Governor Winthrop Rockefeller called for basic revisions in Arkansas’ 1874 constitution and called for a new look at state operations, hindered, according to *Time*, “by an incredible total of 187 boards and commissions.”

Governor Daniel Evans of Washington summed up the states’ predicament in these words:

“State governments are unquestionably on trial today. If we are not willing to pay the price, if we cannot change where change is required, then we have only one recourse. And that is to prepare for an orderly transfer of our remaining responsibilities to the Federal government.”

Senator Muskie, who was himself governor of Maine and who as chairman of a Senate subcommittee on intergovernmental relations has been holding hearings on the administration of federal grants, confirms this general view of state governmental inadequacies. He agreed (*New York Times*, February 7, 1967) that some governors were trying to generate new life into state government, but added:

“\* \* \* they still need legislative and constitutional reform, and they have a long way to go to establish their own leadership over the planning and administration of state programs.”

Under such circumstances, it would appear, at the very least, to be untimely for the federal government to relinquish to the states and local governments present federal controls over the use of federal revenues.

It is important to note in this connection that the mayors of our big cities—where so many of our major social ills and needs are concentrated—apparently have little confidence in the capacity of the states to administer federal revenues fairly under a no-strings tax-sharing approach. Mayor Harold Tollefson of Tacoma, Washington, speaking as President of the National League of Cities, (*New York Times*, February 7, 1967) told the Muskie subcommittee that state governments could not be trusted to respond to urban needs. He said that cities would welcome help from the states but that “the past leaves too many doubts.”

In view of these doubts and the widely shared reservations regarding the effectiveness of state and local governments, reason would seem to counsel against an abdication of federal responsibility in efforts to lighten local and state fiscal burdens. What is truly pernicious about some of the current campaigns to render the federal role in revenue sharing more passive, is that they do more than merely distort the realities of the situation: they reverse the priorities and they call for abdication of federal leadership precisely at a time when the nation cannot meet its mounting human needs and expectations without greater federal expenditures and greater federal leadership in the federal system.

What happens when the federal government fails to assert its proper authority and carry out its proper responsibility in deference to a loose definition of states’ rights is nicely illustrated in the matter of air pollution. President Johnson states the problem in the following passage:

“Under the Clean Air Act of 1963, we have attempted to encourage states to develop effective regional control programs. The act offered three federal dollars for every local dollar spent to develop and support regional interstate air pollution control programs. Despite this incentive, no effective regional programs have been developed under the act.”

The passage is from the President’s message, “Protecting Our National Heritage”, in which he asks for passage of an “Air Quality Act of 1967”, which would provide for more vigorous federal enforcement powers.

Advocates of tax sharing with a minimum of strings attached are not true friends of state and local government or of the people back home who would allegedly benefit from such an approach. For one thing, they imply that the federal system should be or could be a partnership of equals, a concept which sows confusion. The Articles of Confederation provided for a partnership of equals. When that partnership inevitable went bankrupt, we founded this nation on a Constitution which provides for a more perfect union by making the federal government preeminent within the federal system and charging it with direct responsibility for promoting the general welfare. It is also misleading to imply, as they do, that the powers of government within the federal system are a fixed quantity and that the exercise of federal leadership in Washington involves a derogation of the powers of the states. This nation is faced by problems of such complexity and magnitude that government on all levels is challenged to assume greater initiative and become more resourceful. The question is not, as the partisans of untied grants assume, to take away from the powers of Washington in order to augment the powers of the states. It is rather that Washington and the states both should exercise their respective powers to the full, within a system in which all partners acknowledge the necessarily preeminent position of the federal government.

Advocates of tax sharing without strings also fail to take account of the fact that too many states have not put forth enough tax effort and too few have been enough concerned with tax equity. The fact the 17 states have no income tax is relevant with respect to both effort and equity. What assurance is there that states which presently neglect such important sources of revenue will not use federal monies made available on a no-string basis either to reduce existing state taxes or to avoid tax increases necessary, in addition to federally provided funds, to assure an adequate level of services for their citizens? The inequity inherent in the heavy dependence of state and local governments on regressive sales and property taxes, which impose a disproportionate burden on the poor and less affluent, is one of the chief reasons why state and local tax burdens should be eased by increases in federal grants. The grant-in-aid approach can help to assure that the inequities resulting from state and local taxes are offset to some degree by federally financed services for the victims of those inequities.

The fact remains, however, that the chief reason why the states are in trouble is that the federal government has failed to assume its proper responsibilities. If the federal government, for example, were to establish a national guaranteed minimum income program, the \$3.2 billion which the state and local governments are currently spending for public assistance and relief would be freed for use—without strings—as these governments saw fit. And this is just a single example: Washington could free additional billions of dollars of state and local expenditures through exercising similar initiative in many fields where the national interest calls for federal action.

Along with full assumption by the federal government of its direct responsibilities, the best hope of state and local governments lies in increased federal appropriations for grant-in-aid programs, and in the extension of such programs into other categories of need where state and local burdens need to be lightened. There is no reason why the present evolution of such programs cannot continue to make them more responsive to state and local needs, including the need to find regional solutions for many problems, such as water and air pollution.

The main thrust of the united revenue sharing advocates, on the other hand, is not toward increases in federal assistance but toward budget cutting. The chairman of the House Republican Conference was presumably reflecting a widespread sentiment within his party when he said (Congressional Quarterly, Jan. 20, 1967) that of several tax-sharing plans being drafted, the final Republican choice was expected to propose "that no strings be attached to the money and that federal grants-in-aid programs be eliminated or phased out." Illustrative of tax-sharing measures being introduced is one whose proponent told the House that it would return to the states \$2.2 billion of federal funds, less than the \$3.2 billion the states and local governments are now spending for public assistance and relief under that grant-in-aid program—and which they would be free to spend as they chose for other purposes if we had a national guaranteed minimum income. The Congressman apparently conceives of his revenue sharing plan as an eventual substitute for grants-in-aid, since he states that much of President Johnson's contemplated \$2 billion increase in grant-in-aid programs "could be directed toward a federal tax-sharing program." It is pertinent, therefore, to

observe that the federal government turned \$11.2 billion over to state and local governments for grants-in-aid in calendar 1965, or over 15 percent of total state and local government expenditures.

All of which is not to argue that there should never be some form of revenue-sharing in addition to grants-in-aid. First, however, direct federal responsibilities should be squarely met and grant-in-aid programs should be adequately funded and their potentialities fully realized. And states and local governments should bring a much greater degree of order and equity into their affairs. Then it might make sense to offer state and local governments a certain amount of federal revenue, over and above sums distributed through grants-in-aid. This additional revenue would go to states prepared to increase their spending in certain broad areas, which would be defined by the Federal government in order to assure that funds raised nationally would be spent for national purposes; and in these general areas they would be free to experiment. State and local efforts to increase their tax collections to a specified amount in relation to per capita income should be a factor in determining the allocation of funds. And in order to encourage tax equity as well as tax effort, substantially more credit should be given for revenue derived from personal and corporate income taxes than for that collected from sales and property taxes. Many states and localities have feared to increase their tax collections and make their taxes more progressive in the face of business threats to move elsewhere. Such federal inducements would serve to offset these fears. Care should also be taken to assure that the funds would not be used on a racially discriminatory basis; and there should obviously be other safeguards to assure compliance with proper wage and other standards.

That time has clearly not come. Meanwhile, an effort should be made to improve state and local performance by including such standards and incentives in grant-in-aid programs.

#### PRIORITIES FOR GREATNESS

The Great Society is not a transient slogan but rather a continuing commitment to make the quality of American life more worthy of our power, our wealth, and our democratic professions. We look around us at the state of our cities, our air, our water; at the poverty and deprivation and discrimination that persist among us; at the unemployment, disaffection and delinquency that affect so many of our young people; at the insecurity, loneliness and needless suffering that afflict so many of our elderly. We cannot believe, with all due allowance for the exceptional strains and demands of this period in our history, that we are doing nearly as much as we can comfortably do, with our great and growing means, to cope with these domestic dangers and challenges. We are convinced that despite all our other commitments, we can take and we should be taking longer strides toward that society that is more concerned with the quality of its goals than with the quantity of its goods.

We are also convinced that doing more now is the best preparation we can make for the massive forward movement toward a greater society that we must be ready to make when the Vietnam War is ended. We must recover a sense of the urgency of getting on with the great tasks of peace.

We sense that despite evident concern and the best of intentions in Washington, spirits have been chilled and the will to move forward has given way to a marking of time, a treading of water, a spinning of wheels. And, we fear that this dispirited mood will favor the active campaign of retrenchment and retreat on the part of those who see in our Asian involvement a prime opportunity for placing all our clocks on slower and slower time.

We find this dispirited mood understandable against the recent sorry record of authorizations voted and then reduced in the actual funding, a process that has weakened dozens of Great Society programs and virtually or completely destroyed others. While understandable, however, we believe it is a mood that must be resisted out of the knowledge that to indulge it is to pile up greater troubles for the country and the government in coming months and years.

Therefore we say that the time is now to break this mood and to resolve again to move resolutely forward. The limitations on our movement and initiative are not as great as we have lately supposed. We are not condemned, for example, to be victims of old priorities when changing circumstances require a shift to new priorities and enable us to make greater, more significant progress in

achieving other goals. There is no reason, for example, to continue to act as if any fundamental national interest dictates that we put an astronaut on the moon by 1970. No citizen will suffer if it takes a few years longer; but many Americans can be helped to greater hope, health and material well-being if by stretching out the space and highway programs we mobilize more funds for getting on with the work of building the Great Society.

Those funds should be concentrated on the heart of the problem, which is the existence of 32.7 million poor people in this most affluent of nations, a scandal and tragedy which, as the Economic Report so rightly says, indirectly afflict every American.

To put an end to poverty, three operations are absolutely essential:

- (1) We must create jobs for all who can work;
- (2) We must lift the minimum wage to higher levels for those who work at wages that keep them poor;
- (3) We must provide adequate incomes for those who can't work.

We have dealt with the problem of creating job opportunities elsewhere in this statement.

To help those who work but remain poor, we must lift the minimum wage higher faster. To do that, we must first have taken to heart these words that appeared in the Social Security Bulletin for January 1965:

"That a man risks poverty for his family when he does not or cannot work all the time might be expected, but to end the year with so inadequate an income, even when he has worked all week every week, must make his efforts seem hopeless."

And we must reckon with the fact that in 1964 there were 2,100,000 heads of family, with 6,060,000 children, living in poverty despite the fact that the head of family was employed the whole year; and that 570,000 single persons were in the same predicament.

The working poor—farm workers are a notable example—need more, however, than a higher minimum wage. They need the benefits of collective bargaining and such forms of economic protection as workmen's and unemployment compensation.

For those who are poor because they or the head of their household cannot work, we must provide adequate incomes. We should begin by improving public assistance along the lines recommended by the President in his Economic Report, by requiring that each state's payments at least meet its own definition of need, and that the definition evolve with changing conditions. And we strongly support the President's request that Congress put an end to the 100 percent tax on the earnings of those on public assistance in order that they will have an incentive to accept part-time work; for as the Council says, the poor cannot be expected to work without pay, any more than can the rich.

We should be moving more rapidly toward some form of a national guaranteed minimum income, to which every American would be entitled as a matter of right and human dignity, out of the vast wealth and constantly expanding productive capacity of this nation. Such a guaranteed income is essential to meet the basic needs of those who cannot work. And the Federal government, as we have indicated elsewhere in this statement, should also act as employer of last resort for those who are unable to find jobs in the regular labor market. Pending establishment of such a program, we need a national general assistance plan covering all those in need. We support the President's initiative in forming a commission to study the various minimum income proposals; but we earnestly hope that the study will not take as long as the two years now contemplated, and that prompt action will be taken to set up a guaranteed minimum income program as soon as the study commission reports. With the advent of the guaranteed minimum, Americans would have three compatible forms or layers of income, and those who worked would have all three: the minimum; wage-related Social Security programs (which need just improvement); and other benefits, in addition to wages, derived through collective bargaining.

We must recognize that there is a serious lag in this country between our announcements of good works intended and their realization; and that great social and economic dangers breed in the interval between our democratic professions and our performance.

The last few years have been years of great beginnings under the leadership of President Johnson. He has clearly set forth the goals of the Great Society, and he has taken the initial steps to move the nation toward the achievement

of those goals. The resources are available, we have the technical capability, and, if we demonstrate the will and the sense of national purpose, we can bring the promise of the Great Society into practical fulfillment. We must not fail in this great endeavor, for the cost of our failure will be incomparably higher than the cost entailed in moving vigorously forward toward Great Society goals now.

Chairman PROXMIRE. Our next witness is Mr. George G. Hagedorn, vice president and chief economist of the National Association of Manufacturers. Mr. Hagedorn is an old friend of the committee. He is an excellent economist.

We are might happy to have you here, Mr. Hagedorn, with your concise statement.

**TESTIMONY OF GEORGE G. HAGEDORN, VICE PRESIDENT AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF MANUFACTURERS (NAM)**

Mr. HAGEDORN. Thank you, Mr. Chairman.

Chairman PROXMIRE. The rules will be the same. I think we do have time now. Mr. Ruether took 25 minutes for his presentation. We will be happy to have you take 25 minutes, and then we will have a 5-minute limitation on the questions. You go right ahead.

Incidentally, may I say that you have a statement which is rather concise. If you want to skip over some of it, the entire statement will be printed in the record, as well as the tables, and so forth.

Mr. HAGEDORN. I would like, Mr. Chairman, to file the statement for the record and speak extemporaneously. You gentlemen have heard a great deal of testimony, and perhaps the best thing I can do is to try to emphasize some of the points where I think perhaps I might make a contribution to your thinking.

Chairman PROXMIRE. I am sure you will. That will be done. Your statement will be filed in the record at this point.

(The prepared statement of Mr. Hagedorn follows:)

**PREPARED STATEMENT OF GEORGE G. HAGEDORN**

I appreciate this opportunity of appearing, on behalf of the National Association of Manufacturers, before your committee to discuss the 1967 Economic Reports of the President and his Council of Economic Advisers. These annual hearings, and your deliberations, help to establish the essential framework of economic understanding within which Congress will carry on its work during the year. All of us who appear before you have the duty of presenting our best thinking on the economic situation and the government policies it may call for.

As always, the Administration's Economic Reports provide the starting point for your own appraisal and for the comments of the witnesses you hear. Over the years these reports have done a good job of presenting the factual background, stating the important current issues, and raising the considerations which bear on them. But it is surely not being hypercritical to point out, with our advantage of hindsight, that past reports have sometimes fallen short of infallibility in their appraisal of economic trends. And there would be no point in these hearings if there were not room for some disagreement on the value judgments which underlie some of the economic policy recommendations in the Reports.

*Summary of Comments*

At this point, let me summarize briefly the major comments we have to make on the Economic Reports. The analysis underlying our reaction to them will be set forth in greater detail in subsequent sections. The final section will state our own recommendations to you on 1967 economic policy.

Our conclusion, after examining the 1967 Economic Reports, is that they have misread the implications of current economic trends and of the economic measures

proposed by the Administration. Their error is not by a wide margin, but by one sufficient to make their recommendations in the fiscal area inappropriate for dealing with the economic problems of 1967.

It will be recalled that the forecast of 1966 gross national product set forth in the Economic Reports of a year ago fell about \$10 billion short of what actually occurred. This does not seem a very large error in a \$740 billion economy. Yet it made an important difference in the tone and character of the economy in 1966, and in the fiscal policies appropriate for it. Instead of the anticipated stable non-inflationary growth, we had a sharp spurt of unsustainably rapid growth through most of the year followed by a noticeable slow-down toward the end. The Administration's failure to perceive the need at an early stage for a posture of greater fiscal restraint contributed to making 1966 an inflationary year.

This is mentioned only because we fear that the Administration's expectations for 1967 may be similarly in error, *but in the opposite direction*. Our reasons for this conclusion will be presented in greater detail later. It does carry the implication that a year in which the economy will have to adjust to a slower rate of growth is not the year in which it is wise to impose a general increase in income tax burdens.

But there is a larger question to be raised in regard to fiscal policy. It is not merely a device for making short-term adjustments in the economy. It is the means through which fundamental choices are expressed—choices as to how much government, and what kind of government programs, the nation will have. It is a matter of establishing priorities, both as between the government and the private sector and as between various government activities.

The Council of Economic Advisers discusses this matter of priorities, but without ever quite bringing their analysis to a head. And none of us should approach this subject in a doctrinaire way, since value judgments are involved that only the American people as a whole are entitled to make.

Nevertheless, we find it hard to believe, in examining the fiscal record of recent years, that it can possibly represent the true priorities of the American people. We do not believe that the large expansion of federal nondefense programs is in line with the deliberate choices the population would make in allocating the productive resources of the nation to government purposes. We fear that a tax increase in 1967 would validate and confirm this past trend and encourage its continuance in the future. Our specific reasons for this conclusion will be explained later.

In the area of wage-price developments the Council points out that, in 1965 and 1966, inflation resulted from the adjustment to a rapid increase in demand. It goes on to say that, although this is over, ". . . forces were set in motion which will continue to push up prices for a time." In other words, the inflationary problem in 1967 will be of the cost-push variety.

In this we believe that they are right. But it raises the question of whether a tax increase is the proper means of checking such an inflation. Tax increases seem more likely to strengthen the cost-push factors than to weaken them or offset them.

It might be thought that this would be the year, above all others, in which the "guidepost" approach would be most necessary. The Council has chosen this year to make a partial retreat from its former position. It reiterates its view that productivity growth still establishes the non-inflationary limits on the upward trend in wages, but in a context that suggests that it cannot be taken too seriously in 1967.

The NAM has viewed a setting-forth of the wage-productivity relationship as a helpful educational tool in promoting public understanding of the effects of wage settlements. We have always had reservations as to the desirability of using wage and price "guideposts" as a basis for various forms of government intervention. We hope that the retreat of the Council in this field will not too seriously impair the educational value of the productivity criterion. We also hope that it signals an intention to use whatever remains of the "guidepost" approach in an advisory rather than a coercive manner.

Additionally, the Council's urging that industry reduce its profit margins on a wide scale seems to us unrealistic and uncalled for. It is an arbitrary judgment rather than a conclusion drawn from any basic principle.

One economic objective of the Administration, which is emphasized more than any other in its economic reports, is the further reduction of interest rates. This is an aim with which we can sympathize—manufacturers do not like to pay high interest costs any more than anyone else. But it is an objective that must be considered from all sides.

Low interest rates are better than high interest rates in the same sense that lower prices are better than higher prices. We welcome low prices if they reflect a plentiful supply of goods and we welcome low interest rates if they reflect an abundant supply of savings for investment. But if low prices result from insufficient demand for goods they are not a sign of economic health, and neither are low interest rates if they reflect an absence of advantageous opportunities to use capital. And low interest rates are not cause for much satisfaction if they result from excessive expansion of money and credit, thus encouraging inflation at home and weakening the dollar internationally.

The economic program of the Administration might indeed contribute to the lowering of interest rates, but in ways that would yield little gratification. The tax increase might slow down growth and reduce the demand for funds. It, together with guidepost policy, might reduce profit margins and hence the opportunities for using capital profitably. On the other hand, if we assume that these undesirable effects will somehow be avoided, the tax increase will contribute to higher rather than lower increase rates. It will reduce the internal sources of business capital and the savings of individuals, both of which are alternatives to drawing on bank credit. Hence, the tax increase, under these assumed circumstances, would increase the demand for bank credit and thus tend to raise interest rates.

#### *Economic Outlook—1967*

In 1967 it is becoming clear that the economy will have to adjust itself to the termination, or reversal, of certain trends which have given it strong support until recently. The developments of this character which can be anticipated are as follows:

1. *A leveling-off of the capital-goods boom.*—Several factors would lead us to expect this trend—which would be a radical shift from the 16% expansion of capital outlays between 1965 and 1966. First, the growth rate of the economy generally will slow down in 1967. This is expected by practically everyone including the CEA and it is probably inevitable. But capital expenditures are, in practice, a means of providing additional facilities for an expanding economy. Hence a slowing of the *rate* of growth can mean an actual decline in the *level* of capital spending.

Second, the suspension of the investment credit and accelerated depreciation will act as a deterrent to capital spending in 1967. This is only beginning to have that effect since much of the spending in the latter part of 1966 was the result of orders placed prior to the suspension date. The investment credit and accelerated depreciation were conceived as normal and permanent parts of the tax system. They were suspended only because it was thought that demand for capital goods would be excessive in 1967. The matter obviously has to be reconsidered. Meanwhile, we list this among the factors which will depress capital spending this year.

Third, the expected reduction of profit margins, to be discussed later, will reduce both the profit incentive and the funds available for capital spending.

Finally, the proposed 6 percent surcharge on income taxes would further depress profit margins, and intensify the problem of maintaining capital expansion. It is surely undesirable to add this on top of all the other factors tending to reduce the level of business capital spending.

Compilations of business plans for capital spending would indicate that 1967 plans exceed actual 1966 levels by a small percentage. But in the last half of 1966 spending fell well below the previously announced plans for that period, as is common close to a turning point. We conclude that a most optimistic assumption would be that business expenditures on fixed investment will be as high as in 1967 as in 1966. This would mean that capital spending would fall below its level as of the last quarter of 1966.

2. *A topping-off of the defense boom.*—This is a matter on which the statistics customarily consulted may be misleading. For that reason we attach a table (Table 1), comparing the trends as measured in various ways. All the figures are derived from the official compilations in the budget document.

Usually we appraise the economic impact of government defense spending in terms of the amount indicated under that head in the national income accounts. As seen on the table, this portrays a continuing upward trend in fiscal 1968. The increase is expected to be about \$12 billion between fiscal 1966 and fiscal 1967, and an additional \$6 billion between fiscal 1967 and fiscal 1968. But the national income accounts record defense spending at the time the goods and services are delivered. Thus it measures the completion of economic activity related

to defense, rather than its initiation. We get closer to a true indicator of the economic impact of defense outlays if we look at the trend in the "obligations incurred" by the federal government when it places its orders and starts the process going.

On the "obligations incurred" basis (see line 5, Table 1) the trend appears quite different. A large increase is indicated between fiscal 1966 and fiscal 1967, but the total remains almost level between the current fiscal year and the one that begins in about four months.

These estimates may have to be revised, depending on political and military developments. But the revision could as well be downward as upward. We conclude that it is reasonable to assume that the nation is at, or close to, the peak of business activity related to the defense effort.

3. *A reduction in the rate of inventory accumulation.*—Goods added to inventories are as much a part of the annual output as those sold to final purchasers. In 1966 the nation produced \$11 billion for that purpose.

It is universally agreed that production for inventory will be much less in 1967 than in 1966, although there may be room for disagreement as to the amount. The leveling-off of the defense and capital-goods booms will reduce the need for adding to goods-in-process.

The CEA estimates that inventory accumulation will be only half as great in 1967 as in 1966, but even this seems optimistic. We conclude that the reversal of the inventory boom will reduce national output by between \$5 and \$10 billion between 1966 and 1967.

4. *A reduction in profits and profit margins.*—On general considerations, it will be difficult to increase, or even maintain profit levels in 1967. A strong upward thrust of labor costs is anticipated. It may be expected that this will partly be passed on in prices, supporting an inflationary trend, but (as is usually the case) it will also partly be absorbed, reducing profit margins.

The Administration's estimates of before-tax profits in 1967 indicate only a nominal rise—about 1%—over 1966. Since an increase of 6½% in the gross national product is assumed, this implies a reduction of about 5% in before-tax profit margins. And if a tax surcharge of 8% were imposed in the middle of the year, after-tax margins would be reduced by close to 9%.

This is, of course, a matter of immediate concern to manufacturers. It should also be a matter of concern to the nation generally. The profitability of business operations is the chief determinant of the willingness of business to produce, invest, and employ people. Table 2, appended, shows the close inverse connection between profit margins and unemployment rates. Unemployment reached its lowest levels when profit margins were at or near their peaks. With only one exception among the 13 years listed, unemployment never fell below a 5% rate in years when profit margins were under 5%. The process of reducing unemployment to the 4% goal during the past 6 years has been achieved through a steady rise in the profitability of business activity.

We conclude that, in the interests of maintaining a high employment economy, it is undesirable for the government to take deliberate steps to reduce profit margins—whether through a tax increase or through jaw-bone techniques. There will be enough of a problem without that.

Some of the other aspects of economic activity in 1967 are less foreseeable than those discussed above. Automobile sales have been sluggish, and no one expects the industry to have anything better than its "second-best" year in 1967. Consumer non-durables and services will certainly show an increase in volume but there is no reason to expect it to be exceptionally great. Thus it appears that the economy will have a serious burden in 1967 in adjusting to the new, less favorable trends we have described.

The Administration evidently hopes for a substantial expansion of the housing industry to take up the slack. But this is a slender reed to lean upon. The housing industry accounts for only about 3% of total economic activity. It is only about ½ as great in dollar volume as capital goods expenditure, or defense expenditure. This makes it hard to see how even a major recovery in housing could offset the less favorable trends in those two areas.

The Council of Economic Advisers foresees a period of slow growth in the first half of 1967, to be followed by a period of renewed economic strength in the second half. This assumed pattern is their chief justification for recommending a tax increase to take effect on July 1. But the assumption of a pronounced upward change in trend to start at that time seems unconvincing. It is based largely on the hope of an expansion of housing activity in the second

half. Even if this occurs it would seem unlikely to be sufficient to change the general picture.

#### *Fiscal trends and national priorities*

Fiscal policy has an immediate impact on short-term economic developments. But it must also be considered in a larger context. Fiscal policy is the means by which we decide how much of the national productive resources will be devoted to collective purposes through government, and how much will be left at the disposal of private parties for their individual purposes.

There is no formula by which the proper division may be decided. It is a matter of priorities—whether an additional dollar spent by government will yield more of value to the citizenry than that same dollar left in their hands to be spent as they individually see fit.

It is easy to compile a long list of needs that might be supplied by additional government action—in the fields of health, education, civic improvement, etc. The Report of the Council of Economic Advisers supplies an impressive discussion along these lines. But this doesn't decide the issue since any individual can compile an equally long list of his unsatisfied private needs and desires.

There are unsolved problems in the area of government responsibility, but there are likewise individual problems that we would like to solve.

Thus we are left with the question: Assuming that we are not going to abolish our society of individual responsibility, and devote 100% of the national income to collective efforts for social purposes, how do we decide the proper division of resources between government and the private sector?

This is not a question on which anyone, including the NAM, should speak dogmatically. But an inspection of fiscal trends in recent years leads to at least a *prima facie* presumption that the expansion of government activities has exceeded anything that can be justified by a reasonable appraisal of the priorities in the minds of the American people.

A summary of the relevant data since 1959 is presented in Table 3, appended. The results are interesting and in some respects startling.

First, over the nine-year period between fiscal 1959 and 1968 the growth in expenditures has been 87%. But this is not, to any important degree, the result of military needs arising from the Viet Nam War. Defense expenditures over this interval will have increased by 59%, as compared with a 115% increase in non-defense spending. In this perspective, the proposed tax surcharge cannot realistically be regarded as necessitated by the growth of military needs, which everyone will concede have a high priority.

An even more startling result is observed if the nine-year span is divided into three-year intervals. Apparently, in the latest of these three-year intervals, the growth of government will have greatly accelerated if the Administration's programs are carried out. One might have expected that the sudden surge of military needs since 1965 might have restricted the growth of other government activities. Instead, non-defense government outlays have been increasing at a substantially greater rate than in the earlier periods. It is hard to believe that this can be in accord with a genuine ranking of national priorities.

A third significant fact revealed in Table 3 is that in the middle period, 1962 to 1965, federal expenditures grew at a somewhat slower rate than either before or since. This seems to be a reflection of the slower growth of revenues in that period, which is the one in which the tax reduction of 1964 was enacted. I am sure that you will recall the general satisfaction in the country with the results of that tax reduction and with the retardation in the growth of federal expenditures which made it possible. Apparently, the priorities of the population were such that they welcomed an opportunity to spend more of their money individually and somewhat less through government. It is difficult to believe that they would take an opposite position at this time and accept a higher level of government non-defense activity as a fair return for a tax increase.

Throughout the period there has been a rough but noticeable correspondence between the rates of increase in revenues and in expenditures. This creates a reasonable presumption that the expansion of government spending is the result of the effectiveness of our tax system in providing the necessary revenues, rather than a reflection of carefully-weighted national priorities.

We do indeed, as the Council of Economic Advisers points out, have a highly efficient revenue-producing engine in the federal tax system. But it is important to remember the nature and purpose of that engine. It is a pump, which draws funds out of the private economy and makes them available to government. But

the efficiency of the pump is no reason for expanding government activities to match its output. And there do not seem to be good grounds for increasing the capacity of the pump by 6% in 1967.

#### *Wage and Price Trends*

There are, as is recognized in the Economic Report of the Council of Economic Advisers, strong forces tending to raise labor costs in 1967.

If a general rise in costs of production should materialize, it would be unfortunate. Apparently the major justification claimed for raising wages faster than productivity in 1967 is the past increases in the cost of living. These reflected chiefly price rises outside the area of industrial goods—farm products and services. But the impact of the resulting cost rises would be felt mainly in the industrial area. It would tend to spread and to perpetuate inflation, rather than to offset its effects.

Yet we should not take a fatalistic view that such cost increases are inevitable in 1967. An attitude of this type on the part of responsible persons would encourage the very cost increases that concern us here, and weaken any resistance to them.

For that reason we are gratified that the Council of Economic Advisers resisted the temptation to revise its basic concept of the wage guidepost, and to include a cost of living allowance on top of the trend increase in productivity. But, even if one believes that wage increases in excess of productivity growth are very likely in 1967, there is no reason for an official body to endorse or encourage them.

It remains true, as the Council of Economic Advisers reminds us, that: "The only valid and non-inflationary standard for wage advances is the productivity principle. If price stability is eventually to be restored and maintained in a high-employment U.S. economy, wage settlements must once again conform to that standard."

There have been suggestions that Congress should involve itself directly in the process of establishing guideposts and in activities designed to promote adherence to them. It has been proposed that Congressional responsibilities in this area should be set forth concretely in law.

We urge you most emphatically not to take such a step. If the guideposts are to be voluntary standards, and if they are intended for the information of the general public and of the price and wage decision makers, they should not be given the status of inclusion in the law of the land. Since they are necessarily loose standards, to which many exceptions must be recognized, they should not be formalized by any act of Congress.

One would have to view with great concern an annual process of hearings before a Congressional Committee, designed to settle upon the proper guideposts for that year. Presumably both labor and management representatives would be heard—in fact, most of the proposals of this nature call specifically for their participation in the guidepost-setting process. Thus, in effect, the hearings would become a form of labor-management negotiations. They might be the most important labor-management negotiations of the year, since they would set the framework for subsequent bargaining between employers and unions.

The adoption of these procedures would be a long step toward the system followed in some other countries—where a national framework for labor settlements is established by bargaining between a national employers' association and a national employees' association. And, worse, Congress would have put itself in the position of being the mediator or arbitrator in these high-level labor-management negotiations.

Furthermore, if Congress, or one of its Committees, were subsequently to assume the task of applying the guideposts to particular cases, it would be assuming an inappropriate and impossible judicial function. If the Joint Economic Committee were to do this, it would sadly impair its effectiveness in performing the constructive role it has played in the past.

One other aspect of the wage-price situation should be mentioned—the effect of increases in corporate and personal income tax rates. A tax increase seems more likely to stimulate than to restrain the type of inflationary pressures that are to be feared in 1967. A rise in corporate taxes may simply increase the demand for borrowed funds by corporations. An increase in personal taxes may simply increase the pressure for wage increases to offset it.

*Summary of recommendations*

Based on the foregoing analysis of the current economic situation we make the following recommendations for economic policy in 1967:

1. Congress should enact no general increase in personal and corporate income taxes in 1967. The economy will have to adjust to other changes in trend this year, and the additional burden of a tax increase should not be placed on it. Such an increase would validate the undesirably-rapid growth of non-defense spending of recent years and permit its continuance.

2. Congress should start on a program to restrain the growth in federal spending which has been occurring. Even if the whole job can't be done in 1967, a move can be started in that direction. It can take the form of stretching out some programs without necessarily abandoning them.

3. Congress should restore the investment credit and accelerated depreciation provisions of the tax law as promptly as possible. This should not be regarded as a tax cut since these provisions have been accepted as a normal and natural feature of the tax system.

4. Congress should not attempt to assume a formal role, prescribed by statute, in the establishment or enforcement of wage-price guideposts. The Joint Economic Committee should of course continue to have the privilege of reporting its views in that subject area to Congress.

*Table 1.—National defense outlays, as reported in various ways in the budget for fiscal 1968*

[Billions of dollars]

	Fiscal 1966 actual	Fiscal 1967 estimated	Fiscal 1968 estimated
(1) Administrative budget expenditures—national defense.....	\$57.7	\$70.2	\$75.5
(2) Cash payments to the public—national defense.....	58.5	71.3	76.8
(3) Federal expenditures, NIA—national defense.....	56.5	68.3	74.1
(4) New obligational authority—national defense.....	67.4	75.1	77.9
(5) Obligations incurred, net—Department of Defense, military.....	61.8	73.5	74.8

Source: Transcribed from "The Budget of the U.S. Government—Fiscal year ending June 30, 1968" as follows: (1) Table 1, p. 41; (2) table 2, p. 42; (3) table 3, p. 43; (4) table 4, p. 44; and (5) table 9, p. 50.

*TABLE 2.—Trends in profit margins compared with unemployment rates*

	Aftertax profits of manufac- turers cor- porations as percent of sales	Unemploy- ment rate (percent)
1954.....	4.5	5.6
1955.....	5.4	4.4
1956.....	5.3	4.2
1957.....	4.8	4.3
1958.....	4.2	6.8
1959.....	4.8	5.5
1960.....	4.4	5.6
1961.....	4.3	6.7
1962.....	4.5	5.6
1963.....	4.7	5.7
1964.....	5.2	5.2
1965.....	5.6	4.6
1966.....	<sup>1</sup> 5.6	3.9

<sup>1</sup> Average of first three quarters.

Source: Federal Trade Commission and Security and Exchange Commission, U.S. Department of Labor.

TABLE 3.—Federal fiscal trends since 1959

[Receipts and expenditures in billions, based on national income accounts]

Fiscal year:	Receipts	Expenditures		
		Total	Defense	Nondefense
1959.....	\$85.4	\$90.9	\$46.6	\$44.3
1962.....	104.2	106.4	50.2	56.2
1965.....	120.6	118.3	48.5	69.8
1968 (estimated).....	167.1	169.2	74.1	95.1
Percent increases:				
1959-62.....	96	87	59	115
1959-62.....	22	17	7	27
1962-65.....	15	11	-1	24
1965-68.....	39	43	53	36

Source: U.S. Department of Commerce. (For fiscal 1968—Budget of the United States, summary table 3.)

Mr. HAGEDORN. Thank you.

The central question, the most important question, before economic policymakers this year is the fiscal policy that the Government should pursue, and let me get right into it.

To summarize the views of the NAM, we believe that the Government should not increase the tax rate, as proposed, in the middle of this year. It should, instead, make every effort to control and reduce the level of Federal spending. This isn't a new thought to you, but let me bring out some aspects of it that perhaps haven't been emphasized enough in previous discussion.

First of all, in discussing the economic impact of fiscal policy, I find, and perhaps you have observed, too, a tendency to feel that it's all summed up in the one figure, the deficit or surplus on the national income accounts. Thus, the total level of spending doesn't seem to count very much, and the total level of revenues doesn't seem to count very much. It's the difference between the two that is regarded as having the important impact.

I mention this fact because I think some of the witnesses before you have urged that if, through fear of weakness in the economy, you forbear to increase taxes during this year, the same logic would urge that you not reduce spending either. I don't think that conclusion is valid because taxes and spending are not simply the counterbalance to each other. You can't sum up the impact of a tax program and a spending program simply by one figure which states the differences between revenues and expenditures on the national income accounts basis. Taxation has an impact on incentives, for example, and on the whole tone and feeling of the economy. That isn't simply a reflection of the amount of purchasing power withdrawn by the tax system, and its replacement by purchasing power put out into the economy by the Government spending. You have to look much deeper than that into the real concrete impact of the various taxes and proposed taxes on what people do.

Furthermore, the function of fiscal policy is not merely to regulate the economy, to act as a balance wheel to take away from, or add to, the total level of demand in the economy. The fiscal system is much more important than that. It is the concrete way in which you decide

how much Government you are going to have in the country, what Government programs we are going to have, how much resources will be allocated to Government uses, as compared with private uses. So, you have to look at fiscal policy much more than merely as the balance wheel for keeping the economy going.

Now, during this year of 1967, we can see a number of growing weaknesses in the economy, at least developments that will call for some readjustments in the economic system, readjustments that will involve difficulties. For example, we are very close to, if we are not *at*, a peak in the capital goods boom. We had a 16-percent increase in capital goods expenditures last year over the previous year. Some of the more optimistic forecasts have indicated 4 or 5 percent increase this year, but even those are very doubtful.

It is notable in the past that when you were close to the turning point in capital expenditures, you found that the actual level of realized capital expenditures in any quarter fell below the previously compiled plans for such capital expenditures. That happened in the last two quarters of 1966, and that is an indication that we probably are very close to the peak level of capital expenditures.

This is to be expected, because every one agrees, including the Council of Economic Advisers, that the real growth rate in the economy in 1967 has to be less than what it has been in the past 4 or 5 years. We can't continue indefinitely this 5½ percent real growth rate.

We have been drawing resources into economic use that were normally considered standby resources, and we have reached the end of that process. We have to depend on the demographic growth in population and the normal growth in productive capacity, and that won't permit more than something like a 4-percent growth from here on.

Now that in itself is not something to be concerned or worried about, but it does have a bearing on the capital goods picture, because the production of capital goods is itself determined, at least partly, by the need to provide additional facilities for meeting the needs of growth. As the labor force increases, you need capital expenditures to provide them with the tools and equipment that they work with. So that when the economy generally decreases its growth rate, you find that the actual level of capital spending may decrease, at least the level of the part of capital expenditure that is for expansion of capacity.

A second adjustment that we will have to make during this year is to a leveling off of the defense boom. This is somewhat concealed by the usual figures we see in the national income accounts. These indicate about a 20-percent increase in defense spending between fiscal 1966 and fiscal 1967, and a 10-percent increase between 1967 and 1968. But actually, in the national income accounts, defense spending is counted at the time when the goods are delivered to the Government. The economic activity is all over by that time.

If you look at the actual obligations incurred in the Government, you find that what is planned for fiscal 1968, is only about 1 or 2 percent above what is expected in fiscal 1967. In other words, the figures that indicate the economic activity arising out of defense orders will about level off between the current fiscal year and the one to come. There is very little growth there, so we have another factor to which the economy has to adjust, a leveling off of that growth.

As you know, the inventory increase was very large in 1966, far larger than we can expect it to be in 1967. There was \$11 billion added to inventories in 1966.

The Council of Economic Advisers expects the 1967 figure to be about half that, but I think even that is optimistic, because we have to have some reversal, some period of using up of those inventories that have been accumulating. So you have something between \$5 and \$10 billion decline in demand from cessation of inventory buildup.

Finally, another thing that is leveling off is profits and profit margins. The estimates of the Government used in preparing the revenue estimates in the budget, indicated that between calendar 1966 and calendar 1967 there would be about a 1-percent increase in the actual dollar profits. At the same time they are anticipating a 6½-percent increase in the dollar gross national product. This suggests there will be something like a 5- or 5½-percent decline in profit margin, which is the ratio between dollar profits and the dollar volume of business.

Then, if in the middle of the year you impose a 6-percent surcharge on corporation taxes, that would further cut this, and you would have perhaps as much as a 10-percent reduction in profit margins during the year.

This is something that it would be very hard for the economy to adjust to, because profits and profit margins determine the profitability of undertaking various business enterprises, the profitability of hiring people, the profitability of investing in new plant, the profitability of producing goods for various markets. And, when you cut down that profit margin, you have effects on employment, production, and everything else.

This is indicated rather clearly, if you just put profit margins and unemployment rates down in parallel columns. I have done this in a supplementary table. (See p. 798.)

Just to summarize this very quickly, if you will look down the line, you find that the unemployment rate gets below 5 percent when the profit margin rate—this is after-tax profit margins for manufacturers—gets over 5 percent.

Now after 1957, we had a long period in which we couldn't seem to get the unemployment rate down below 5 percent. We all remember that. That is on our mind. And it wasn't until we got profit margins above 5 percent that we began to get the unemployment rate down close to this 4-percent objective.

So reducing profit margins during the coming year might be one of the worst things we could do, if our real effort is to maintain unemployment down at the low level that it has reached.

In 1966, for the first three quarters, the profit margin was 5.6 percent, and if you cut that by about 10 percent, you see you are down close to that limit of 5-percent profit margin, which seems to be about the breaking point where you get unemployment above 4 percent. When you get the profit margin down below 5 percent, you tend to raise unemployment above 4 percent.

These are several factors to which the economy has to adjust in 1967, and it is our opinion that you shouldn't add another factor of adjustment in the form of a 6-percent surcharge on income taxes.

Now, from the point of view of concern about inflation, I think you

reach the same conclusion. In the past couple of years, in 1965 through much of 1966, the inflation seemed to originate from supply and demand factors, and largely outside the industrial sector of the economy, in the food and in the service area. This was a reflection, I think, of supply and demand in those sectors of the economy. It looks as though that phase of inflation is about over, especially if the economy has the weight of adjusting to the several negative factors that I mentioned.

The strength of markets isn't going to put inflationary pressure on consumer prices generally. But the inflationary pressure is quite likely to come this year from the cost side, the cost-push side, which is a quite different situation. When there is a heavy upward pressure on costs, what usually happens, and what I think is likely to happen in this year, is that part of the increased cost gets passed on in higher prices. Part of it has to be absorbed in profit margins. This reduction of profit margins is something that is just as bad as the inflation, because the reduction in profit margins is a thing that prevents you from realizing your objectives as far as employment is concerned. A part of it will be reflected in higher prices. But you are not going to stop that sort of cost-push inflation by increased taxes. I think you are likely to make it worse, because the tax increase is itself an increase in costs.

Furthermore, the tax increase on individuals is likely to increase their efforts to get wage increases that would compensate them for the increase in taxation. That would again add to the cost pressures during the year. Thus we don't see that the tax increase during the year is going to be a very effective way of controlling inflation during the year.

Now, I would like also to look at fiscal policy from a broader perspective. Has the course of fiscal policy, the growth of Government expenditures in the past few years, really reflected the priorities of the American people?

This is a very difficult subject to talk on. I can find no formula that says such-and-such is the proper level for Government expenditure; that some given figure is the proper percentage of the national income that should be taken by the Government and channeled through Government for the purposes of Government.

Obviously, that percentage is not going to be zero; there are things that have to be done by Government. Obviously, it's not going to be 100 percent; we still want to preserve a generally individualistic society. Thus you have the question: Where do you put the level of Government spending? As I said, I can find no way of deriving a formula for answering this question. It has to come down to a matter of what are the priorities of the American people. They have their own personal desires that they expect to satisfy through the part of the national income that is left to them after taxes. They have certain collective desires that they want the Government to pursue for them.

I can't reduce it to a formula, but I can show you some figures. They are in table 3 at the end of the study, which I think corrects some misapprehensions. They lead me to draw at least the *prima facie* conclusion that what has happened in recent years can't possibly represent a genuine appraisal of what the American people want in

the way of Government service as contrasted with the amount that they want to keep for themselves out of the national income.

I have just compiled the figures on receipts and expenditures, the total expenditures as divided between defense and nondefense expenditures, over the fiscal years from 1959 through 1968.

The first point I would make is that, if you look at the whole period, the growth in expenditures has occurred chiefly in the nondefense field. The growth in defense expenditures over this period, taken as a whole, has been quite modest, and if we had held nondefense expenditures down to the same level, we certainly wouldn't be suggesting that a tax increase might be necessary at this time. So that we shouldn't have the illusion that the basic reason that a tax increase is being considered at this time is the sudden increase in the past couple of years in defense expenditures. When you look at it in the longer perspective, it is the nondefense growth that has been much greater.

Now if you divide this whole period into three 3-year periods, there are some interesting facts revealed there, too. The growth in spending and in nondefense spending in the most recent 3-year period has been the most rapid of all. We have been accelerating the growth in nondefense spending. You might have expected to find that in a period when we were running into military difficulties and needed more of our national income for that purpose, we would have been holding down on the growth of nondefense spending. Instead, it accelerated in the most recent period.

You notice that the period in which the growth in expenditures was held down is the middle of these three periods, the period 1962 to 1965. That, of course, is the period when the 1964 tax reduction was being discussed and was being finally enacted. In that period, when the American people and you, their representatives, were considering the relative advantage of more spending as against leaving more income in the hands of the people as individuals, you decided that the best thing to do was to leave more income in their hands and to reduce the rate of Government spending if that was the price you had to pay for such a tax reduction.

I think my time is running out, so I want to get on to another aspect.

Chairman PROXMIRE. You have about 2 more minutes, Mr. Hagedorn. Would you like to summarize?

Mr. HAGEDORN. There is one more important thing I wanted to say, and I will have to reduce it greatly. In the field of price-wage policy, the most important lesson that I think has to be put across in the way of educating the American people and the participants in the price-wage determining process is that the greatest enemy of full employment is the forces that would push wages up too fast and price labor out of the market. If this fact is learned, we have a greater hope of maintaining full employment without inflation in the country. If this lesson is not learned, if we pretend that you can push wages up faster than productivity, without suffering in employment, why then the country is going to be faced indefinitely with the choice between inflation and unemployment.

I would like to say just one thing more because I know it has been on your minds, and I feel this very deepy. I would urge you gentlemen in Congress not to enact a price-wage guidepost system that would draw yourselves into either the derivation of price-wage guideposts

or their enforcement. I will expand on that if you wish me to, Senator.

Chairman PROXMIRE. I would like to ask you, Mr. Hagedorn, directing your attention to the proposal that Mr. Reuther made. You heard it, his national income policy proposal; that is, that you have a productivity increase for wages and in addition an escalator to reflect the rise in the cost of living, with possibly a profit sharing added on to that. And then in order to prevent inflation, he proposes review boards with possibly some kind of a tax system that would provide for penalties for price increases that aren't justified. What is your feeling about this kind of a proposal?

Mr. HAGEDORN. I don't think that incomes policy, the way it is generally understood, and certainly this proposal for a review board, is either workable or desirable, Senator. The difficulty with the price-wage guideposts has been that they correctly define the way we would like to see the economy move in its largest aspects. We would like to see wage increases average out in line with productivity, and we would like to see price stability be the result of the averaging out of price reductions and price increases.

But I don't think you can apply such a rule as a method of administering the price system.

Chairman PROXMIRE. Let's start right at the beginning. You indicated that we have to worry very much about a cost-push inflation. You know that there are a number of important labor-management contracts that have to be settled this year including the auto workers as represented this morning, including the Teamsters, and so forth, involving 3 million people, much more than last year. Under these circumstances—and labor feels that they have some catching up to do.

Mr. HAGEDORN. That is right.

Chairman PROXMIRE. Now, if there is no wage-price guideposts, I might point out that if you took the Reuther proposal and made the assumption as the Council does that the rise in the cost of living this year would be a 5.7-percent guidepost, most of the estimates I have seen indicate that they expect settlements to be higher than that. So that in this sense the Reuther proposal might tend to hold down wage increases, and, therefore, exert less pressure on prices than you might have if you don't have any guideposts at all.

Furthermore, you have no effective discipline, if you walk away from this, on prices in the administered price area.

Mr. HAGEDORN. I understand, Senator, and I have to confess I have ambivalent feelings about the wage-price guidepost system. Insofar as it is a way of bringing out the importance of the relationship between productivity and wages, and its connection with the whole area of employment and inflation, I think perhaps the guideposts have made an important contribution. But they have broken down because they can't be applied in detail to the specifics of the economy. They give a good picture of what ought to occur to the economy when it's viewed from a distance in perspective, but not what you should expect to occur in every detail in the economy.

The proposal of Mr. Reuther for adding a factor recognizing the increases that have occurred during the past couple of years in the cost of living would—

Chairman PROXMIRE. As I understand it, there would be a cost escalator in it rather than recognizing what has happened in the past

I would agree with you if you recognize what has happened in the past, you would have an enormously high guideposts, but if you simply do as Alvin Hansen proposed the other day, and as I understood Mr. Reuther to propose—I may have misinterpreted it—you would have 3.2 for productivity, 2.5 for the cost of living expected this year, whatever it turns out to be, you would simply recognize the current expectation of a rise in the cost of living.

This way labor would get its real increase in productivity. In other words, the real income would depend on the productivity, corrected for cost-of-living increases.

Mr. HAGEDORN. Yes.

Chairman PROXMIRE. The productivity of the whole work force throughout the economy.

Mr. HAGEDORN. I don't think you have a workable system there that can be applied in every area of the economy. Now if people reach an agreement like that in collective bargaining, I see nothing wrong with it. If the company figures that it can live with it, and it's desirable, and it gets a reasonable return in collective bargaining for this, I see no reason to oppose this on principle, when it is done individually in collective bargaining.

But to impose it as a national income-policy system has other implications. I thought that is what you were referring to, Senator.

Chairman PROXMIRE. Let me ask you something else. You said that the real growth rate should be 4 percent from now on. Now in saying this, you differ from almost every witness we have had. The Council said it should be 4 percent this year, but not 4 percent indefinitely. The Labor Department projected a 4.3 or 4.4 percent increase in growth in real terms, and said that this would be sustainable within inflation. Some economists quarrel with the Council for this year, but no other economists to my knowledge has said that we should settle for a 4-percent growth rate.

On what basis do you think that this is the best we can do?

Mr. HAGEDORN. Well, I should say, Senator, that I don't feel qualified to pin down the last decimal place in such a calculation, and frankly I am not sure that anybody else is either.

Chairman PROXMIRE. You understand how important this is to us because we want to have a policy which on the basis of the best estimates and statistics we can get provides for maximum growth consistent with price stability. I understand your position. You say approximately 4 percent.

Mr. HAGEDORN. It's a lot different from the 5½ percent we have had in the past 4 or 5 years in any case. I think I would be prepared to argue 4 percent against 4½, but something in the middle, 4.2, 4.3 is too fine a distinction for the type of analysis we can make.

Chairman PROXMIRE. My time is up. Senator Miller.

Senator MILLER. Thank you, Mr. Chairman.

Mr. Hagedorn, Mr. Reuther seemed to emphasize the role of price increases by major corporations as the fundamental cause of inflation. I believe he made the statement, and I am sure you heard him, that if there had not been price increases by the major corporations, we would not have had inflation. Do you agree with that statement?

Mr. HAGEDORN. No. It is obviously wrong on the face of it. If you look at the components of the Consumer Price Index, it is food

and services that have been the chief forces of pushing up the level of consumer prices. The price of finished manufactured goods has not been rising, at least not rising nearly as much as the cost of food or of services. And the price of finished, durable manufactures has actually been about level for the past several years, amazingly so.

Senator MILLER. Then do you think that the operations of the Federal Government, especially in connection with deep and multibillion-dollar budget deficits, have a role to play in this inflation problem?

Mr. HAGEDORN. Oh, of course, and this is tied in with the whole question of full employment, Federal fiscal policy and monetary policy.

When you get uneconomic excessive increases in labor costs, the initial impact is to reduce employment. It is just the same thing as when you raise the price of onions, you are going to sell fewer onions. When you raise the cost of employing somebody, fewer people will be employed.

But now one way of offsetting that is to use an inflationary fiscal policy or an inflationary monetary policy. In a way you are tricking people out of the increases they thought they got. You are nullifying them by reducing their real wages through price increases, so that the unemployment creating effect of the original cost increase is then nullified. This is the progress of events: you get the cost increase and you get the inflation because you are trying to counteract the unemployment creating effects of that cost increase.

Senator MILLER. I have noted that during the last few years, that there is a definite relationship between inflation and deep multibillion-dollar deficits of the Federal Government under the administrative budget. I believe in recent years that we have had a billion dollars of deficit, that has been accompanied by two or more billion dollars of inflation.

I take it that you are suggesting that it would be helpful in dealing with the inflationary problem for the Federal Government to avoid these deep multibillion-dollar deficits.

Mr. HAGEDORN. Yes, sir.

Senator MILLER. All right. Now how should we avoid having these deficits? On the one hand we could have a tax increase. On the other hand, we could have a cutback in spending, or we might try a middle road and do some of each. Do you have any suggestions?

Mr. HAGEDORN. I think you should operate on the spending side. Reduce spending as a way of controlling inflation, for the reasons that I gave.

If you try to control inflation by raising taxes, you are likely to make it worse under the situation that exists here in the year 1967.

Senator MILLER. How are we going to cause a problem if, as Mr. Reuther pointed out, the profits after taxes in the big three are so apparently large compared to the normal? Would it not be feasible to have a tax increase of some kind which would not particularly affect the production and the operations of some of these corporations?

Mr. HAGEDORN. Well, I don't see how you can have any kind of a tax increase that wouldn't affect their operations.

Senator MILLER. Well, would it affect them to the extent that there would be a reduction in their production? Suppose that—I don't recall the figures, but suppose that—there was, in General Motors' case, a billion dollars more profit after taxes than normally would be the

case. Suppose further that now that was plowed back into plant, but only a very small part of that was plowed back into plant. Would a small tax increase particularly aggravate that situation, do you think?

Mr. HAGEDORN. Well, I can't answer for General Motors and even if I could, you can't design a tax system with a view only to its supposedly desirable effects on General Motors. It has to be a tax system that is going to affect everybody else, too. The effect of a tax increase is bound to be to discourage production to a degree.

Now there may be times in the country's history when that is exactly what you want to do. When we are in an all-out war, you certainly have to increase taxes because you are trying to discourage civilian production and to move the resources of the country into the defense field. I don't think that is the situation we are in now.

Senator MILLER. Of course, the difficulty is that we are in a middle area here. However, when we are faced with a \$20 to \$30 billion a year cost of the war in Vietnam, it seems to me that it would be very, very difficult to reduce Federal domestic spending sufficiently to offset that, so that there would be no tax increase at all.

I am willing to listen and I certainly would advocate taking a look at expenditures in order to avoid a tax increase, but I must say that I fear that the amount of the reduction of expenditures will not be sufficient to enable us to come out with a reasonably balanced budget to avoid inflation, and if that is the case, then it seems to me that a tax increase is indicated, and we have to make up our minds what we are going to do.

Are we going to take purchasing power away from the American people by inflation, or by taxes. And I think most of us would agree that taking it away by taxes would be more fair than by inflation. That is why I am wondering if you wouldn't agree that we might reach a point in this cutback in Federal domestic spending beyond which it would be undesirable, which would in turn require a tax increase of some kind.

Mr. HAGEDORN. Well, I am sure that you can't accomplish everything that you perhaps would like to accomplish in the way of reducing Federal expenditures in one year. But I think a good start can be made if you look at the spending programs and decide maybe there is something here that can be postponed to a later year.

It may be a matter of stretching out various programs. Instead of doing everything as presently laid out, delay things a little bit. The American people would probably view such a program of stretching out expenditures and delaying some of your programs as a good price to pay for not getting a tax increase this year.

Senator MILLER. May I say that I agree with you. I am wondering if your association has come up with any suggestions, specific suggestions of what programs to stretch out, what programs to reduce, and how much. Have you any suggestions specifically?

Mr. HAGEDORN. Not specifically, sir.

Senator MILLER. I wonder if you could furnish them to this committee?

Mr. HAGEDORN. We have some general discussion of the important areas in the budget and what their fate has been and what is involved in them, and if you wish, Mr. Chairman, I would like to submit that study for the record.

Chairman PROXMIRE. Yes, without objection.

Mr. HAGEDORN. It is prepared by the Government expenditures committee of the NAM.

Chairman PROXMIRE. How big a study is that?

Mr. HAGEDORN. About 30 mimeographed pages.

Senator MILLER. I think, Mr. Chairman, if these contain specific proposals, that it might be useful to have something like this.

Chairman PROXMIRE. Does this study declare the NAM position on reducing spending?

Mr. HAGEDORN. It contains the reaction of our Government expenditures committee to the budget that was submitted by the President.

Chairman PROXMIRE. Without objection, it will be included in the record at this point.

(The study referred to follows:)

THE GOVERNMENT EXPENDITURES COMMITTEE OF THE NATIONAL ASSOCIATION OF  
MANUFACTURERS

REPORT ON THE FEDERAL BUDGET FOR 1968

This memorandum on the President's budget for fiscal 1968 deals with budgetary factors involving policy issues in which NAM's Government Expenditures Committee has particular interest.

It covers the fiscal and economic premises of the budget: the "three-budget" complex; the program-funding requests in the budget with which Congress deals; and trends in the level and components of non-defense expenditures.

Appended to the text are tables covering both administrative budget expenditures and spending authority—first by the organization units of government and second by the broad purposes for which expenditures are made. A table of civilian employment figures is also added.

A final tabulation shows the detailed composition of Great Society programs and the gross level of spending for those purposes—welfare, health, education, employability, housing and community development, and economic development.

*Major premises of the 1968 administrative budget*

The *international and domestic premises* of the spending budget for 1968 involve the President's intent to press forward in defense of freedom and in search for peace, to improve the quality of American life and to guard against any interruption of our prosperity. Although the President acknowledges that prosperity is everywhere evident, he qualifies this by pointing out that the economic progress achieved "still left far too many behind." He indicated this was one of the problems met in 1966, and that its solution is one of the tasks of 1967.

The President's intention regarding "those left behind" is clear: he is requesting Congress to provide him with \$5.2 billion more in regular spending authority than it did in 1966, and, additionally, he is anticipating \$2.1 billion more than in 1966 of proceeds from the sale of loans, which would be used for expenditures. This is a \$7.3 billion increase of financing for such purposes as health, labor and welfare, education, housing and community development over the amounts provided in the fiscal year ending only last June.

By contrast, for defense and international purposes together the 1968 requests for funds are only \$10.1 billion above the amounts provided in 1966.

Another indication of the relative emphasis on forwarding domestic spending is its contrast to an apparent plateauing of defense. This is seen in the respective amounts of deferred spending in these two general areas.

Deferred spending can be estimated by showing the relationship between expected expenditures for a given year and the obligations which will be incurred in that year—which will all ultimately have to be met. Here are such indications of future spending based on current estimates:

[In billions of dollars]

1968	Department of Defense, military	All other departments, etc.
Obligations incurred.....	74.8	68.3
Expenditures (deduct).....	72.3	62.7
Deferred spending.....	2.5	5.7
Total.....	8.2	

It is interesting to note that this total of \$8.2 billion in deferred payment of 1968 obligations is almost an exact equivalent of the rise in budgeted expenditures from 1967 to 1968. That increase in spending is \$8.3 billion. However, a more significant point lies in the components of the deferred payment.

The commitments now being made for non-military purposes will entail in future almost \$6 billion of expenditures not now included in the budget. This amount compares with a \$6 billion "deferral" in 1966 and \$5.6 billion now estimated for 1967.

Military spending, on the other hand, is more fully anticipated within the presented budget estimates. However, this \$2.5 deferral is substantially *less* than the \$7.4 billion deferred in 1966 and the \$6.5 billion deferral now estimated for 1967.

This contrast of the 1968 military estimate is especially significant because a long-lead is normally required, due to the time lag needed for delivery of defense hardware. There are two interpretations of the low deferred military spending as estimated. First, it could be simply a substantial underestimate—as the \$10.5 billion expenditure estimated last January for the 1967 Vietnam spending turned out to be a gross underestimate. (The 1967 spending is now estimated at \$19.4 billion). Second, it could be a genuine leveling off, a real assessment that the basic investment in high-cost hardware is fairly complete. The latter contention receives hopeful support in the evidence of intensified attention around the world to peace potentials, and in a cryptic sentence from the President's Economic Message:

"... peace will return . . . and it *could* be sooner than we dare expect."

The *economic premise* of the 1968 budget is that the economy needs a little nudge from fiscal policy. The deficit positions (all three budget deficits are, after all, interrelated) are justified on the basis of *not* being restrictive—because the President is seeking a 7th year of uninterrupted growth.

The mildly stimulative character of the budget is the net result of two somewhat opposing forces which it puts into motion. The first influence comes from the stimulate of high spending and a high administrative deficit. This is the particular deficit which indicates the amount of debt to be monetized and is thus the source of a fillip of inflation. The countervailing influence comes from the increased resources to be taken out of the economy via the President's tax proposals.

A first point to note is that the tax proposals<sup>1</sup> would bring in \$5.5 billion in 1968, which would slightly more than offset the \$5.3 billion rise in spending for national defense over the 1967 expenditures—a coincidence which serves as an appealing and compelling basis for the tax increases.

A second point to note is that 1968 budget receipts, even without the proposed tax increases, are expected to be \$7.4 billion higher than in 1967—within a billion of the parallel rise in spending.

And a third point is that the rise of \$8.3 billion in spending for 1968 over 1967 is roughly equivalent to the administrative deficit of \$8.1 billion—which, *without* the proposed new revenue, would be \$13.6 billion.

Clearly the nature of this tax increase is for revenue purposes only. It is not to calm down an over-buoyant economy; for, the acknowledged economic aim of the 1968 budget is to offset suspected sluggishness with slightly stimulative fiscal action. The President has said "a more restrictive fiscal program would

<sup>1</sup> \$4.7 billion from the proposed surcharge and \$800 million from further acceleration of corporate tax payments.

be unwarranted and self-defeating under present economic conditions . . . could depress economic activity . . .”

Thus, there is no “new-economics” purpose for the tax increase, but simply the “old-economics” purpose of reducing a potentially massive deficit—one reached more through long-term snowballing of non-defense spending than by heavy military requirements or a retreat of revenue. The 1968 non-defense spending is doubled over 1960; is 56% above 1963; and nearly 25% over last year.

These being the facts, control of the deficit level and the economic stimulant sought by the President could be accomplished equally well through a 1968 budget in which overall spending, particularly on the domestic programs, was held to a level low enough to avoid any need of revenue through increased taxes.

#### *The three-budget complex*

For years federal finances have been reported and accounted for by several different sets of figures. Depending on who is talking, and to what purpose, one of the three “budgets” is cited. Here are the three sets of totals:

[In billions of dollars]

1968 estimate	NIA	Administra- tive	Cash basis
Expenditures.....	169.2	135.0	172.4
Receipts.....	167.1	126.9	168.1
Deficit.....	2.1	8.1	4.3

The President, as Chief Executive, the heads of his department and agencies, and others concerned with management costs of the branches of national government, speak in terms of *the administrative budget*.

Accountants and others interested in full accounting of government funds will refer to government finance figures reported on *the consolidated cash basis*, the record of receipts from and payments to the public, or the so-called “cash budgets”.

Economists and analysts evaluating the impact of federal fiscal policy on the nation's economy deal with government finance figures reported in the *national income accounts*—sometimes called the NIA budget.

All three sets of figures are regularly presented in the budget document. Since they have different purposes and significance, reference to one or the other is used when it is most appropriate for the point or argument being made.

For example, currently the President wants to explain that the federal deficit is not so high as to be unduly stimulative to the economy, or so low as to be a restrictive, he refers to the \$2.1 billion deficit for 1968 in the “NIA Budget” rather than the \$8.1 billion deficit in the administrative budget, or the \$4.3 billion deficit in the cash budget.

One major area where these accounts differ in composition involves federal loans, their repayments and proceeds from their sale—*excluded* from NIA accounts.

These accounts intend to show the volume of income and production in the economy, and they therefore use *the same measures* of receipts and expenditures as business does. Because business does not count loans or the proceeds of loan-sales as income or expenditures, the national income accounts do not include these either.

Most loans and proceeds of sales *are*, however, included in the so-called “cash budget”. Excluded would be only loans or sales between governmental funds such as selling participation certificates to the trust funds.

In the administrative budget, the effect of loans, repayment and proceed is somewhat complicated. Most loan activities are carried on in “public enterprise accounts”, the gross operations of which are *outside* the administrative budget. Only their deficits or surpluses affect the administrative budget—in which those net figures become respectively expenditures or offsets to expenditures. Also in the administrative budget would be an *initial* loan made by the government, which then becomes an asset whose sale brings proceeds credited as receipts to the public enterprise accounts not to the administrative budget.

To assure that budget expenditures more fully reflect program costs, NAM has recommended that they be *included* as non-tax receipts in that budget, and

not accounted for simply as reductions of expenditures which would otherwise be made.

It is quite probable that any budgetary restructuring to consolidate the administrative and cash accounts into a single working whole would have the effect of implementing this recommendation.

And such a consolidation may ultimately be forthcoming, if certain implications of the President's Budget Message are brought to logical conclusion. He frankly admits that "the traditional administrative budget is becoming an increasingly less complete<sup>2</sup> and less reliable measure of the government's activities..."

And he further says:

While the national income accounts budget is the most appropriate measure of the overall economic impact of the Federal budget, a discussion of individual Federal programs is best carried out in terms of the more conventional administrative budget and the various Federal trust funds. (emphasis added)

In that word "and" lies a substantial practical difficulty to presenting, understanding, or appraising the full story of federal finance.

With the present budget composition, expenditures of the trust funds must be added to those of the administrative budget in order to show the total dollars that the Treasury pays out. The budget document always computes these combinations for tables especially designed to show the overall federal spending for given functions. But this is only an informative section. There is a complete separation of the administrative and trust accounts in the basic tables of the budget. Here are summary figures showing the combined expenditure totals for 1968.

[In billions]

Function	Administrative budget	Trust funds	Adjusted totals <sup>1</sup>
National defense.....	\$75.5	\$1.4	\$76.8
International affairs.....	24.8	.2	4.9
Space.....	5.3	(3)	5.3
Agriculture.....	3.2	1.2	4.1
Natural resources.....	3.5	.1	3.5
Commerce and transportation.....	3.1	3.7	6.9
Housing and community development.....	1.0	.9	1.8
Health, labor, welfare.....	11.3	37.1	46.6
Education.....	2.8	(4)	2.7
Veterans.....	6.1	.6	6.7
Interest.....	14.2	-----	<sup>5</sup> 10.5
General government.....	2.8	(4)	2.7
<b>Total.....</b>	<b>135.0</b>	<b>44.5</b>	<b>172.4</b>

<sup>1</sup> Since the cash consolidated concept involves only payments to the public, intragovernmental funds are deducted, along with other adjustments.

<sup>2</sup> Includes \$1.9 billion for "Food for Freedom."

<sup>3</sup> \$2 million.

<sup>4</sup> Offset of \$31 million.

<sup>5</sup> Reflects deductions of \$3 billion for interest paid to the trust funds and an excess of \$630 million in interest accrued over interest paid.

<sup>6</sup> \$29 million.

Payments to the public, or the cash budget, thus combine the administrative and trust accounts. The ramifications of these two sets of figures have long been recognized by those knowledgeable in budgetary ways. But their concepts are often questioned by serious students and their totals have always been confusing to the public. And when the NIA budget figures<sup>3</sup> are also used, the three-budget complex presents a package truly formidable to understanding.

The President's proposal for an objective review of budgetary concepts is therefore most welcome—NAM supports this proposal and hopes that the bi-

<sup>2</sup> This development is largely the result of having transferred out of the regular budget to the trust funds large amounts of spending (highways for example) and of having gross loan operations accounted for in the public enterprise funds.

<sup>3</sup> The national income accounts are not a budget, though they are often referred to as such. They are a series of economic interpretations of federal finance figures developed by the Department of Commerce.

partisan group to be formed for this purpose will, indeed, as the President hopes "recommend an approach to budgetary presentation which will assist both public and congressional understanding of this vital document." That method would quite logically be a single budget representing the consolidation of administrative and other accounts, presented under acceptable accounting principles, rules of disclosure, etc.

*The budget Congress deals with*

The "three-budget" complex, which so often confuses rather than clarifies public understanding becomes a four-headed monster when the aspects dealt with by the Congress are segregated.

Congress acts on the legislation that funds the thousands of accounts for the administration's programs. This series of figures represents the spending authority or money "requests" of the President. And these might be called the *appropriations budget*.

It is these figures in the budget document that are translated into the items in appropriations bills. The Congressional Appropriations Committees and their various subcommittees evaluate the President's requests, first in the House of Representatives and then in the Senate. Differences between the amounts passed separately by each House are settled in conference committees. The conferees' bills go back to each House, and final action is an appropriation bill enacted into law. There are about a dozen regular appropriations bills each year.

It is at this stage of the total budgetary process that the opinions of concerned parties can have influence on the ultimate level of government spending. This is when—and why—the advice to "write your Congressman" is so often heard. And Congressmen themselves often plea for mail. Chairman George H. Mahon (D-Tex.) of the House Appropriations Committee has pointedly said, "A letter, I tell you, like a vote, can make a difference—perhaps *the* difference."

It is practically impossible, however, for the ordinary citizen or businessman to get sufficiently acquainted with the technical details to write his Congressman on specifics. This undoubtedly explains a number of things: the reason there is a lack of mail received by Congressmen on how to curb spending, the reluctance of people to express themselves at all when it must be in general terms only, a pervasive public sense of defeatism and frustration on high spending and high taxes, and the subsequent continuing increase of central government power over the economy and the communities of the country.

The size of the budget that Congress acts on has risen from \$102 billion in 1963 to \$144 billion for the new fiscal year 1968. A large part of this increase—\$17.5 billion—represents the rise from June 30, 1966. Table 3 indicates how much of the rise goes to non-defense activities. For example, funds for the Department of Housing and Urban Development are up 62% from 1966—to \$3.2 billion. And this does *not* take into account the additional \$2.4 billion of proceeds from the sale of loans and mortgages which are expected to be applied directly to departmental programs. Money for the Department of Health, Education and Welfare, a third higher than in 1966, is a massive total of \$13.3 billion.

The total of the President's request for 1968 funds is up only 3.2% from the *present* estimate for 1967; but 18% above the original estimate for 1967; and nearly 14% above the funds provided for 1966.

[In billions]

1966 .....	\$126.4
1967 original estimate.....	121.9
1967 current estimate.....	139.6
1968 estimate .....	143.9

Although Congress acts on the President's requests by organization units, departments, agencies, bureaus—that is, the line item accounts for program activities—the amounts representing the allocation of these funds by government functions is helpful information. These totals illuminate trends of spending by kinds of expenditures, and the relative emphasis given to certain areas of government effort. Table 4 presents this view of government financing.

These figures by function may be more helpful than dollar data by agency for the ordinary citizen or businessman wanting to express his general view to Congress. It is not only relatively easy, but quite understandable, for a businessman to say to his Congressman, for example—

Requests for defense funds are increased only 3.7% over 1967—is it really necessary to increase funds for education by 13%, when the war is our priority job now?

Funds for veterans' benefits are only 3.1% higher than 1967—why is 12% more needed for health and welfare benefit programs, especially when employment and wages are so high?

Interest costs are up 5.2% from 1967; why can't you defer some spending so as to cut the \$8.1 billion deficit, prevent a rise of \$7 billion in the public debt and leave less of it to pay interest on in 1968?

In both his State of the Union and Budget Messages, the President stressed that he welcomed a searching examination by Congress of his budget program. Congress in turn needs, and always welcomes, the views of constituents.

In the interest of aiding Congress to do its job effectively, members of the business and industrial community and civic leaders should acquaint themselves with the President's budget enough to make known to Congress their general views on current federal fiscal policy and their relative preference for either the proposed tax increase or sufficient spending reduction to obviate any call for tax increases. In the absence of a national equivalent to local referenda on spending and taxing issues, communications to Congress become the only practical way of registering pertinent taxpayer opinion.

*"Backdoor financing"*

When authority to spend is given through the "backdoor" of permission to make contracts or to spend debt receipts, the regular appropriation process is circumvented and the control that Congress can exert on spending, by way of that process, is by-passed.

These two methods of financing government expenditures have been held in relative control since the early sixties, but the immediate trend seems to be opening up that door again:

*Backdoor authority in billions (excludes permanent authorizations)*

1964 -----	\$0.7
1965 -----	1.8
1966 -----	1.9
1967 original estimate -----	2.2
1967 current estimate -----	2.7
1968 estimate -----	.3

The rising trend since 1964, and the jump of \$3 billion from the original to the present estimate for 1967, suggest that the minimal estimate now being made for 1968 may well be revised upward by next year.

Increased use of these doors is a tendency to be fought again, as it was in the late fifties, by the Congress itself as well as by thoughtful appraisers of federal budgetary practices. This "backdoor" should not be opened wider, but closed.

There is a side door to which very large resort has recently been given, especially since passage of the Participation Sales Act of 1966. This side door is using the proceeds from sale of federal loans and mortgages for *direct* financing of public enterprise activities, bypassing the regular budget. This artificially reduces the expenditures presented in the budget accounts and accordingly lowers the administrative budget's deficit. This sale-of-assets technique is, in effect, a form of borrowing to finance federal programs. As such, it qualifies as another form of backdoor authority and spending. Here is the record of the increased use of such proceeds:

*Receipts from sales of credit assets*

	Total sales	Participations in pooled assets
1964 -----	1,077	(1)
1965 -----	1,564	750
1966 -----	2,961	2,601
1967 original estimate -----	4,739	4,205
1967 current estimate -----	3,922	3,580
1968 estimate -----	5,275	5,000

<sup>1</sup> Not separable. At this time only the Export-Import Bank had authority to sell participations in pooled loans. The Banks total loan sales in 1964 were \$436,000,000.

NAM's established policy attitudes regarding these forms of backdoor financing are: first, disapproval of by-passes of the appropriation process; and second, belief that proceeds from sale of assets should be treated as non-tax receipts in the budget, rather than as offsets to expenditures.

*Trends in non-defense spending*

To show the *full* level of the financing of federal programs, the gross expenditures of activities carried out in the public enterprise funds, any transfers of cost to trust funds, and the programed level of administrative budget accounts or obligations must be pulled together. None of the "three" budgets do this. The consolidated cash basis comes closest, but only by rather summarized items. In order to show this full scope and cost development of Great Society programming, a tabulation of the various budget accounts involved is presented here with sub-totals by broad categories. (See the summary tables and detailed tables I-VII immediately following this commentary.)

Here are key figures covering the development period of the Great Society:

[Dollar amounts in millions]

	Number	1963	1968 estimate
Welfare oriented programs.....	21	\$3,853	\$7,914
Health programs.....	10	509	1,724
Education programs.....	16	602	4,116
Economic development programs.....	22	226	514
Employment opportunity programs.....	3	161	830
Community development.....	25	423	1,883
Miscellaneous programs.....	3	321	557
Total.....	105	6,081	17,238

<sup>1</sup> Up by 184 percent.

Last year at this time program costs of the various Great Society accounts totalled \$15.1 billion. The spending authority requested to cover these program costs is \$17.4 billion. But the administrative budget totals from them are only \$12.6. The difference represents program costs carried *outside* the regular budget in enterprise or trust accounts.

The hard-core programs of the Great Society are intergovernmental in nature. They provide funds by grant or loans to states and communities to carry out programs. These programs are more and more being initiated and controlled by the federal government. The trend is toward centralized planning-programing-financing by the federal government with dollars and directives to the agencies carrying out the programs at the community level. The multiplicity of these programs in itself tends to minimize potential for greater control and responsibility at state level. There is generally no single focus at state level for coordination of responsibility. The many direct federal-local programs, which in effect by-pass the states, also work against a stronger or independent state position.

Indication of this trend is especially clear in the area of public assistance. The budget detail says:

Legislation will be proposed to *assure* that public assistance payments more nearly meet the economic needs of recipients, to *require* all States to provide assistance to families with children who are impoverished because of unemployment of a parent, to provide incentives for employment, and to improve work and training programs to help restore recipients to independence. (emphasis added)

Further evidence comes in the President's Economic Message—which is worth quoting at length:

Completely new proposals for guaranteeing minimum incomes are now under discussion. They range from a "negative income tax" to a complete restructuring of Public Assistance to a program of residual public employment for all who lack private jobs. Their advocates include some of the sturdiest defenders of free enterprise. These plans may or may not prove to be practicable at any time. And they are almost surely beyond our means at this time. But we must examine any plan, however unconventional, which could promise a major advance. I intend to establish a

commission of leading Americans to examine the many proposals that have been put forward, reviewing their merits and disadvantages, and reporting in 2 years to me and the American people.

1. State standards of need are miserably low. It is time to raise payments toward more acceptable levels. As a first step, I ask the Congress to require that each State's payments at least meet its own definition of need; and that its definition should be kept up to date annually as conditions change.

2. With minor exceptions, payments under public assistance are reduced dollar for dollar of earnings by the recipient. It is time to put an end to this 100 percent tax on the earnings of those on public assistance. I shall therefore ask Congress to enact payment formulas which will permit those on assistance to keep some part of what they may earn, without loss of payments.

3. Many recipients of public assistance are capable of receiving training which would ultimately make them self-supporting. I therefore urge the Congress to make permanent the Unemployed Parent and Community Work and Training programs and to require all States receiving Federal support under AFDC to (make this) available for the unemployed parents of dependent children.

One further indication of overall federal planning in the welfare field merits reference here. The Department of Health, Education and Welfare has reprinted a summary of the report and recommendations of the Advisory Council on Public Welfare called "National Blueprint for Public Welfare". The Council's full report was entitled, "Having the Power, We Have the Duty". HEW's cover letter distributing the reprint says.

The Council's National Blueprint for public Welfare provides a workable solution for dealing with many of the Nation's unresolved social problems. The Council's major recommendations are:

A national minimum standard for public assistance payments below which no State may fall

A nationwide comprehensive program of public assistance based upon a single criterion: Need

A uniform, simple plan for Federal-State sharing in costs of all public welfare programs which provides for equitable and reasonable fiscal effort among States, and recognizes the relative fiscal effort among States, and recognizes the relative fiscal capacity of the Federal and State Governments

Comprehensive social services readily accessible, as a right, at all times to all who need them

All welfare programs receiving Federal funds administered consistent with the principle of public welfare as a right.

The Council's proposal for comprehensive social services envisions "provision of essential services to all individuals and families *without regard to income*" (emphasis added) Provision would be through public welfare agencies.<sup>4</sup> HEW staff and resources would be enlarged to implement the entire program, including resources "to strengthen (HEW's) role in international social welfare programs."

It is becoming apparent that a massive public framework for social and economic opportunity is being centered in Washington. The 1968 budget would strengthen much of it without pause for essential review, consolidations or spin-offs.

It is to this area of the Great Society programs that Congress should direct especially searching examination—to achieve substantial reductions in and deferrals of financing.

#### CONCLUSIONS

The President's budget for 1968 involves hard-made decisions for increasing support of both military and non-defense programs, on which he has asked for the searching examination and evaluation of the Congress. The Congress should accept this as a literal challenge and act upon it promptly. The purpose of such action should be to reduce the spending authority now sought by amounts sufficient to void any reason for additional taxes.

<sup>4</sup> The implications of this for the support and continuance of the private agencies in the country are profound.

From a fiscal viewpoint, Congress should defer consideration of the proposed tax increase until it has first acted upon—and appreciably cut—the funds requested in the 1968 Budget. The accumulated increases of non-defense spending in recent years are so great as to require critically sober appraisal of both current and proposed levels. Furthermore, evidence indicates that the people prefer to meet any necessary defense increase by postponing or reducing non-defense spending not by reducing their personal spending through a tax rise.

From an economic viewpoint, the impact of a further tax claim on the country's resources in a period of already slowing growth should be avoided. The mild economic stimulation sought by the President through a budget deficit could as well be achieved by a lower spending level without a tax increase.

The level of federal spending and taxing is being paid thoughtful and increasing public attention. Such constructive and encouraging response to federal fiscal policy should be aided; but the variations of figures in the "three-budgets" complex prevents really adequate public understanding. In order that the people may know the full burden of federal finances, and more intelligently appraise them, a single consolidated budgetary concept and method of presentation should be sought.

TABLE A.—"The Great Society," summary of program costs

[Millions of dollars]

Program identity	1963	1966	1967 estimate	1968 estimate	Percent change 1963-68
I. Welfare-oriented.....	3,853.2	5,673.6	6,950.1	7,913.7	+105.4
II. Health.....	509.0	958.5	1,491.3	1,724.3	+238.8
III. Education.....	602.3	3,214.0	3,673.8	4,115.7	+583.3
IV. Manpower training and employment opportunities.....	160.9	454.5	755.1	829.6	+415.6
V. Community development and renewal.....	422.8	758.8	1,453.8	1,553.2	+274.5
VI. Area and regional economic development.....	225.5	331.6	451.5	513.9	+127.9
VII. Miscellaneous.....	320.8	468.2	506.7	557.3	+73.7
Program costs, total <sup>1</sup> .....	6,080.9	11,859.2	15,282.3	17,237.7	+183.5
For comparison: New spending authority.....	6,138.9	13,065.5	14,306.0	17,409.2	+183.6
Budget expenditures: Total for same items.....	4,982.2	9,234.9	11,331.9	12,582.0	+152.5

<sup>1</sup> These figures are not the equivalent of budget expenditures; they are the "gross" levels of resources called for by program scope.

TABLE B.—"The Great Society," summary of administrative budget expenditures

[Millions of dollars]

Program identity	1963	1966	1967 estimated	1968 estimated	Percent change 1963-68
I. Welfare-oriented.....	3,359.1	5,337.3	6,402.1	6,967.9	+107.4
II. Health.....	380.1	606.9	830.4	1,168.1	+207.3
III. Education.....	542.8	1,861.4	2,252.3	1,759.2	+224.1
IV. Manpower training and employment opportunities.....	156.1	459.1	617.2	699.4	+348.0
V. Community development and renewal.....	236.2	445.7	606.9	1,043.6	+341.8
VI. Area and regional economic development.....	101.5	74.7	219.3	473.5	+366.5
VII. Miscellaneous.....	206.4	369.8	403.7	470.3	+127.9
Administrative budget expenditures, TOTAL <sup>1</sup> .....	4,982.2	9,234.9	11,331.9	12,582.0	+152.5
For comparison: New spending authority.....	6,138.9	13,065.5	14,306.0	17,409.2	+183.6
Total program costs.....	6,080.9	11,859.2	15,282.3	17,237.7	+183.5

<sup>1</sup> As explained in the text, these figures include many "net" components, and do not reflect the total cost level of programs.

TABLE I.—*Welfare-oriented programs*

[Millions of dollars]

Program	1963	1966	1967 estimate	1968 estimate
1. Grants for public assistance, health services for aged.....	2,706.8	3,528.7	3,981.5	4,265.0
2. Bureau of Family Services.....	3.8	6.1	7.6	8.6
3. Grants for maternal and child welfare.....	76.3	179.5	225.9	277.3
4. Children's Bureau.....	2.9	5.4	6.0	6.5
5. Juvenile delinquency and youth offenses.....	5.6	5.9	7.4	-----
6. Cooperative research or demonstration projects.....	1.1	1.7	2.9	4.0
7. Office of Commissioner of Welfare.....	.6	1.2	1.5	1.9
8. Administration on Aging.....	.5	7.3	9.6	18.5
9. Foster grandparents program.....	-----	.1	.2	.2
10. Office of Secretary, Health, Education, and Welfare; salaries and expenses.....	2.7	2.0	6.5	9.3
Subtotal, items 1 to 10.....	2,800.3	<sup>1</sup> 3,737.8	4,249.1	<sup>1</sup> 4,591.2
11. Office of Economic Opportunity.....	-----	966.3	1,619.9	2,085.4
12. Economic opportunity loan fund.....	-----	33.7	36.6	36.1
Subtotal, items 11 and 12.....	-----	1,000.0	1,656.5	2,121.5
13. Special milk program.....	94.4	97.4	104.0	104.0
14. School lunch program.....	169.1	201.2	213.6	243.7
15. Food stamp program.....	20.2	70.1	139.5	195.0
Subtotal, items 13 to 15.....	283.7	368.7	457.1	542.7
16. Rural housing, domestic farm labor.....	-----	-----	6.0	4.0
17. Rural housing direct loans.....	183.2	85.9	41.4	36.0
18. Rent supplement program.....	-----	.3	2.3	6.2
19. Low income housing demonstration.....	.1	1.3	1.5	2.0
20. Low rent public housing programs.....	566.6	426.0	469.9	526.6
21. Housing for elderly or handicapped.....	19.1	53.7	66.2	83.5
Subtotal, items 16 to 21.....	769.0	<sup>1</sup> 567.1	587.3	<sup>1</sup> 658.3
Total, welfare programs.....	<sup>1</sup> 3,853.2	<sup>1</sup> 5,673.6	<sup>1</sup> 6,950.1	7,913.7

<sup>1</sup> Total does not coincide with sum of individual items due to rounding.TABLE II.—*Health programs*

[Millions of dollars]

Total program costs	1963	1966	1967 estimate	1968 estimate
1. Health manpower.....	16.0	164.6	342.1	384.3
2. Disease prevention and environmental control.....	106.4	129.7	187.6	222.7
3. Health services.....	217.9	274.5	388.1	385.4
4. Regional medical programs.....	-----	2.6	34.3	85.3
5. Environmental health sciences.....	2.0	7.5	13.3	20.6
6. Grants, construction health research facilities.....	50.0	56.3	41.0	50.0
7. Community mental health centers.....	-----	55.0	125.2	100.2
8. Construction, mental health neurological research facilities.....	0.1	2.6	4.7	2.6
9. Comprehensive health planning services (present and proposed expansion).....	-----	102.1	123.6	168.6
10. Federal Water Pollution Control Administration.....	116.6	163.6	231.4	304.6
Total, health.....	<sup>1</sup> 509.0	958.5	1,491.3	1,724.3

<sup>1</sup> This is a higher figure than was shown in last year's analysis of 1963 health programs because the grouping of accounts somewhat changed the "mix" of health programs included.

TABLE III.—*Education programs*

[Millions of dollars]

Program	1963	1966	1967 estimate	1968 estimate
1. Elementary and secondary school activities.....		1,276.6	1,438.5	1,707.0
2. National Teacher Corps.....		6.3	20.0	36.0
3. Higher education activities.....		1,029.8	1,162.5	1,173.2
4. Expansion and improvement of vocational education.....	34.7	237.1	266.4	267.9
5. Libraries and community services.....	7.4	108.8	147.0	166.0
6. Educational improvement for handicapped.....	2.5	26.8	36.0	53.4
7. Research and training.....	5.2	66.9	75.0	118.6
8. U.S. Office of Education, salaries and expenses.....	12.2	26.4	32.3	40.3
9. Civil rights educational activities.....		5.5	7.1	26.2
10. Arts and humanities education activities.....		.9	1.0	1.0
11. National Defense Education Act activities.....	201.2	( <sup>1</sup> )	(*)	( <sup>1</sup> )
12. Student loan insurance.....				.9
13. Higher education (construction) loans.....			14.4	49.9
14. Higher education for international understanding.....		13.2	16.5	36.5
15. Educational television.....	( <sup>2</sup> )	13.2	9.1	20.3
16. College housing loans.....	339.1	402.3	448.0	418.6
<b>Total, education programs.....</b>	<b>602.3</b>	<b>* 3,214.0</b>	<b>3,673.8</b>	<b>* 4,115.7</b>

<sup>1</sup> Distributed among other accounts.<sup>2</sup> Less than \$60,000.

\* Total does not coincide with sum of individual items due to rounding.

TABLE IV.—*Manpower training and employment opportunities*

[Millions of dollars]

Program	1963	1966	1967 estimate	1968 estimate
Office of Manpower Administration, salaries and expenses.....	0.8	17.2	31.8	36.8
Manpower development and training activities.....	51.9	215.7	392.6	401.9
Area redevelopment training activities.....	8.3			
<b>Subtotal.....</b>	<b>61.0</b>	<b><sup>1</sup> 232.8</b>	<b><sup>1</sup> 424.3</b>	<b><sup>1</sup> 438.6</b>
<b>Vocational Rehabilitation Administration:</b>				
Salaries and expenses.....	2.4	3.5	5.2	6.0
Grants for services and facilities.....	72.1	161.8	260.1	311.6
Research and training.....	25.5	52.7	59.5	65.5
Grants, correctional rehabilitation.....		.5	.8	.8
<b>Subtotal.....</b>	<b>100.0</b>	<b><sup>1</sup> 218.6</b>	<b>325.6</b>	<b><sup>1</sup> 383.8</b>
<b>Equal Employment Opportunities Commission.....</b>		<b>3.1</b>	<b>5.2</b>	<b>7.2</b>
<b>Total, manpower training and employment opportunities.....</b>	<b>161.0</b>	<b><sup>1</sup> 454.5</b>	<b><sup>1</sup> 755.1</b>	<b><sup>1</sup> 829.6</b>

<sup>1</sup> Total does not coincide with sum of individual items due to rounding.

TABLE V.—Community development and renewal

[In millions of dollars]

Program	1963	1966	1967 estimate	1968 estimate
Grants for neighborhood facilities			8.0	27.0
Renewal and housing assistance, salaries and expenses	(1)	27.7	31.9	32.8
Urban renewal grants	<sup>2</sup> 335.7	320.4	364.5	450.0
Urban renewal loans	(2)	292.6	640.2	379.3
Rehabilitation loan fund		1.8	11.8	23.6
Subtotal (renewal and housing assistance)	335.7	642.5	1,056.4	912.7
Urban planning grants	12.4	20.1	22.0	30.0
Metropolitan development incentive grants				7.0
Open space land programs	.3	7.9	28.5	57.8
Grants for basic water and sewer facilities		5.7	150.0	175.0
Grants, advance acquisition of land				.2
Metropolitan development, salaries and expenses	(1)	3.9	5.3	6.4
Public works planning fund	12.5	16.2	20.5	19.1
Public facility loans	36.4	41.1	62.1	65.6
Subtotal (metropolitan development)	61.6	<sup>3</sup> 94.8	288.4	<sup>3</sup> 361.2
Comprehensive city demonstration programs			6.0	149.5
Urban information and planning assistance				1.5
Community development training programs				1.3
Fellowships, city planning and urban studies				.3
Urban research and technology <sup>4</sup>	.2	.3	.7	7.5
Housing, zoning, building code study			.6	.8
Salaries and expenses, demonstrations and intergovernmental relations	(1)	.5	1.7	5.9
Subtotal (demonstrations and intergovernmental relation)	.2	.8	<sup>3</sup> 9.1	166.6
Urban mass transportation fund	(2)	18.9	56.5	110.3
Department of Housing and Urban Development, salaries and expenses	25.2	(1)	(1)	(1)
Subtotal (Department of Housing and Urban Development)	422.7	<sup>3</sup> 756.9	1,410.4	<sup>3</sup> 1,550.7
Rural water and waste disposal		.1	40.9	30.0
Rural renewal		1.1	1.9	2.0
Rural community development service program	.1	.7	.7	.5
Subtotal (rural development and renewal, Department of Agriculture)	.1	<sup>3</sup> 1.8	<sup>3</sup> 43.4	32.5
Total, community development and renewal	422.8	<sup>3</sup> 758.8	<sup>3</sup> 1,453.8	<sup>3</sup> 1,583.2

<sup>1</sup> New accounts to parallel programs; salaries and expenses for 1963 of Department of Housing and Urban Development.

<sup>2</sup> Grants, loans and funds for urban mass transportation demonstrations were grouped together in 1963.

<sup>3</sup> Total does not coincide with sum of items due to rounding.

<sup>4</sup> Urban studies and housing research in 1963.

TABLE VI.—Area and regional economic development

[Millions of dollars]

Program	1963	1966	1967 estimate	1968 estimate
<b>Appalachian programs:</b>				
1. Region conservation program.....		6.6	3.2	3.0
2. Development highways system.....		12.0	42.3	80.9
3. Regional commission.....		1.1	1.1	.8
4. Fish and wildlife restoration.....		( <sup>1</sup> )	1.3	.9
5. Mining area restoration.....		.5	12.3	10.8
6. Timber development loans.....		( <sup>1</sup> )	.2	.7
7. Supplemental grants-in-aid.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
Subtotal, items 1-7 Appalachian redevelopment.....		\$ 20.3	60.4	97.1
8. Area Redevelopment Administration.....	70.6	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
9. Development facilities grants and loans.....		248.2	258.9	211.6
10. Industrial development loans and guaranties.....		44.4	57.1	57.9
11. Planning, technical assistance and research.....		2.8	21.6	29.7
12. Operations and administration.....		10.7	15.9	22.7
13. Economic development revolving fund.....		1.5	1.6	22.7
14. Development assistance grants.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
15. Technical and community assistance.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
16. Economic development.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
17. Economic center assistance.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
18. Grants, local development districts.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
19. Regional economic planning.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
Subtotal items 8-19 economic development assistance.....	70.6	307.6	353.1	\$ 344.7
20. Public works acceleration.....	154.8	( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
21. Transportation research, including high-speed ground transportation.....		( <sup>2</sup> )	( <sup>2</sup> )	( <sup>2</sup> )
22. Highway beautification.....		3.7	38.0	\$ 72.1
Total, area and regional economic development.....	\$ 225.5	\$ 331.6	451.5	\$ 513.9

<sup>1</sup> Less than \$60,000.<sup>2</sup> No obligations listed for these years, although funds for these programs are included in new spending authorization and/or expenditures comparisons.<sup>3</sup> Total does not coincide with sum of individual items due to rounding.<sup>4</sup> Legislation to be proposed to transfer financing of this program to beauty-safety trust fund.

TABLE VII.—Miscellaneous

[Millions of dollars]

Total program costs	1963	1966	1967 estimate	1968 estimate
1. National Science Foundation.....	320.8	466.4	490.3	538.6
2. National Foundation on the Arts and Humanities and National Council on the Arts.....		1.5	16.1	18.4
3. President's Committee on Consumer Interests.....		.3	.3	.3
Total, miscellaneous.....	320.8	468.2	506.7	557.3

TABLE 1.—Federal administrative budget expenditures by agency  
 [Dollar amounts in millions]

Department and agency	1963	1966	1967 esti- mate	1968 esti- mate	Percent change	
					1967-68	1966-68 <sup>1</sup>
Legislative branch.....	\$147	\$232	\$263	\$270	+2.7	+16.4
The judiciary.....	63	79	90	96	+6.7	+21.5
Executive Office of the President.....	23	26	31	28	-9.7	+7.7
Funds appropriated to the President.....	2,247	4,324	4,806	5,418	+12.7	+25.3
Agriculture.....	7,735	5,949	5,751	6,047	+5.1	+1.6
Commerce.....	<sup>1</sup> 632	673	746	997	+33.6	+48.1
Defense—Military.....	49,973	54,409	66,950	72,300	+8.0	+32.9
Defense—Civil.....	1,128	1,309	1,345	1,415	+5.2	+8.1
Health, Education, and Welfare.....	4,909	7,552	10,746	11,739	+9.2	+55.4
Housing and Urban Development.....	<sup>2</sup> 410	767	586	-102	-117.4	-113.3
Interior.....	<sup>1</sup> 1,030	1,437	1,456	1,692	+16.2	+17.7
Justice.....	317	372	426	445	+4.5	+19.6
Labor.....	257	503	500	527	+5.4	+4.8
Post Office.....	770	888	1,208	544	-55.0	-38.7
State.....	408	407	424	420	-0.9	+3.2
Transportation.....	<sup>1</sup> 1,008	1,276	1,471	1,375	-6.5	+7.8
Treasury.....	<sup>10</sup> 731	13,055	14,460	15,116	+4.5	+15.8
Atomic Energy Commission.....	4,758	2,403	2,270	2,330	+2.6	-3.0
General Services Administration.....	464	601	695	710	+2.2	+18.1
National Aeronautics and Space Administration.....	2,552	5,933	5,600	5,300	-5.4	-10.7
Veterans' Administration.....	5,173	5,070	6,400	6,121	-4.4	+20.7
Other independent agencies.....	<sup>1</sup> 292	275	1,052	651	-38.1	+136.7
District of Columbia.....	66	71	119	127	+6.7	+78.9
Allowance for:						
Pay increases.....				1,000		
Short full in asset sales.....				750		
Contingencies.....			100	400		
Interfund transaction adjustment.....	-513	-635	-766	-682		
Total.....	92,642	106,978	126,729	135,033	+6.6	+26.2

<sup>1</sup> 1963 figure for Department of Transportation derived by transferring expenditures for functions now in the Department—Coast Guard, Federal Aviation Agency, Bureau of Public Roads, Transportation Research, Alaska Railroad, and St. Lawrence Seaway.

<sup>2</sup> Housing and Home Finance Agency.

TABLE 2.—Federal administrative budget expenditures by function

[Millions of dollars]

Function totals with selected components	1960	1963	1966	1967 esti- mate	1968 esti- mate	Per- cent change 1966-68
National defense total.....	45,691	52,755	57,718	70,222	75,487	+30.8
DOD military.....	41,215	48,252	54,409	66,950	72,300	+32.9
Military assistance.....	1,609	1,721	968	1,000	800	-17.4
International total.....	3,195	4,412	4,191	4,608	4,797	+14.5
Economic assistance.....	1,381	1,826	1,864	2,321	2,403	+28.9
Food for freedom.....	1,458	2,040	1,784	1,710	1,799	-1.0
Space.....	401	2,552	5,933	5,600	5,300	-10.7
Agriculture total.....	3,475	5,050	3,307	3,035	3,173	-4.1
Farm income stabilization.....	2,239	3,693	1,925	2,368	2,467	+28.2
National resources total.....	1,798	2,506	3,120	3,226	3,518	+12.8
Land and water.....	1,319	1,853	2,235	2,218	2,443	+9.3
Forest.....	220	303	406	463	449	+10.6
Recreation.....	74	112	152	199	246	+61.8
Commerce and transportation total.....	1,963	2,843	2,969	3,495	3,089	+4.0
Air transportation.....	568	808	879	946	890	+1.3
Water transportation.....	508	672	708	757	806	+13.8
Advancement of business.....	265	366	193	182	407	+110.9
Area development.....		101	156	207	323	+107.1
Housing and community development <sup>1</sup> .....	122	-67	347	890	1,023	+194.8
Public housing.....	134	178	233	263	282	+21.0
Urban renewal and facilities.....	130	222	446	561	982	+120.2
Health, labor, and welfare total.....	3,650	4,715	7,574	10,389	11,304	+49.2
Health.....	774	1,437	2,523	4,265	4,767	+88.9
Public assistance.....	2,061	2,631	2,797	2,942	3,036	+8.5
Economic opportunity.....			1,018	1,580	1,860	+82.7
Education.....	866	1,244	2,834	3,304	2,816	-6
Veterans.....	5,266	5,186	5,023	6,394	6,124	+21.9
Interest.....	9,266	9,980	12,132	13,508	14,152	+16.7
General Government.....	1,542	1,979	2,464	2,725	2,781	+12.9

<sup>1</sup> Federal Savings and Loan Insurance Corporation, FNMA operations frequently result in offsets to budget expenditures rather than additions to them, thus the net effect for this function as a whole is a total smaller than the expenditures for some of the subfunctions above.

TABLE 3.—New spending authority by agency

[Millions of dollars]

Department and agency	Enacted		1967 estimate	1968 estimate	Percent change	
	1963	1966			1967-68	1966-68
Legislative branch.....	160	237	269	275	+2.2	+16.0
The judiciary.....	64	83	90	96	+6.7	+15.7
Executive Office of the President.....	24	27	29	28	-3.4	+3.7
Funds appropriated to the President.....	5,663	5,894	5,045	5,431	+7.7	-7.9
Agriculture.....	8,032	7,571	7,763	6,001	-22.7	-20.7
Commerce.....	760	948	1,066	1,160	+8.8	+22.4
Defense, military.....	51,120	63,892	72,034	74,674	+3.7	+16.9
Defense, civil.....	1,092	1,399	1,382	1,370	-.9	-2.1
Health, Education and Welfare.....	5,333	9,966	12,317	13,294	+7.7	+33.1
Housing and Urban Development.....	1,785	1,961	2,025	3,179	+57.0	+62.1
Interior.....	1,134	1,617	1,704	1,859	+9.1	+15.0
Justice.....	319	389	410	467	+13.9	+20.1
Labor.....	362	704	638	650	+1.9	-7.7
Post Office.....	840	962	1,227	651	-46.9	-32.3
State.....	423	403	398	415	+4.3	+3.0
Transportation.....	1,123	1,479	1,826	1,308	-23.4	-11.6
Treasury.....	10,742	13,102	14,479	15,125	+4.5	+15.4
Atomic Energy Commission.....	3,135	2,366	2,199	2,493	+13.4	+5.4
General Services Administration.....	622	596	662	569	-14.0	-4.5
National Aeronautics and Space Administration.....	3,673	5,175	4,968	5,050	+1.7	-2.4
Veterans' Administration.....	5,534	6,003	6,479	6,649	+2.6	+10.8
Other independent agencies.....	1,285	1,943	2,261	1,320	-41.6	-14.5
District of Columbia.....	70	118	141	159	+12.8	+34.7
Allowance for:						
Civilian and military pay increases.....				1,000		
Contingencies.....			150	800		
Total <sup>1</sup> .....	102,283	126,439	139,562	143,994	+3.2	+13.9

<sup>1</sup> Housing and Home Finance Agency.<sup>2</sup> Individual items may not add to totals due to rounding.

TABLE 4.—New spending authority by function

[Billions of dollars]

Administrative budget	1963	1966	1967 estimate	1968 estimate	Percent change	
					1967-68	1966-68
National defense.....	54.3	67.4	75.1	77.9	+3.7	+15.6
International affairs and finance.....	5.7	5.5	4.8	5.1	+6.3	-7.3
Space research and technology.....	3.7	5.2	5.0	5.0		-3.8
Agriculture and agricultural resources.....	7.1	5.0	5.1	3.1	-39.2	-38.0
Natural resources.....	2.4	3.4	4.5	3.6	-20.0	+5.9
Commerce and transportation.....	4.0	3.9	4.3	3.3	-23.3	-15.4
Housing and community development.....	.6	1.8	2.2	3.0	+36.4	+66.7
Health, labor, and welfare.....	5.4	9.3	11.1	12.4	+11.7	+33.3
Education.....	1.4	4.3	4.6	5.2	+13.0	+20.9
Veterans benefits and services.....	5.5	6.0	6.5	6.7	+3.1	+11.7
Interest.....	10.0	12.1	13.5	14.2	+5.2	+17.4
General government.....	2.2	2.5	2.7	2.7		+8.0
Allowances for:						
Pay increases.....				1.0		
Contingencies.....			.2	.8	+300.0	
Total.....	102.3	126.4	139.6	144.0	+3.2	+13.9

TABLE 5.—Permanent, full-time civilian employment in the executive branch, by agency

[Thousands]

Department and agency	1966	1967 estimate <sup>1</sup>	1968 estimate	Difference	
				1967-68	1966-68
Agriculture.....	84.1	84.4	85.8	+1.4	+1.7
Commerce.....	25.1	25.1	26.8	+1.7	+1.7
Defense-Civil.....	30.3	32.3	33.0	+2.7	+2.7
Health, Education, and Welfare.....	91.7	95.9	99.8	+3.9	+8.1
Housing and Urban Development.....	14.0	14.2	15.4	+1.2	+1.4
Interior.....	59.4	60.2	62.1	+1.9	+2.7
Justice.....	33.1	33.1	33.7	+0.6	+0.6
Labor.....	9.2	9.3	9.8	+0.5	+0.6
Post Office.....	489.9	525.0	539.3	+14.3	+49.4
State.....	24.6	25.0	25.4	+0.4	+0.8
Agency for International Development.....	14.9	16.8	17.5	+0.7	+2.6
Peace Corps.....	1.2	1.2	1.6	+0.4	+0.4
Transportation.....	52.9	53.9	55.8	+1.9	+2.9
Treasury.....	80.2	80.9	83.2	+2.3	+3.0
Atomic Energy Commission.....	7.0	7.0	7.2	+0.2	+0.2
General Services Administration.....	36.0	36.6	37.5	+0.9	+1.5
National Aeronautics and Space Administration.....	33.5	33.6	34.0	+0.4	+0.5
Veterans' Administration.....	147.6	149.3	154.2	+4.9	+6.6
Other:					
Selective Service System.....	7.0	6.3	6.3	-----	-0.7
Small Business Administration.....	3.9	4.1	4.8	+0.7	+0.9
Tennessee Valley Authority.....	11.5	11.8	12.3	+0.5	+0.8
Panama Canal.....	14.1	14.6	14.9	+0.3	+0.8
U. S. Information Agency.....	11.5	11.9	12.0	+0.1	+0.5
Miscellaneous.....	30.8	31.7	32.9	+1.2	+2.1
Contingencies <sup>2</sup> .....		1.9	4.8	+2.9	-----
Subtotal <sup>3</sup> .....	1,313.3	1,366.0	1,410.1	+44.1	+96.8
Defense, military and military assistance.....	1,053.0	1,180.5	1,204.9	+24.4	+151.9
Total <sup>4</sup> .....	2,366.3	2,546.5	2,615.0	+68.5	+248.7

<sup>1</sup> Year ago and current estimates for 1967; selected contrasts.:

[Thousands of dollars]

For 1967	Year ago	Current	Change
Total.....	2,416.5	2,546.5	+130.0
Military.....	1,073.0	1,180.5	+107.5
Other.....	1,343.5	1,366.0	+22.5
Selected agencies:			
Post Office.....	500.0	525.0	+25.0
Agriculture.....	82.9	84.4	+1.5
Commerce.....	31.8	25.1	-6.7
Health, Education, and Welfare.....	99.0	95.9	-3.1
Treasury.....	86.2	80.9	-5.3
Veterans' Administration.....	150.9	149.3	-1.6

<sup>2</sup> Subject to later distribution.

<sup>3</sup> Individual items do not add to exact total because of rounding.

Chairman PROXMIRE. Congressman REUSS?  
 Representative REUSS. I was particularly interested in your table 2 "Trends and profit margins compared with unemployment rates," and would ask that you refer to it. (See p. 798.) It's interesting to note that in 1961, the unemployment rate was 6.7 percent, and as your chart shows, it has gone steadily downward so that in 1966 it was 3.9 percent, and conversely the after tax profits of manufacturing corporations as a percentage of sales back in 1961 was 4.3 percent, and it has gone steadily upward, year after year, until in 1966 it was at 5.6 percent.

Doesn't this suggest that the economic policies of the period of 1961 and thereafter have been successful in reducing unemployment, and that the economic growth inherent in that reduction in unemployment has redounded to the benefit of manufacturers, as shown by the steady increase in their after tax profits?

Mr. HAGEDORN. I sort of draw the opposite conclusion, Congressman. Yes, the policies that have been pursued have had good results, both on the profit side and on the employment side. The train of causation in my mind is that the general policies pursued have permitted a rise in profit margins, and that rise in profit margins has caused employers to hire more people and to relieve the unemployment problem. That would be my analysis of the train of cause and effect. May I explain why?

Representative REUSS. Surely.

Mr. HAGEDORN. First of all, on the general principle that people are hired because it is profitable for somebody to hire them. This is the basic fact you have to recognize on the question of how big unemployment is going to be in a free economy.

Representative REUSS. People hire them, though, depending on the level of total demand.

Mr. HAGEDORN. Well, it has to be a demand that makes it profitable for you to hire them. You are not going to hire people just to satisfy a vague demand that exists out there, if the cost level is such that you lose money satisfying that demand. It has to be demand under conditions that makes it profitable to supply the demand.

Second, I don't know whether I can illustrate it from this chart. If you look at the fine detail, you find that the unemployment rate tends to turn up somewhat after the profit margin turns down. For example, the profit margin actually reached its peak in 1956, but the peak of the business cycle itself you will recall was in 1957, and unemployment didn't start rising until the end of 1957.

This point could be illustrated better with monthly figures or with quarterly figures. But if you look at the fine detail, you find that the profit margin is one of the first things to turn in business turns, whereas employment is one of the last things.

Representative REUSS. What we have had is policies since 1961 which have obviously been successful in reducing the unemployment rate. Equally, the after tax profits of manufacturers have gone up percentagewise. Now I would have thought, very frankly, that the pleasing performance of the after tax profits of manufacturers was due to the greater use of the economy, as indicated by the reduction in unemployment.

You aren't suggesting the exact opposite, are you, that it should be the task of Government to concentrate on increasing the after tax profits of manufacturers, and then that will then tend to bring down unemployment?

Mr. HAGEDORN. Well, I think I am suggesting that you should move very cautiously in doing things that obviously would reduce those after tax profit margins, because it will have a repercussion on employment. Yes, sir, I am saying that.

Representative REUSS. Well, it's an interesting position, and I suppose it is the "chicken and the egg" school.

Mr. HAGEDORN. Perhaps I have oversimplified it.

Representative REUSS. I am much more impressed, I must say, by what actually happened, where the governmental attack was on unemployment, and unemployment did go down, and where the after tax profits went up for what seems to me the logical reason that with greater production, manufacturers' fixed costs could be spread over a larger number of units and their profits went up.

I should think, equally, that one could increase manufacturers' profits, in the first period at least, by wiping out the corporate income tax, just to take an absurd example. Yet, I wouldn't be at all sure that this would have a healthy result on the unemployment figure, and I don't think you would either.

Mr. HAGEDORN. No. I have been oversimplifying here, because what economists should be talking about is the marginal profit rate, and the marginal rate of employment. Profits at the margin—does it pay you to undertake the next bit of business that would draw so many people into the labor market. However, this would get us into a complicated discussion.

Generally, I think this is a very important principle, that you can operate to increase employment only by first creating profitable opportunities for people to hire others. That is, unless the Government is to hire the people, hire the whole labor force itself.

Representative REUSS. Thank you very much. My time is up.

Chairman PROXMIRE. Mr. Hagedorn, in looking over this Government expenditures committee study that you have here, even this committee specifically organized to study expenditures, does seem to be unfortunately generalized in their recommendations as to where we should specifically cut, but they seem to zero in on what is called "the massive public framework for social and economic opportunity," and you go on to have a series of analyses showing that 21 welfare oriented programs are up \$3.8 billion in 1963 to \$7.9 million—health programs have tripled, education programs have gone up sevenfold, and so forth.

Now, many economists who appeared here argue that education programs represent a good economic investment in general. The one area it would seem to me that represents a very large dollar increase at all comparable with the increase in defense spending would be the proposed increase in social security benefits.

If we are going to be realistic about it, if we are going to really cut spending—I mean if we are going to reduce the spending on the basis you have proposed here—that is, not cut public works or the space program very much, or some of these other programs, it would seem to me we have to think very carefully about the President's suggestion of a 20-percent increase in social security benefits.

Do you think we should not increase social security by 20 percent, that we should keep it down to an 8-percent increase, or something of that kind?

Mr. HAGEDORN. I can't give you any official view of the National Association of Manufacturers on that question, sir.

Chairman PROXMIRE. You see, we look to the NAM because the NAM has been a very strong conservative bulwark and a very thoughtful group too, I think.

Mr. HAGEDORN. Thank you, sir.

Chairman PROXMIRE. But, you know when we look in the area of cutting spending, and you fellows don't come up with any specific recommendations, it makes it hard for those of us who are Members of Congress, who have to run for reelection and have to stand or fall on somebody cutting spending—you fellows don't have to worry about that.

Mr. HAGEDORN. I understand your position, Senator. All I can say is that if the NAM were to make a list of the specific things they would like to have cut out of the budget, they would in effect be exhibiting that their priorities are different from somebody else's priorities, and as I said, and it was a very heartfelt statement, there is no formula that anybody can derive that will enable you to put something through a computer and say "This is worthwhile, that isn't worthwhile."

Chairman PROXMIRE. That is what we have got to do.

Mr. HAGEDORN. That is what you have to do.

Chairman PROXMIRE. You have manufacturers in aerospace and they are members of your organization.

Mr. HAGEDORN. That is right.

Mr. PROXMIRE. They don't want to see the space program cut. Maybe they do. I doubt it. You have people who are in the road building and in road construction and who work at producing the materials for these big reclamation projects and I can see why they would be concerned.

But that is the whole trouble, you know, with cutting spending. If we are going to cut it, we have to establish priorities, and if this great organization of American business can't give us any specific advice, it is difficult, as I say, for us to establish the priorities over the President.

Mr. HAGEDORN. I know it is, Senator, and I have to admire you, and I say I am sure you have the courage to do it. But I don't have any set of priorities of my own to offer you.

Chairman PROXMIRE. Let me ask—referring to your very interesting table which Congressman Reuss mentioned before—if you could give us the statistics for 1952 and 1953, 1953 especially? 1952 was a price control year, so that wouldn't be quite as appropriate.

Mr. HAGEDORN. I think you can find that.

Chairman PROXMIRE. I have got your figure for after tax profits of manufacturing corporations as a percent of sales. That particular statistic was one that was not in the council's tables, but the price increase was very interesting. I mean the unemployment rate that year was the lowest we have had since—

Mr. HAGEDORN. That was during the Korean war period.

Chairman PROXMIRE. Well, it was after the Korean war. In 1953 when the Korean war ended, unemployment was 2.9 percent, and the price controls expired in April. Prices rose less than 1 percent. I would be interested to know whether after-tax profits of manufacturers as a percentage of sales were very high. According to your thesis, they should be. I am not so sure they were.

Mr. HAGEDORN. That was also a year of excess profits tax. I believe it was still in effect in that year, reducing the profit margins in that year.

Chairman PROXMIRE. Well, that may be, but that would argue, on the other hand, that either you are going to have prices go up, which we didn't have, or you are going to have unemployment develop, which we didn't have. In other words, the Government adopted a policy of reducing profits deliberately.

Mr. HAGEDORN. Yes.

Chairman PROXMIRE. And unemployment stayed down.

Mr. HAGEDORN. Well, in a wartime situation like that—you still had the Korean war.

Chairman PROXMIRE. It was over. Furthermore, we have a war-time situation now.

Mr. HAGEDORN. But a much smaller percentage of the national product is being devoted to war.

Chairman PROXMIRE. It is smaller; yes.

Mr. HAGEDORN. At this time.

Chairman PROXMIRE. Yes. Well, it's an interesting thesis and I think there is a lot to be said for the notion that if you do stimulate business to expand and grow, this obviously can provide jobs. I think that thesis makes sense from a logical standpoint. Senator Miller?

Senator MILLER. Thank you, Mr. Chairman.

Mr. Hagedorn, I share with you the desire to have a reasonably balanced Federal budget as a means of avoiding further inflation. I invite your attention to the fact that for the coming fiscal year, 1968, which we are now involved with in our appropriations and our revenue estimates, the President's budget forecasts an \$8 billion deficit.

Now in order to hold it down to \$8 billion, he estimated a \$5 billion sale of participation certificates, a \$5 billion tax revenue from the 6-percent surcharge, and \$700 million from a postal rate increase.

I don't know whether you favor a postal rate increase or not, but that is relatively small in the overall picture, but I would point out to you that all of these added together, in other words, a \$8 billion deficit estimate, and if the Congress does not go along with the postal rate increase, and if it does not go along with the tax increase, and if the participation sales are not accomplished, this would bring us to a deficit of \$18.7 billion.

Now let me ask you first, do you favor this participation certificates sale of \$5 billion?

Mr. HAGEDORN. Let me answer that question this way. The sale of participation certificates is not necessarily wrong, but the extent to which it should be done depends on the situation in monetary markets. What shouldn't be done is to pretend that this is offset to spending. It's a form of Federal debt, and has the same impact on using up capital resources of the country as the sale of Federal debt. We shouldn't be deceiving ourselves, by pretending that this is a reduction of expenditures.

Senator MILLER. I agree, but the point I am making is that if you are interested in avoiding a pressure on the capital market, which will result in an increase in interest rates, then you are interested, I presume, in not having the sale of participation certificates.

Mr. HAGEDORN. Well, if you didn't sell the participation certificates as a result of not needing to because of curtailment in other forms of Government spending, why yes, that would be something accom-

plished. But if instead of selling the participation certificates you sold ordinary Treasury notes or bills, then it doesn't really make an important difference.

Senator MILLER. I agree. So what we are talking about really is a cutback of \$18.7 billion of domestic spending so that we won't have inflation. Now, if we could reduce domestic spending by \$18.7 billion, we wouldn't have to have a postal rate increase of \$700 million. We wouldn't have to have a tax increase of \$5 billion, and we wouldn't have to have a sale of participation certificates of \$5 billion, and we wouldn't have an \$8 billion deficit forecast by the President.

Now I must say that I have very deep doubts whether or not domestic spending should be cut back by \$18.7 billion, but what I would like to have, I would like to have you furnish this committee with some suggestions along this line, and add them up, and then if you are short of the \$18.7 billion, then give us a suggestion on whether a tax increase should be enacted, and if so, what kind, or whether you prefer to have inflation, which will inevitably follow, if we have that deficit.

I think it would be meaningful to us, and I think this is something that I think many people have completely dodged since the President's budget message. I think it might be a good place to start, to have your association give us some recommendations on this, giving us your own views on it.

Mr. HAGEDORN. I can't promise you anything of that sort.

Senator MILLER. If you can, I would invite you to do so, because I think you represent a very important sector of the economy, and I think that your views on this should be made known, and I think they might be helpful to us in evaluating what to do.

Referring to table 2 in your statement, may I ask what percent of the total industry in this country, which now has Department of Defense contracts or subcontracts would your association represent, do you suppose?

Mr. HAGEDORN. I can't give you a percentage figure offhand, but a good many of the companies with Defense contracts would be members of our association.

Senator MILLER. Would you say 75 percent?

Mr. HAGEDORN. It might be roughly somewhere in there. I don't know. I haven't seen any compilation on that.

Senator MILLER. Would you be able to get that figure?

Mr. HAGEDORN. I am not sure that we would have information on our membership that goes into that detail. What is your point, Senator?

Senator MILLER. My point is this. Suppose you can check this out and concluded that roughly 75 percent of the businesses in this country which now have or have been having Defense Department contracts or subcontracts is involved in your membership. Perhaps you could then isolate those members of your association which do have those contracts, and give us the picture of their employment for say the years 1963, 1964, 1965, and 1966. I am very interested in finding some fairly good estimates of how much employment has been increasing in these plants that have Defense contracts or subcontracts over the last 4 years.

Mr. HAGEDORN. I believe the Bureau of Labor Statistics has compiled figures on defense-oriented industries.

Senator MILLER. I understand.

Mr. HAGEDORN. You can't pick out particular people who are working on defense jobs.

Senator MILLER. I am not talking about that. I am talking about the total employment. For example, manufacturer A, which happens to be a member of your association, and is a Defense contract type plant, let's say in 1963 they had a thousand employees. Today they have 4,000 employees. I would like to see how you come out and compare this to the Bureau of Labor Statistics' information.

My guess is that this favorable unemployment rate, which is shown especially for the last 2 years, would be very substantially affected by the numbers of people who have been added to the payrolls of defense-oriented plants, and I don't know where else to go to get this information, unless it is to your association, outside of the Bureau of Labor Statistics.

Do you have a feeling that the favorable unemployment rate shown in this last column in the last 2 or 3 years is attributable in some measure to the increased employment in Defense plants?

Mr. HAGEDORN. Oh, undoubtedly this has been one factor among many; yes.

Senator MILLER. I am very interested in knowing how big that factor is. I have reason to believe it's quite substantial, but I don't know where to get that verification unless it would be as I say from the Bureau of Labor Statistics or some association such as yours.

Mr. HAGEDORN. Well, I would think the Bureau of Labor Statistics would be able to provide you more detailed information than I could, Senator, because most of our members cooperate with the Bureau of Labor Statistics in providing them with monthly figures on employment, and so forth.

Senator MILLER. You are saying that we will have to rely exclusively on the Bureau of Labor Statistics and I will. I thought you might possibly be able to get some information together.

Mr. HAGEDORN. I don't think we could get anything more detailed than what they have on the defense-oriented industries. Incidentally, I see no reason for any lack of faith in the figures that they have prepared.

Senator MILLER. I have no reason to doubt the veracity of what they are putting out. My only question would be the coverage that they have, how accurate that is. It's like employment statistics. Nobody is questioning the truth of the unemployment statistics. We question the depth in which they go to arrive at the unemployment statistics. We have had extensive hearings under Senator Proxmire's leadership a couple of years ago.

Mr. HAGEDORN. I recall them, sir.

Senator MILLER. Which showed a lot of softness in unemployment statistics, and I am concerned about how hard these figures on increased employment in defense plants are. But my point is—and if you can shed any light on it, I would appreciate it—my point is that for somebody to trot out an unemployment statistics table and show that in the last 2 or 3 years we have had a very substantial decline in unemployment statistics, and then to jump from that observation to

the conclusion that this means, automatically, that the policies of the Federal Government have been so wonderful in arriving at this statistic, does not impress me very much when I realize that there are hundreds of thousands more people working in defense plants because of a war.

Mr. HAGEDORN. What you mean is that there might have been better ways of getting unemployment down to this low level.

Senator MILLER. Well, I don't know, I would hope that there would be ways of getting it down to a low level, but if there is a wartime factor involved, which has had a major impact in increasing employment in defense plants, I don't like to see that forgotten when somebody talks about wonderful policies of the Federal Government in reducing unemployment rates.

That is my point. If you have any light you can shed on it for the committee by a separate memorandum I would appreciate it. I have no further questions, Mr. Chairman.

Chairman PROXMIRE. Thank you, Senator Miller.

Thank you very much, Mr. Hagedorn, for your usual very helpful and enlightening appearance. I appreciate it a great deal.

Our witnesses this afternoon will be Robert Roosa, general partner of Brown Bros., Harriman, former Under Secretary of the Treasury; and Charles Kindleberger, a very distinguished professor of economics at MIT, on the balance of payments.

The committee will stand in recess until 2 o'clock.

(Whereupon, the committee recessed until 2 p.m. of the same day.)

#### AFTERNOON SESSION

Chairman PROXMIRE. The committee will come to order.

We are very happy and fortunate to have as our witnesses today two of the most distinguished experts in the world on the balance of payments, and two men who have the admiration of this committee.

Our first witness is the former Under Secretary of the Treasury for Monetary Affairs, a man who has found particular esteem throughout America. I have talked to so many people in the financial business who are very much impressed by your brilliance, Mr. Roosa, and we are very happy to have you here. You are now, I believe, the partner of Brown Bros., Harriman & Co.

Mr. ROOSA. Yes.

Chairman PROXMIRE. You have an amazingly short statement. In all the years I have been on this committee, I have never seen a shorter statement, but we will have to go after you in the questioning period pretty hard. You go right ahead.

#### TESTIMONY OF ROBERT V. ROOSA, GENERAL PARTNER, BROWN BROS., HARRIMAN & CO.

Mr. ROOSA. Mr. Chairman, as I indicated in the statement, I have been impressed this year particularly with the wide range of issues that seem to me to be appropriate for this committee's attention. As I attempted in a cursory way to follow what has already proceeded in the hearings that you have been having, I have found it quite difficult

to decide where I could appropriately try to make some contribution, particularly because I have, for 2 years, learned what it means to live without an official "in" basket, and without a staff. Therefore, since I am flying solo, I thought it would be more constructive from your point of view if we could, after this very brief introductory comment, turn in whichever direction—in the areas that I might try to comment on—that appears promising to the members of the committee, and in that way maximize your use of this time.

It does seem to me that in the year ahead, we are going to have to face, as a number of members of the Senate have already in a very telling way suggested, another appraisal of our foreign commitments, and one that takes into account the economic dimensions that our own economy is capable of supporting.

I think this means, without going into again, as you have heard so often, the background in the balance-of-payments performance of 1966, it does mean that we have this additional motive, the motive of limiting our own outflow of dollars on Government account, to reinforce what are in their own right valid and I think compelling reasons for reviewing the entire posture of the United States and its allies in maintaining an appropriate military presence in Europe.

Alongside that, and I just hinted at this in some of the questions I posed in the statement, I think it is also going to be appropriate to ask some questions about the continued sustainability or viability of some of our own domestic programs. I don't here refer to the poverty programs at all, but instead to those that we may have lived with for so long that we are losing sight now of the fact that they are not only perhaps out of phase with the historical stage our economy has reached, but perhaps also not going to permit us to make the kind of contribution over the next 10 or 20 years that we should be considering.

I refer particularly here to our agricultural program, where I think it is, broadly speaking, an anachronism that we continue, although in reduced amount to be sure, to have to appropriate and spend substantial amounts this year in the proposed budget, to be sure only in the magnitude of something over \$2 billion, but still substantial amounts for the limiting of crops, for the restraint of what is, in a competitive sense in the world economy, our most productive enterprise, the agricultural sector of the economy.

I think perhaps the time has come for a reconsideration there of the gains that might be achieved, if we could make more rapid progress toward a freeing and an opening to the free market of the potentials of our agricultural economy.

And I think, too, in order to continue to maintain the growth that the economy needs, not just for this year but for the long term, I regret very much that there was a suspension of the investment credit last year.

I would have much preferred to have seen a comparable or appropriate degree of restraint effected through overall tax measures, but since that stage has been passed, I think given the present phase that the economy has entered, it is going to be appropriate promptly to consider—from the standpoint not just of the moment, not just of the phase of the cycle we are in, but in terms of the longrun needs of the economy to maintain its price competition, and in a competitive world

where our balance-of-payments position has certainly been slipping—to restore the investment credit as an incentive to the deepening of the productivity base of the American economy, particularly in the manufacturing-distributive sectors.

These, Mr. Chairman, are some of the observations that I made in initial comment, but only as a way of suggesting in this specific form that I was probably right in my first presumption, that the areas that can be covered here are so wide, and certainly the capacity I would have is so limited in any of them, I would rather not pretend to choose, but instead follow in whatever direction your own questioning is likely to lead.

(The complete statement of Robert V. Roosa follows:)

PREPARED STATEMENT OF ROBERT V. ROOSA

Mr. Chairman, it is a privilege to appear once more before this distinguished committee. It is here that the array of governmental economic programs can be brought together, in order to appraise their combined impact on the performance of the economy as a whole. It is here that the Congress can step aside from the immediate urgencies of legislation to appraise as well the implicit, and perhaps otherwise unnoticed, implications of many Government activities that are not ordinarily viewed in an economic context. This is indeed the place where the testing can take place, to determine whether and how the potentials inherent in all forms of governmental action may be used to reinforce the main lines of explicit governmental economic policy.

It is that kind of reappraisal—to assure adequate consideration of the economic dimensions of the entire array of public policies—that may have a dominating importance within the scope of this committee's responsibilities for the coming year. For speaking broadly, and without for a moment questioning the Administration's aims in defense and diplomacy, I think it is fair to say that the American economy would at this moment be enjoying sturdier expansion at home, and a sustainable viability abroad, had not additional distortions and pressures been imposed by the Vietnam effort. In setting the sights now for the economy in 1967, and beyond, the Legislative branch, it seems to me, can appropriately ask not only "What do our military and foreign affairs commitments imply for the American economy," but also "What do the priorities and potentials for our own economy's health imply for the dimensions and scope of our undertakings abroad."

It does not seem to me to be an impairment of our dignity or prestige to take stock of the two-way interactions between our economic capabilities and the responsibilities we wish to assume in world affairs. My own very modest attempts at that kind of appraisal, within the limitations that are inherent for any private citizen, have led me to a number of tentative conclusions with respect to the programs and prospects for the American economy this year.

Because I cannot presume to bring the comprehensive background needed for an adequate appraisal, my participation today can only be that of an anxious questioner. For that reason, I am not presuming to present a brief in support of a fully developed position. I do welcome very much however, your Chairman's invitation to discuss with you a number of compelling questions—though by no means, of course, covering the full range of relevant inquiry. First, may I suggest several questions of a broad analytical nature; and then second, several of more specific immediacy.

I. The general nature of our problems:

1. Is the economy now entering a cyclical recession, or is it instead in a hesitation phase induced mainly by the mix of governmental economic policies of 1966?
2. Why did our foreign trade and payments position deteriorate in 1966 and what is the prognosis for 1967?
3. Why have no dollars been added on balance to the official monetary reserves of other countries for the past two years? Is there a weakening underway in the world economy as a whole, or in the United States position within the world economy?

## II. Some more specific questions :

1. Should a surcharge be made on Federal corporate and individual income taxes?
2. Is there scope for changing the impact of Federal Government expenditures upon the economy, including defense expenditures?
3. What can be done through a harmonization of monetary policy, debt management, and the borrowing and lending activities of Federal credit agencies?
4. Should the investment credit promptly be restored?
5. Should the Interest Equalization Tax be renewed? Are there other sectors of the balance of payments that need comparable selective treatment?
6. Has the time come to promote agricultural production via the free market, rather than to limit that production and pay heavy subsidies?
7. Are there alternative monetary techniques, not yet tried, which could insulate the American economy? Could these be consistent with American foreign policy objectives?

Mr. Chairman, the agenda of your committee is so extensive, and the documentation already presented to your members is so lengthy, that I have not presumed to elaborate on any of these questions in advance. From among them, I would hope, the various members of the committee may find some which they would like to pursue, while undoubtedly discarding others which they have already explored to their full satisfaction.

Chairman PROXMIER. Thank you very much, Mr. Roosa. We will have the statement from Mr. Kindleberger, and then we will question you. I should introduce our other distinguished guest, incidentally, who as I say has been a well-known monetary authority for years. He comes from the Massachusetts Institute of Technology. We are very honored and delighted to have you here, Mr. Kindleberger.

**STATEMENT OF CHARLES P. KINDLEBERGER, DEPARTMENT OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY**

Mr. KINDLEBERGER. Thank you, Mr. Chairman.

I am honored in being asked to comment on the balance-of-payments passages in the Economic Report of the President and the Annual Report of the Council of Economic Advisers. May I refer at the same time to a somewhat wider discussion of the subject in recent weeks, including the speech to the Economics Club of New York on January 18 of my distinguished colleague today, former Under Secretary of the Treasury Robert V. Roosa?

What follows on the U.S. balance of payments and choices for policy is idiosyncratic. In particular, I do not think the balance of payments is in bad shape, or that there is need for further steps to improve it. I oppose taking measures solely for balance-of-payments reasons, such as bringing home troops from Europe, raising or maintaining high interest rates here, or seeking to cut the United States still further off from the international capital market through higher taxes on international capital movements, as recommended by the President and supported by the Council. The international capital market is a highly flexible and efficient instrument for transferring liquidity internationally which saved this country from a serious banking crisis last August. The world needs it and we need it.

My observations are presented under three headings: (1) The balance of payments of the United States in 1966; (2) the impact of the balance of payments on domestic monetary policy; and (3) the importance of the international capital market to the world economy.

## THE U.S. BALANCE OF PAYMENTS IN 1966

The balance of payments of the United States improved in 1966. It is true that the "overall balance" showed little or no gain, but that Department of Commerce definition of equilibrium is not acceptable to me. It is true, further, that there was a worrying decline in the balance-of-payments surplus on current account as a result of the rise in imports and the increase in overseas expenditures owing to Vietnam. Moreover, Mr. Roosa is right in not being cheered by the improvement in the balance on official transactions—the so-called Bernstein balance. That definition loses significance when it is realized that the \$2 to \$3 billion which was borrowed or brought back from the Euro-dollar market last summer is not a permanent movement of capital to the United States. The loans have to be repaid, and the repatriated funds owned by U.S. banks will be replaced abroad. The basis for stating that the balance of payments improved is that we lost less gold. Our gold losses, which rose from \$100 million in 1964 to \$1.7 billion in 1965, declined to \$571 million in 1966. This amount represented a loss of \$600 million to France, offset by a small net gain otherwise. And the improvement extends into 1967 since the French balance of payments has turned from surplus to deficit last September.

This judgment of the balance of payments solely by gold losses is not based on the theories of Jacques Rueff, nor does it ignore the fact that the monetary authorities have wide latitude in which they can adjust the figure to their public purpose. The position is in fact somewhat worse than \$571 million, since there was a reduction of \$700 million in our gold tranche position at the International Monetary Fund, offset to the extent of \$500 million in holdings of convertible currencies, both during the first 9 months of the year. Moreover, there may be need for further adjustments on account of changes in official swap positions, Roosa bonds, et cetera.

This view is not then based on a naive interpretation of the gold standard. On the contrary, it rests on the belief that the liquidity and official-transactions criteria for judging the balance of payments of the United States are thoroughly misguided, since they treat the United States as a firm when it is in fact a bank. A firm typically wants a current ratio of quick assets to demand liabilities of something like 3 to 1, because it must meet and pay off its demand liabilities. A bank on the other hand is in the business of having its liabilities used as money. It is in the business of lending long and borrowing short, continuously. Under normal conditions its liabilities run on indefinitely. And a bank is in good shape so long as its depositors have confidence in it, and its assets are sound, if it has a quick-asset ratio of, say 1 to 5. This ratio for the United States as a bank is roughly 1 to 2 if you measure gold and convertible currencies of the Government against demand liabilities, or virtually 1 to 1, as calculated by Mr. Roosa in his New York address, if you add in short-term liquid claims. The real questions then turn on the character of our assets and the confidence of our depositors.

Almost no one questions the soundness of the assets which U.S. investors are acquiring abroad. In a little-noticed speech on December 8, 1965, before the U.S. Council of the International Chamber of Commerce in New York, however, Secretary of the Treasury Henry H.

Fowler observed that rates of growth were leveling off in Europe and profits were declining. This should make direct investment there less attractive, although some investment may continue at a high level because of plans laid down earlier, or because of investment in Europe continues fashionable. To a certain extent, new investments take time to pay off. Nonetheless, it is somewhat disconcerting to observe large losses on some investments—General Electric in Machines Bull in France and Chrysler in Rootes in England. On the whole, there is no reason to doubt that the profitability of the U.S. foreign investment in general, but the academic economist can express surprise that it is not more sensitive to profit prospects.

The big change, however, has occurred in the confidence of the foreign depositors in the U.S. bank. The major depositor which had strongly negative views on the United States as a bank—France—is no longer in a position to exert pressure by converting dollars into gold. Countries like India, the Philippines, South Korea, Taiwan, and Thailand, mentioned by Mr. Roosa as gaining dollars in 1966, need and want to hold dollars. The counterpart of the French, Italian, and Dutch deficits in 1966 was the German surplus, which follows on the heels of a substantial German deficit in 1965.

Here two points can be made. First, in common with other countries of Europe, Germany now understands that large swings in the balance of payments occur because of differences in cyclical timing. France had large surpluses in 1964 and 1965, when it was relatively depressed; it is having deficits in 1966 and 1967 now that it has gotten growth going again. Germany had a deficit in 1965; now that it has gotten its inflationary spending under control, it has a surplus in 1966 and 1967. There is no European surplus as a whole against the United States, and the large swings of the separate countries are best settled in dollars rather than in gold.

In the second place, Germany and the world have learned a lot more about international financial transactions. The report of the Common Market on "The Development of a European Capital Market" (the so-called Segré report) of the European Common Market observed that in the period 1960–65 the net import of private medium- and long-term capital by the Community amounted to slightly more than \$6.5 billion which was more or less offset by the net export of official capital and short term funds. The surpluses of the continental European countries are therefore not earned but borrowed. A study by the Bundesbank last November of the external assets and liabilities of 700 domestic German business enterprises shows these to have net external liabilities at the end of September 1966 of more than \$1 billion each on short-term and long-term account. Some of these liabilities have been incurred by foreign-owned firms, to be sure, and \$800 million of the Community inflow represented direct investment which can be regarded as permanent. Nevertheless, the point is dawning in Europe that a country is not in a real surplus when it borrows long and lends short. Soon it will be seen that the United States is not in real deficit when, within limits, it lends long and borrows short.

In my view, then, confidence in the dollar and the utility of dollar reserves improved in 1966 and this is an improvement in the balance of payments of the United States which no rule of thumb can measure.

I therefore disagree with Mr. Roosa when he says, "All of us should give the highest priority in 1967 to closing the gap in the basic balance of payments," and I disagree with the New York Times editorial on January 23 entitled "The Persistent Deficit," which applauded Mr. Roosa's remarks and criticized the President for not playing up the balance of payments in his state of the Union message. The President was right. The war in Vietnam and poverty in the United States are far more important issues today than the balance of payments.

#### THE IMPACT OF THE BALANCE OF PAYMENTS ON MONETARY POLICY

Mr. Roosa foresaw the need to keep short-term interest rates high in the months ahead as a means of holding foreign short-term funds in this country. I disagree. Part of the reason is the different view of the balance of payments already set forth. In addition, however, we have a different interpretation of how the international capital market works. My view is given in a submission to the Joint Economic Committee's compendium entitled "Contingency Planning for U.S. International Monetary Policy,"<sup>1</sup> especially pages 60 to 62, and I can be brief. In general, the view is that monetary policy in the United States operates over the Atlantic Community as a whole, with certain exceptions like Great Britain, where dealing in the Euro-dollar market on an uncovered basis is restricted. Just as the action of the Federal Reserve System is tightening interest rates in November 1965 and July 1966 raised interest rates in Europe, so the reversal of Federal Reserve policy in September reduced them. The recent reductions of the discount rates in Germany and Belgium were required by the fall in market rates brought about by a reduction of negative reserves of member banks in the United States.

With joined capital markets, and even with capital markets imperfectly joined, somewhat separated as they are by the interest equalization tax, Gore amendment, V.C.R.P., and restrictions in Europe, monetary policy should be made jointly. Secretary Fowler's participation in the meeting of January 22, at Chequers with other finance ministers to lower interest rates is to be applauded—although there is something to be said for using the regular OECD machinery of Working Party No. 3 and not leaving out important parties to the decision. In the long run we need an Atlantic Open-Market Committee rather than a Federal one. But at the same time, the international capital market remains dominated by New York. If foreign central banks raise interest rates, it affects the spread between New York and their market; if New York changes its rate, it alters the whole level. Without denigrating the importance of Chicago or the European financial capitals, the same asymmetrical relationship obtains between New York and Europe as between New York and Chicago, although in lesser degree. The link, of course, is the Euro-dollar market.

For this reason, the United States has much more freedom than European countries to adjust its level of interest rates to its domestic needs. We should set these rates, as I have suggested, cooperatively.

<sup>1</sup> "Contingency Planning for U.S. International Monetary Policy," statements by private economists submitted to the Subcommittee on International Exchange and Payments of the Joint Economic Committee, December 1966.

I am persuaded, moreover, that Europe, where growth outside of France is slowed down, needs lower rates. To hold U.S. interest rates high for the sake of the balance of payments would be a double error. It would not help the balance of payments much, and it would wrongly tighten interest rates in Europe, as in the United States.

#### THE IMPORTANCE OF THE INTERNATIONAL CAPITAL MARKET IN THE WORLD ECONOMY

The Economic Report of the President recommends an increase in the interest equalization tax and the Report of the Council of Economic Advisers on pages 189 and 190 provides the analytical basis of that recommendation. A much stronger statement of this position, however, was set forth by Gov. Sherman J. Maisel of the Federal Reserve System in a speech at Portland, Oreg., on February 1, 1967. He argued that capital movements from the United States are excessive because they are inadequately taxed, and that we should apply a tax like the interest equalization tax to all capital outflows, not just the bonds and long-term bank loans now subject to interest equalization tax, varying the level of the tax to regulate capital movements in ways required by domestic goals, and particularly the appropriate mix of monetary and fiscal policy. I must respectfully disagree on all counts.

First with respect to the inadequate taxation of foreign investment. Governor Maisel, I take it, regards the tax credit on corporate income taxes paid abroad as a subsidy to foreign investment. Without taking up the question of taxing retained earnings abroad after adjustment for the tax credit, which is only a small issue in Europe where corporate income taxes are on the whole at the U.S. level, but where I incline to agree with the Kennedy administration's position in the revenue proposals for 1962, I infer that Governor Maisel wants it both ways. It seems unlikely that he wants to shift from tax on income produced to one on income received, which would require the United States as well as other countries to give up corporate income on foreign-owned firms within their borders and hardly seems practical. He must then believe in double taxation, which implies that foreign-earned income is somehow inferior to domestically earned income and should be discriminated against. This comes close to an isolationist position. Does he want to collect a national income tax on profits earned on imports, as well as the income tax we now collect on profits on exports, putting a special tariff on all imports because their producers do not pay U.S. income taxes? Admittedly, the question of how to share taxation between jurisdictions is a complex one, but most analysts have abandoned the position that the solution is to reduce or eliminate international transactions through double taxation.

Second, with respect to increasing the interest equalization tax and extending it to all foreign lending. The argument of the Council that the interest equalization tax has been successful is not compelling. It stopped lending through new bond issues in New York, but the capital outflow changed to other channels, first bank lending, then direct investment, and then the Canadian gap, the pension fund

gap, the foreign-securities gap, etc. Would the interest equalization tax be applied to foreign sales of U.S. securities already owned? If so, how? If not, it must be remembered that there are \$56 billion of foreign investment in this country which can be withdrawn to Europe if returns there become sufficiently more favorable than those in this country. What about the \$1 billion or so in unrecorded capital movements (errors and omissions). To extend the interest equalization tax involves in practice foreign-exchange control. I oppose escalation on this front and favor withdrawal.

Third, Governor Maisel and many other critics are concerned that if the United States remains joined to an international capital market, it will lose the use of monetary policy for domestic purposes and be forced to rely exclusively on fiscal policy. This fear, fed by inadequate analysis, is excessive. It is true that monetary policy has to be operated differently in an open than in a closed economy, and likewise fiscal policy. But it is not true that in an open economy with close financial ties to abroad monetary policy works solely on the balance of payments and fiscal policy solely on domestic employment and stability. Monetary policy can be set internationally on an agreed basis to meet the domestic employment and stabilization goals of the group of countries as a whole. In this process, the United States carries great weight because of its size and importance in capital markets, and retains its sovereignty in the event of inability to agree. Fiscal policy has to cover only a short distance between the agreed overall policy and the particular national domestic stabilization requirement. In a world of many nations, there must be coordination of national policies, and compromise between national objectives and international constraints. Those who put domestic policy first and international economic policy nowhere are falling into an isolationist way of thought.

The fact is that much as an international capital market is needed abroad—to provide liquidity and perhaps capital to Europe, and to provide capital and perhaps liquidity to Canada, Australia, New Zealand, Mexico, Taiwan, Peru, and other developing countries as they establish their credit standing—it is not without its relevance for the United States. Severe as was the banking squeeze last summer, the \$2 to \$3 billion which American banks borrowed in Euro-dollar market or brought home prevented a real crisis and even collapse. The Federal Reserve System may object to having its control of the domestic money market tempered by access to the international money market. In the absence of more perfect knowledge of the breaking points in the system, however, it has been helpful. Italy was saved in 1963 and 1964 from a devaluation which was unnecessary and would have upset the Common Market by private borrowing of \$1.5 billion or more in the Euro-dollar market. A further official line of credit was needed in 1964 to quiet down the speculation.

My point is that the international capital market is not only an effective instrument for providing longrun capital for economic development. Supported by joint official arrangements of the Basle-agreement type, it is a highly efficient and flexible means of providing liquidity internationally, far superior in my judgment to the plans

for a new international reserve unit. To kill the international capital market and to create a new reserve unit is to seize the shadow and throw away the substance.

More than this: the group of experts who wrote the Common Market report on the development of European capital market make the point very strongly that with fixed exchange rates, which they advocate for the Common Market, the freedom for transactions in goods and services, freedom of capital movements is necessary to make the balance-of-payments adjust. I agree. Where I would disagree is in the importance they attach to freedom of capital movements among the various constituent parts of the Common Market. So long as each country is joined after a fashion to the Euro-exchange market, largely the Euro-exchange market, largely the Euro-dollar market, and so long as New York is similarly joined, the international capital market can provide a mechanism for matching international payments. It will be a world loss and a national loss if our Government continues in its policy of escalating barriers between the United States and the international capital markets.

Thank you, sir.

Chairman PROXMIRE. Thank you very much.

Mr. ROOSA, every economist and every witness who has appeared here, including Chairman Martin of the Federal Reserve Board, has said that we need a somewhat easier money policy, prescribing that we get interest rates down, especially long-term interest rates down.

We are all familiar with the speech that you made, to which Mr. Kindleberger referred, in which you called the payments deficit coming up crucial to the dollar, and in which as I understand it, your position was that one reason for the great improvement, or the improvement that we may have had, was because of the tight money and high interest rates that we had in 1966.

How serious do you think the restraint the balance of payments places on our domestic monetary policy is? How serious do you think that is?

Mr. ROOSA. For myself I don't believe the restraint that is necessary for the balance of payments is going to affect, necessarily, at all the kind of ease that I would consider appropriate in the monetary policy for the whole economy.

First I should clarify a little the implication of my old commanding officer's remarks. He suggested that in my proposal, or at least seemed to imply in my appraisal, that I was arguing for—

Chairman PROXMIRE. Is Mr. Kindleberger your former commanding officer?

Mr. ROOSA. Yes.

Mr. KINDLEBERGER. Yes, indeed. I keep trying to preserve my authority, but it doesn't always work.

Chairman PROXMIRE. Try harder.

Mr. ROOSA. The only way he got me out of a pup tent onto a cot was to get me commissioned when we were in different circumstances, so you see I have to be very careful when I make any comment now.

But at any rate, what I am afraid he was implying was that I felt it was necessary to maintain high interest rates, regardless of the differentials or relationships which prevailed between New York and

Europe. On the contrary, I join him in applauding the efforts that are being made to gain greater harmonization between countries.

I don't think that it is going to prove possible, because it is an international capital market, for our shorter term rates to fall to the levels that we used to identify with a really easy money policy, the 1-, 2-, 2½-percent, short-term money rates.

I think that is partly because the worldwide demand, both for long- and short-term money, would create a tremendous outpouring from the United States, if we tried to bring the whole world capital market, following the Kindleberger framework, down to consistency with a 2-percent Treasury bill rate let's say. I think this is the kind of constraint on the structure of interest rates resulting from monetary policy that we have to take into account.

Chairman PROXMIRE. I want to try and bring you former service buddies together a little more. You say a 2-percent Treasury bill rate, which I don't think is Mr. Kindleberger's point.

Mr. ROOSA. No, no.

Chairman PROXMIRE. And at the same time he implied that this country pretty much settles international interest rates. Once he said we had a sovereignty in interest rates, and then again he implied we had a domination, that what New York did was more important to Europe than what Europe did as far as New York is concerned.

I take it that you would not necessarily disagree with his position on our domination—or would you—in international monetary affairs?

Mr. ROOSA. Well, in the sense that one may at any given time say that either the supply side or the demand side dominates an equation, I think you have to recognize here that both sides are important, and that the European pull on our market will be great enough so that we would have, in my view, a very large outflow of short-term money of the magnitude that we had coming in last year, if we tried to get our short-rate structure down, and to pull short rates down as Kindleberger has implied we might be able to do.

All I am trying to stress is that the interrelations are there, and I am trying to keep them in view, but we have to be a little more creative about the way in which the entire impact of monetary policy is exerted on interest rates as a whole. In my view, and here I am disagreeing with respect from views expressed by Governor Brimmer I guess just a day or two ago, but in my view it is entirely possible to maintain rates that will hold roughly a balance—

Chairman PROXMIRE. An international interest rate balance?

Mr. ROOSA. Yes, between markets between Europe and the United States, and at the same time have conditions of genuine ease in the all around capital markets in the United States, and I don't really see that this is an impossible technical goal.

Chairman PROXMIRE. Have we had much success with that, though? Didn't we try that? What you are saying as I understand it, for the record, is that you would favor perhaps a drop in long-term rates, and less of a drop in short-term rates.

Mr. ROOSA. Yes.

Chairman PROXMIRE. If the short-term rates, however, are high, relative to long-term rates, doesn't the capital flow to short-term rates?

Mr. ROOSA. That depends on the pattern of expectations set up, and whether the short rate is maintained for any considerable period above the long rate.

I don't expect to see—even if policy were followed just as I would like to apply to it—I wouldn't expect to see the short rate maintained above the long rate very long.

But it could go above from time to time, that is quite possible. Even to the extent of easing that has occurred in monetary policy already there is a spreading through into the longer sector.

It takes time after the kind of blow that the financial institutions suffered last year, because there is liquidity position to be built up in the institutions that have to distribute the longer term funds around the economy.

But I don't accept the implication of Professor Kindleberger's remark suggesting that because there is a close relationship between the European and the American capital markets, that we can set the entire level of interest rates without any concern then for the flow of funds in or out of the country that would occur. It just doesn't seem to me that that is possible. It isn't possible because we are a bank, and I just see the implications of our being a bank differently from the way in which he has expressed them.

Chairman PROXMIRE. Let me pursue this a little further. Maybe Professor Kindleberger can give us his feeling on this.

Supposing, Professor Kindleberger, your optimism is not well founded. Supposing we do have a deterioration in our balance of payments this year, and supposing we continue to have a deterioration. Supposing we continue to lose gold. When does this really become very serious in your view, or does it ever?

Mr. KINDLEBERGER. Well, I think the time that it becomes serious is when it becomes clear that the world is not ready to operate this kind of a system.

Chairman PROXMIRE. The world is not what?

Mr. KINDLEBERGER. Ready to operate on a dollar system at all. I think that the world is having doubts about it, but my suggestion has always been that they don't understand it. If they understood it, they would realize it is a very good system indeed.

Chairman PROXMIRE. So what you would pay attention to is the confidence in the dollar?

Mr. KINDLEBERGER. Yes.

Chairman PROXMIRE. And you think regardless of what the statistics may show in one year or another—

Mr. KINDLEBERGER. Exactly.

Chairman PROXMIRE. How would you measure the confidence in the dollar?

Mr. KINDLEBERGER. Well, sir, I am impressed by the extent of the use of dollars in Europe. For international transactions, the dollar is the unit of account, the medium of exchange, and the store of value in which Europeanwide bonds are issued, and the market for short-term capital operated.

I am impressed by the fact that the Electricité de France, which is the big public utility, issued a dollar bond in Europe, and this must have caused a certain twinge on the part of French nationalists. This

is the currency which people use for international transactions, just as people speak English all over the world when they are trying to carry out international communication.

Chairman PROXMIRE. But you see what concerns us, many people in Congress and throughout the country, if you assume this is important at all, is that for so many years we have had a steady adverse balance of payments where we have had a steady loss of gold.

The momentum seems to be against us. We seem to be losing control to some extent as the years do go on. And if you think of this as significant, I just wonder why you aren't concerned when we continue to suffer adverse balances in spite of all these devices to overcome it, including the interest equalization tax, which may be doubled.

Tie our aid stringently at some sacrifice in efficiency and we still continue to have this adverse balance of payments. What we would like to get maybe is some reassurance that this determination is not significant if we can get it, or if we can't get it, the recommendations as to what we can do to reverse this.

Mr. KINDLEBERGER. So long as international markets are joined, or are imperfectly separated by such devices as the interest equalization tax, and so long as there are differences in liquidity preference between Europe and the United States, with Europe having a much higher demand for liquidity than this country, there will be a strong tendency for the United States to lend long, and borrow short, and for Europe to borrow long and lend short. This is what may be called international financial intermediation.

Apart from capital, what Europe needs typically is liquidity, which the international capital market can provide them. This means, if this continues until Europe's liquidity preference gets back to something like ours, that with freer capital markets, or with capital markets no more tight than they are now, you can expect for us to lend long and borrow short for a long time.

Mr. Roosa's "Operation Twist" will accentuate this. If you lower long-term interest rates any more, then Europe will want still more to borrow here. I would say that Operation Twist worsens the balance of payments in the Department of Commerce definition, a definition which I don't accept.

I think we have been mesmerized by a Department of Commerce definition. The Chase Bank has had a deficit every year since it got started in these terms, that is, its deposits and assets have grown. I don't call it sensible to regard a bank, if its deposits and assets grow, as in deficit.

That is why the Department of Commerce definition of the deficit, which you seem to worry about and which many people worry about, is not the appropriate definition. The United States is a bank, and on that definition, any bank which is growing year by year is in deficit year by year.

Chairman PROXMIRE. My time is up. Mr. Roosa is anxious to comment.

Mr. ROOSA. I would just like to make a quick comment if I may, Mr. Chairman.

It seems to me that what Professor Kindleberger is saying is this: If the rest of the world will always have faith in the dollar as he

thinks they should, the system is safe. But in order to prove to them that they should have faith in the dollar, let's break the system first.

Let's let it go bust by creating more and more short-term liabilities to the point where they will pull out every short asset we have when there is a moment of fright, and then afterward they will say, "Aren't we sorry." And the question is whether we can sit here and say we are ready to run that experiment because we are so sure we are right, that it will all come back in place afterward, or whether we have to be seriously concerned about the threat in advance, because we have the primary responsibility to maintain confidence in the dollar from the beginning.

Chairman PROXMIRE. Congressman Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. ROOSA, you suggested that an avenue of inquiry might be with respect to the interest equalization tax. Do you believe it should be renewed?

Mr. ROOSA. Yes; I do. As you know, I appeared before the various committees of the Congress when the interest equalization tax was being first considered, and when I did, I said with all the capability that I then possessed that I considered it as a temporary measure.

I still consider it as a temporary measure, and I certainly realize the awkwardness of having to come again to support its renewal. But I believe the renewal is necessary because, as you have seen, the separation in the capital markets is not all that secure.

There is a real danger that there will be an outflow of investment funds to Europe, or around the world for that matter, at a time when we are under continuous balance-of-payments strain. It seems to me that the measure has worked.

This is something which we could explore in the statistics at great length, and it is a rather circumlocutious process, but the essential point, as I see it, is that the loopholes that Professor Kindleberger implies were there, indeed were there. We knew that when the interest equalization tax was first being proposed. But you have to have some evidence that these risks of outflows really exist, before anything can be done about them in the context that will assure public support or understanding.

We knew that the next risk was that there would be an outflow of banking funds, and that one way or another, through a voluntary program or a Gore amendment or both, something would have to be done about that, once you put a barrier against this particular part of the capital flow structure.

We also knew that if that were ever done, there would then be another loophole, the potential for a substantial further outflow of funds through the direct investment window. You would move from portfolio over to the bank loans, and then to direct investment.

These had to be taken up one by one, as they became important. The way in which to do it effectively, because the administrative problems and exchange control are so obnoxious, as Professor Kindleberger says, is through a demonstration of need which can then be met through a program which is essentially voluntary in its enforcement rather than through detailed regulation. That is the pattern that has been followed.

We went from the interest equalization tax to, of course, the imposition of the Gore amendment, which I think is relatively unnecessary, as long as a voluntary bank credit program is effective, and then we had to have along with that a voluntary restraint on overseas direct investment.

All of this is indeed regrettable, but it is necessary in order to slow down the total outflow of investment and to keep some kind of brake on this, valuable as it is to us in the long run, because even a bank as strong as ours can't afford to expand beyond its immediate present capacity. That capacity is indicated by what our balance of payments will bear.

Representative WIDNALL. As I understand your views, you do feel a material impact, if interest rates are materially lowered here in this country. Professor Kindleberger, on the other hand, doesn't seem to fear that. As I understand his testimony, he thinks that the economy and the balance, such as they are today are in a far healthier state than most people seem to acknowledge.

It isn't clear in my mind why there is such a great variance in optimism and pessimism between the two of you. We have such a good opportunity under one tent to understand each other.

Mr. KINDLEBERGER. I do want to make one remark, which is that I demur rather strongly from Mr. Roosa's interpretation of my views in his last answer to the chairman, but since the chairman's time was up, I didn't get a chance to demur. I think that is the appropriate legal word. I just disagree with everything he said. That is demurring.

If I may go back to Mr. Roosa's latest remark, which is to say that the interest equalization tax has slowed down capital outflows, I have before me page 183 of the Economic Report of the President and the Report of the Council of Economic Advisers, and it is a little hard to see it.

In fact, the U.S. private capital flow net, 1961, 3.2; 1962, 3.9; 1963, 3.4; 1964, 3.5; 1965, 6.4, after the interest equalization tax, to be sure and then it comes down again to 3.7 and 3.6. I have a very difficult time seeing overall that the interest equalization tax has helped much. I would add one more thing: that the reason for raising the interest equalization tax now is that the administration is worried that people may pay the tax and use the New York bond market.

This is intended to be a prohibitive tax, as in tariff discussion, and this means that you have got to police the market, to make sure nothing happens, not that you collect the tax, but nothing happens. This means in effect you must apply foreign exchange control if you try to apply the tax beyond major issues.

But to take your question, sir, as to why we differ: reasonable men differ, as is well known as some reasonable men from unreasonable men. I can further recall when I was in Government my irritation with professors from outside the Government, free from the pressure, men who did not have their feet to the fire, the fire in many cases coming from the Congress, criticizing economists in Government for not being sufficiently classical in the application of economic principles. This was particularly true in Agriculture where professors of agriculture from the universities would object to the interference with the price system and attack the Department of Agriculture economists for

failure to be pure. The latter has responsibilities for running a real program, and would naturally become irritated with the irresponsible outside criticism.

The tables are now turned, and I am a professor without responsibility. You may well hold that my views are irresponsible, but I think I have a responsibility to provide a truthful analysis, as truthful as I can. I am inclined to think that we got off on the wrong foot in the Government in interpreting the balance of payments.

We got off on the foot of saying that no short-term asset besides gold was any good, and that every short-term claim was about to be presented, and that if we had a gain in short-term assets and a gain in short-term liabilities, we were worse off.

Once you get this idea in your head, it is very easy to apply it by rote, to get the journalists all thinking in these terms, get, if I may say so, the Congress thinking in these terms, and it is very difficult to effect a change.

Europeans think in these terms too, but as I said in my testimony, I think their views are changing. I think they are beginning to see that they are not really in surplus to the extent that they have borrowed a good deal of the increase in short-term assets, just as we are not altogether in deficit as we have good assets against our increased liabilities.

Representative WIDNALL. I take it you believe the balance-of-payments outlook is far more favorable than most of the economists do, who have appeared before this committee?

Mr. KINDLEBERGER. Yes, sir.

Representative WIDNALL. There is a greater worry on their part.

Mr. KINDLEBERGER. There is a small coterie of us, one of whom appeared before you in September, Despres. We are distinguished by our smallness in number.

Representative WIDNALL. I would like to have answers from both of you with respect to your own views on the proposed surcharge tax, as to whether or not you think it would be helpful at this time, or detrimental.

We certainly have great areas of difference of opinion in the Congress and outside of the Congress on this. Walter Reuther testified this morning that he thought it would be a mistake, with the state that the economy is in today, to impose a surcharge tax. That it would be detrimental to the economy.

Mr. ROOSA. Yes, I would have to disagree with Mr. Reuther and a good many other people. I do feel that the surcharge is appropriate.

I think the timing is wisely selected, since we are at this present moment undergoing the aftermath of adjusting to the way in which the brakes had to be put on the economy last year. It was running ahead too fast. It wasn't possible to sustain it. Whether it was braked just in time or not, we won't know for awhile yet, but I am inclined to think it was.

Therefore, I think what we are doing is readjusting through a hesitation phase that will take only a few short months to complete, and I think that the resumption of expansion needs two things. It needs first an easier money position because of the need to repair quite a lot of fracturing that went into the internal structures of many lending institutions last year.

We need easy money for awhile for that reason, relatively easy money, not throwing it out at all corners, but relatively easy money, and I think at the same time we need, on the stimulative side, the immediate restoration of the investment credit. On the other side, in order that as this stimulation and the continuing effect of the growing Government expenditures seeps through the economy, I think it is entirely logical and reasonable to expect that we will need a little restraint on the fiscal side.

Now, it is a very modest restraint which is proposed.

I certainly don't disagree with those who would try to find a comparable result in total fiscal impact through spending reduction, but I would start with the assumption that something in the order of \$5 billion ought to be found, and if it isn't found through expenditure change, it ought to come through the surcharge, and I further say that it is important enough to do it, that Congress should be considering new techniques.

I know it is repugnant to one end of the Avenue to think about giving discretion to the other, but there is nothing wrong with the Congress giving discretion to itself. It seems to me that enactment could be effective the first of July as proposed, along with the provision—if it isn't constitutionally barred—that this effective date could be deferred if necessary by a calendar quarter, and from quarter to quarter, by joint resolution without the entire apparatus of congressional hearing and full review. This, I think, would be entirely appropriate.

What I am saying is that we are undergoing now a period in the economy when the immediate impact of a surcharge at this moment might be unduly heavy, because we are not yet clear on the ingredients, all the ingredients, of the adjustment taking place.

My own expectation is that this will have worked out and that the economy will be back on an expanding phase or can be by midyear. I think the greatest threat to that is the investment credit, not because there aren't, as McGraw-Hill shows us, a fair amount of capital expenditures coming through in the rest of this year, but what has happened is that all the orders have stopped. There have been no orders to speak of, in terms of the scale of capital investment that we need for expansion, since last October-November and the impact on the flow of capital expenditures needed for the economy will be tremendous in 1968.

It seems to me that is the delayed effect of the investment credit that we ought to be very concerned about. We don't want to get that impact by that time. If we don't want that slump in 1968, we should restore the investment credit now, or restore it at least at the same time that the surcharge is imposed. That is a long answer to a simple question, Mr. Widnall.

Representative WIDNALL. Mr. Chairman, my time is up, but may we have an answer from Professor Kindleberger to the same question?

Mr. KINDLEBERGER. This is a question, sir, that I really have no claim at all to expertise on. My intuition tells me, and it is not very useful in these matters necessarily, that it might be well to have it on the Walter Heller-Robert Roosa sort of conditions that you would be able to get rid of it quickly if the economy should take a turndown sharply, either because of a cutback in military expenditures through

a change in the situation in Vietnam, or a downturn in business. Since it takes so long to get it on the books, it is useful to go to work to get it on, even though you may want to take it off rapidly, if conditions change.

I do feel some little concern about the Federal Reserve Production Index for January, which leveled off a bit for the first time in how many months—70 months—but that doesn't seem to me yet enough of an indication that it is unwise to put it on at all.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

I want to express our appreciation to both of you gentlemen, not only for your appearance here today but for the help you have given our International Exchange and Payments Subcommittee for many years, officially and unofficially.

I would like to leapfrog over the immediate argument between you two gentlemen to ask a question which is very much in my mind.

Currently, the United Kingdom is renewing its effort to join the Common Market. The Kennedy Round trade negotiation deadline is approaching. And it remains to be seen whether the international monetary reform, which is targeted for next September at the IMF meeting, will in fact come off. I take it there is general agreement on all three of those propositions that the future is very cloudy.

If there is failure on these things, if the United Kingdom doesn't enter the Common Market, and if the Kennedy Round does not achieve a meaningful lowering of tariffs, and most important of all, if there is no agreement as to an international monetary reform which would take some of the weight off the dollar and substitute some new form of international currency, if as I say there is failure on these things, and if there appears to be a continued propensity on the part of some people to demand gold for their dollar holdings in excess of what you would expect them to demand, in view of their reasonable needs for holding dollars for their interest and for the reserve future, what would you gentlemen respectively think of the suggestion which has been made that the United States ought then, (1) to repeal the remaining portions of the gold cover and, (2) to invite those countries which have shown in the negotiations a cooperative attitude, and here I am thinking, I guess, of Canada, Japan, Australia, and the EFTA countries as opposed to the Common Market; what would you think of inviting the countries which have shown a cooperative disposition to, one, enter into some form of agreement, either under the IMF or under some new international monetary organization, to form what might be called a dollar bloc; that is, that the participants agree not to make damaging demands on our gold, and (3) instead to hold dollars?

Accompanying this could well be an agreement to give those countries that cooperate free access to our capital markets, while continuing some sort of an interest equalization tax, perhaps of a prohibitive nature, on other countries and, (4) in the trade fields to consider the organization of something like a free trade area within that bloc, which would have the effect I suppose of having a fixed exchange Bretton Woods type system within the dollar bloc, but letting the exchange rate float between such a dollar bloc and whoever the others were,

probably as I have hinted, the Common Market, or at least some members of it.

I don't know if I have given you anything that you can sink your teeth into, but roughly, what do you think of that kind of contingency plan, on the assumptions I make that we are not successful?

Mr. ROOSA. Yes, I would like to precede any response by indicating that this is based on all three assumptions, the British failure in the Common Market, the failure of the Kennedy Round, and failure of any promising progress of monetary reform by the end of this year. This, I think, has a lot to do with the approach you take to any kind of selective isolationism, which is what the dollar bloc concept is.

It is selective in that you are inviting a few to share with you, but it is restrictive in the very ways in which you have outlined it. I would say just as a preface on your first question, that in any case the gold cover should be repealed. That is necessary in any event.

Representative REUSS. May I interrupt you at that point, just briefly?

Mr. ROOSA. Yes.

Representative REUSS. Wouldn't it be an excellent idea if we repealed that any day now?

Mr. ROOSA. Yes; it would. I regretted the apparently tactical decision to only do half of it when it was up a year and half ago, and I think it should just be done quickly and preferably without too much sounding of alarm.

I think if we are going to get, or have a chance of getting, the kind of understanding that Professor Kindleberger is quite sure will be forthcoming, we at least have to have evidence that the gold is there. This is the only way we can be sure of having a chance at all that it won't be taken.

Otherwise, with only roughly \$3 billion of margin remaining, it doesn't take too long before you reach a crucial point, and if we don't enact the legislation we might indeed be forced to improvise something of the kind you have outlined here, something which I would very much regret to see.

I think, with Professor Kindleberger, that the dollar is and will remain the best currency in the world, that most people will continue to use it as they do the English language, when they are dealing in international affairs, but that this is not going to be encouraged, nor are the conditions that we seek in our foreign policy at large going to be fulfilled, if we acquiesce in the sort of sense of defeat implied by saying we will just pull our few friends around us and create a new set of economic arrangements.

It is possible, and Dr. Schacht did it, and with advantage, for some time. I don't want to seem to be just name calling here. It was an economic achievement, the way in which he did it, and there is much to be learned from it. If, for example, the Kindleberger formula were to be followed, and we were to relax and enjoy the withdrawals that may occur if we don't worry about our balance of payments, we might end up having to resort to some combination of methods of this kind to give ourselves a semblance of orderliness in some of our world trade. But I would surely hate to come to that, and I think far short of that, there are a good many other things that we could do.

That hasn't answered specifically your three points, the notion of creating a dollar bloc, the question of relating that to free access to our capital markets, and then around that building a free trade area. I think if we come to any extremity of this kind, and I repeat it requires not only your three premises but even more in the way of balance-of-payment failure to necessitate it, it does seem to me that all three would want to come together.

We would not want to think in terms of only any one of them. We would need a kind of an exchange control net outside a dollar bloc—I am speaking here as a technician and not as an advocate—and to make that work, we would have to give free access to our capital markets to everyone inside the bloc, and we would have to move toward a free trade area.

Representative REUSS. Thank you.

Mr. Kindleberger?

Mr. KINDLEBERGER. I am happy to agree almost entirely with Mr. Roosa, except that I would demur a little bit when he implied agreement with your suggestion that the most important of these three was international monetary reform.

I am not impressed by international monetary reform. I have tried to indicate that it is much better to have effectively functioning international capital market which does the job, than monetary reform, a sort of Rube Goldberg international monetary machine, with the three kinds of money: gold, dollars, and then the funny stuff. Three sorts of money are going to make the Gresham law problem much worse than it is now with two, but that is a separate issue.

But let me go back to your positive remarks. An economist who has been before your committee, Harry Johnson, said once some time ago, and it was food for thought, that if the Kennedy Round were to collapse, there would be a movement against one of the two aspects of it. The Kennedy Round and the Reciprocal Trade Agreements Act of the United States going back to 1934, have two underlying principles. One is reciprocity and the other is nondiscrimination. And he said one of these is going to collapse, and it is going to be non-discrimination. We are going to discriminate. But any economist would say that if you have to choose you should forget reciprocity and cling to nondiscrimination.

In 1963 when De Gaulle closed the door to the Common Market in the British face, I heard many people say, let's join Britain in a common market right away. But it is not clear that the British want to. We are industrially more powerful than they. Nor do the Canadians want the kind of free trade area you speak of.

Whether we could effectively operate a closed dollar bloc with, as Mr. Roosa says, a fairly elaborate foreign exchange control is a question. If Latin-America were in it, if this were a Monroe Doctrine sort of thing, you would find that there would be a Latin-American gap of some size, as there is now in the Bahamas, and so on.

I don't think this is very feasible. I don't think it is very attractive. I don't think, in other words, that the United States in its foreign policy is ever going to turn inward to the point where it forgets what goes on in Asia, Africa, and Europe; and I don't think it is appropriate in our economic affairs that we should try to achieve the same

sort of tidying up which is more comfortable perhaps, but which I think fails to reckon with serious world problems.

I would rather hope we went the other way and kept on trying to build a non-discriminatory world, letting go on the reciprocity if we had to. There are lots of tariffs in this country we ought to lower for ourselves and not for the Kennedy Round, not for some concession we get over in Europe, not for outlets for wheat.

I want, for example, lower prices in certain commodities. I think we should prevent price rises in steel. Five years ago, the President should have said:

"I don't care what you do in steel, but you are never going to get an increase in tariffs for this. Whatever you do, make up any deal on wages and prices you want, but we are going to maintain competition from abroad.

I would rather let reciprocity go, if it has to go, and cling to non-discrimination. Obviously in the long run we have got to live with all the countries of the world, not just with some. That is a pretty histrionic reply. I am sorry.

Representative REUSS. Thank you. My time is up.

Chairman PROXMIRE. Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Mr. ROOSA, you apparently are concerned because you raise the question that our foreign trade position on payments deteriorated in 1966.

I detected concern in your statement when the question was raised. On the other hand, Professor Kindleberger, while he agreed there is evidence of deterioration due to a rise in imports and increase in our expenditures in Vietnam, and then he goes on to point out that the loans of \$2 and \$3 billion have to be paid, and the repatriated funds owned by the U.S. bank will be replaced abroad.

Mr. Kindleberger goes on to say at another point in his statement that, "Severe as was the banking squeeze last summer, the \$2 to \$3 billion which American banks borrowed in the Euro-dollar market prevented a real crisis and even a collapse."

Yet I can't understand your lack of concern, Professor Kindleberger, in recognizing the near collapse, as you have stated it here, and the fact that balance of payments is pretty much a matter of confidence in the dollar. I wish you would elaborate on that a little bit, please.

Mr. KINDLEBERGER. What I was really talking about was the pressure that the Federal Reserve System put on the domestic money market by squeezing down negative reserves to the point where they, I think, hit \$450 million last August.

Now, there was, as is well known, very severe pressure in the mortgage market, in the savings and loan associations in California and elsewhere. The Congress took cognizance of this, and tried to provide money for FNMA, and so on. But that crisis was not really limited.

In August we looked the possible collapse of the savings and loan associations squarely in the face, and took steps. What I am saying is that if it hadn't been for the \$2 or \$3 billion which U.S. banks brought home or borrowed from London, there might really have been more trouble elsewhere. It is very hard to predict what would

have been. We can't run the experiment over again without it, unhappily, or happily.

What I am suggesting is that the Federal Reserve System doesn't really know with any great care exactly where the breaking points are, what straw breaks the camel's back, and here is a machine, if I may pursue the analogy a little further, which removes some of the weight off of the camel at the time when the camel's knees were beginning to look wobbly.

Senator JORDAN. You are not concerned so long as confidence remains in the dollar?

Mr. KINDLEBERGER. No, sir. In this particular case we were bringing back dollars that were abroad. These dollars are useful to us. In our Department of Commerce accounting, we say that assets abroad are not useful to us. We say they are lost. They are not counted against any liabilities we owe. We say every asset is frozen and every liability is about to be presented tomorrow. So that if we have an increase in assets and an increase in liabilities, this is regarded as a deficit. Now, I say that is absurd, and the fact that these dollars are useful to us is illustrated by the fact we brought \$2 to \$3 billion home in a month. That suggests that the system works pretty well, that these dollars we had abroad were not frozen. They were available. The Euro-dollar market was an effective means of tempering an excess of domestic monetary deflation if you like.

Now, Mr. Martin might have properly claimed—and by the way central bankers all over the world claim it—that the existence of international short-term capital flows means that they lack control of their monetary policies, and that is true. But sometimes if their control is exercised without the perfect knowledge of where all the breaking points are, this may be a good thing. I say we are lucky to have had this money to bring back home.

Senator JORDAN. Do you agree, Mr. Roosa?

Mr. ROOSA. I can't give a "yes" or "no" answer, Senator. The fact is as Professor Kindleberger indicated that the inflow of those dollars at that time, provided relief from a strain that was otherwise at that time, I believe, becoming unbearable. If that supply had not been available, I suspect that the way in which Federal Reserve policies were formulated and imposed would have also differed, so that the interactions are a little hard to sort out.

I would go one step further though to say I think it will always be true that short-term money flows have to be taken into account in the formulating of monetary policies. They are going to have to have something to do with the formulating of monetary policies designed to accomplish their purpose within any country. That is the meaning that I attach to what I call operation twist in the present circumstances, which I think does make some sense as a technical proposition. So that I won't go all the way with Kindleberger, I would say that these flows at some time relieve some strain. The outflow, as is occurring now, will not impose any great domestic strain, because monetary policy is itself easier, providing the offset for that loss of reserves. It will, however, show up, or some of it will, in a rather sharp reversal of balance-of-payments figures, and while all the figures are not necessarily alarming, and Professor Kindleberger is right in putting some cau-

tion around that, nonetheless the fact is that we will be witnessing a return flow of dollars to Europe where in many cases the likelihood is greater that there will be a flow into central bank hands.

Professor Kindleberger, don't be misled, by the way, about Electricite de France. The whole notion of borrowing in dollars by an agency of the French Government, at a time when they are not gaining dollars through their central bank in any other way, has two interpretations.

Senator JORDAN. Thank you.

To what extent would the continuous year after year lack of balance of the Federal budget have to do with the undermining confidence in the dollar, and thus affect the balance of payments? Professor Kindleberger.

Mr. KINDLEBERGER. Well, sir, I think on the whole this is not a major factor. There was a time when European countries through the Working Party No. 2 of the OECD in Paris were urging that we pursue the tax reduction, which finally occurred in 1964. This was at the working level if you like. They were all technical economists and they thought we ought to have had a bigger budget deficit at that time. But whether private bankers are moved by this kind of consideration I don't know, since while my acquaintance is positive it is not widespread, but I think we are all Keynesians now and I think that wise policies, applied at the right time, such as a tax reduction in 1964, but a tax increase in 1966, this is the kind of policies which gains respect in the international capital markets, and with foreign governments. I think that it is not really so much the appearance of a deficit in 1966 that worries them. It is the fact that we were so slow in reacting to the inflationary strain on the economy, in one way or another.

Senator JORDAN. Do you agree in substance?

Mr. ROOSA. Yes; I do.

Senator JORDAN. Thank you, Mr. Chairman.

Representative REUSS. Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman. Mr. Secretary, it is good to see you again. I would ask, do you think repeal of the 25 percent gold reserve would improve international respect for the dollar?

Mr. ROOSA. I think it will improve confidence in the U.S. commitment to maintain a fixed \$35 price for gold, which is an undergirding for the entire world monetary system as we have it now. In that sense it improves respect.

I think it must be coupled with the recognition that anything that has brought us to the point where this becomes necessary is in itself evident that we have been at fault, and we are not going to reacquire full respect easily. It is a little like the position of the property poor wealthy man, who has gotten deeper and deeper into debt without having the liquidity to go along with it. He has finally reached a point where he says, "All right, I will take a major step. I am going to—in that analogy—I am going to borrow \$100,000 to make sure I have really got something in the checking account," and people say, "Well, thank goodness he is beginning to do something. He can meet his bills. He isn't going to be a kind of property poor deadbeat. But on the other hand he has not yet reached the stage of providing secure confidence."

Senator SYMINGTON. Thank you, sir. Dr. Kindleberger, I ask this with respect and in no sense in snide fashion. In reading your statement and your later disagreements with Mr. Roosa, would you say that the more gold we lose the more respect there will be for the dollar?

Mr. KINDLEBERGER. No, sir. I don't take that line at all. What I was trying to suggest was that the big loss of gold we had in 1965, was in fact brought about by a determined policy of the French to put pressure on the dollar, to discipline the United States. The French were doing it very openly. Now their capacity to do that is stopped. This means that our loss of gold is going to decline, and I think that is on the whole, a strength.

Senator SYMINGTON. Then would you say the more gold we obtain the more respect there would be for the dollar?

Mr. KINDLEBERGER. Well, I have a hard time thinking that we ought to adopt the Midas philosophy and to try to acquire lots of gold. I would think we may be a little more comfortable with a little more but on the other hand I wouldn't want to say there was a linear relationship, one for one, between dollars of gold and increases of respect.

Senator SYMINGTON. Thank you. Mr. Secretary, if you were a member of the Outer Seven, would you rather join a proposed dollar bloc in an effort to get out of this growing jam, or if on good terms with France, would you rather join the Common Market based on your knowledge of the situation as it is today.

Mr. ROOSA. Given the present pattern of trade of most of the members of the Outer Seven—and there is a little different story for each one—the choice would probably be to get into the Common Market.

Senator SYMINGTON. Thank you.

Dr. Kindleberger, in your statement on page 3 there are some remarks I don't quite understand. You stress the difference between a "firm," and a "bank." To me, and I say this as a former member of bank executive committees, also one who has been involved in business, a bank is a firm and a firm is a bank. You present some ratios like 3 to 1 for industrials. Some I have operated, I only wish were half that good. Now it looks to me as if you say a bank is in good shape only as long as its depositors have confidence. But isn't that also true of a business?

Mr. KINDLEBERGER. Well, sir, business on the whole does not like short-term liabilities.

Senator SYMINGTON. A business like General Motors, that is a bank, too. I am thinking about the average business in the United States. I know a company that did about \$1 billion of business with about \$20 million in cash. So it seems to me your distinction between what constitutes confidence in a firm as against confidence in a bank is a little theoretical.

Mr. KINDLEBERGER. It can be overdone. I am talking about typical cases—typologies if you like.

Senator SYMINGTON. You could say, could you not, that a country, or an individual, or a firm, or a bank, can only improve its living standards so long as it is trusted by its lenders.

Mr. KINDLEBERGER. Well, sir, that is entirely true, but in the case let's say of the International Bank for Reconstruction and Development, they have a project basis for loans. They will make a loan on

the basis of a project and they will take what they call a hard banking attitude. They look at the project rather than what J. P. Morgan used to look at, I take it, which was character. They are interested in what the country is doing in terms of projects. I would say such a country, it is highly desirable for it to build character and reputation and credit standing. I did make reference at one point to countries needing credit standing and when they get credit standing then they can turn to the international capital market to borrow in, and we can stop giving foreign aid or intergovernmental loans.

Senator SYMINGTON. I would make this comment: We have been told for many years that it is important we balance our payments, but the less we seem to be able to do to that end the less important it would appear to become to a lot of people. That worries me.

Now, on page 5, you talk about confidence in the dollar, improving in 1966. We have been told by other foreign countries that if we don't balance our payments pretty soon, they are going to start unloading dollars just as the French did. At the bottom of page 5 you say, "The war in Vietnam and poverty in the United States are of far more important issues today, than the balance of payments."

If by any chance we misfire in our calculations about what is or is not important in respect to the integrity of the dollar, and you run into real inflation which then curtails much more sharply that value you would be creating a type and character of poverty we have not known in this country for some 35 years, would you not?

Mr. KINDLEBERGER. Well, sir, I am not at all sure I follow the reasoning behind what you said.

Senator SYMINGTON. We have, as I understand it, over \$30 billion now owed abroad, controlled primarily by the foreign central banks. If they begin to sell those dollars for any reason you may think is logical or illogical to the point where you run into lack of confidence in the dollar then the fact the dollar itself would be considerably less valuable than before would in itself be a serious matter, would it not and would further emphasize the balance of payments problem?

Mr. KINDLEBERGER. No; I don't think I agree at all, sir.

Senator SYMINGTON. You don't agree?

Mr. KINDLEBERGER. No; I don't think so.

Senator SYMINGTON. I have a friend a prominent newspaperman who says he has just received a paid-up life insurance policy, and he said to me the other day "My insurance policy is worth so little as compared to what I thought it was going to be worth, I wish I had never taken it in the beginning." What would be your comment on that?

Mr. KINDLEBERGER. My comment on that would be that it is better than any insurance policy anywhere in the world. I am not happy about the price increases in the United States in the last year at all. This is why I was, say, for a tax increase last spring. But nonetheless our prices are rising 3 percent a year whereas they are 4 to 5 percent in France. If you think the French franc is any bargain as compared with the dollar I think you are mistaken in terms of real purchasing power.

Senator SYMINGTON. Is it quite fair to compare everything to the franc?

Mr. KINDLEBERGER. Take Britain, Germany.

Senator SYMINGTON. There are other people besides the French.

**Mr. KINDLEBERGER.** German prices are rising 5 percent a year, Britain, 5 percent a year, Italy, they are rising 5 or 6. I can't see we are worse off. I am not saying we are well off, but we are certainly not worse off. Certainly, in general, it would be a mistake for a young man to buy lot of insurance because there is probably going to be a trend of prices upward.

**Senator SYMINGTON.** I am not criticizing you in any sense, I just want to learn. I am uninformed in these matters, and have great respect for you. I have heard Secretary Roosa before and have equal respect for him. But would you say that the more money we lend out through paper gold in the form of dollars all around the world, the better off is our own economy?

**Mr. KINDLEBERGER.** That has some complications. On the whole, I think the international capital market helps us a little bit, but much more important is its help to the economy of the world. I think the dollar is important to us but also it is important to the world to have an international monetary system which works, which makes trade possible, which has gotten us out of the 1930's. If I may go back to your previous remarks, sir, if it turned out that everybody in the world lost confidence in the dollar, we could get along pretty well with less foreign trade, and turning inward with foreign exchange control in the same way that Mr. Roosa said Germany in the 1930's did. This would not be a very attractive role for the United States, in the world, but the isolationist position would be tolerable. I think our role is much more international than that. My view would be we need to support the dollar, only partly for ourselves.

By the way, if I may say so, there is an awful lot of talk in the literature about prestige. In the course of reading the Joint Economic Committee Compendium on Contingency Planning I found two or three people who said we could not do particular things without humiliating conditions. This "humiliation" refers to prestige. I am not interested in prestige. I think prestige is the last thing to go for. I want a strong dollar, used widely in international trade because it is efficient, an international capital market spreading capital around the world partly because it helps the United States but partly because it makes the world economy go. Prestige is not disregarded by, say, the French, if I may say so. I use that country again despite your suggestion that we should not compare everything with it. I think the prestige aspects of international monetary arrangements are really derisory, very unimportant, but the inefficiency is important. The reason I think English is becoming the international language is not because of the prestige of the Anglo-Saxons. It is because more people know it than anybody else. It works. It is a common currency just as the dollar is a common currency.

**Senator SYMINGTON.** My time is up. Mr. Secretary, would you comment, also?

**Mr. ROOSA.** I just would add, I think, that insofar as we think of the dollar's prestige, it is possible semantically to turn that in various ways, but I do believe, as Professor Kindleberger has indicated, that foreign economic strength for a nation is essential, if you are going to maintain a strong position in diplomacy, defense, or the whole gamut of international relations.

I realize there are difficulties of definition, but I do feel a strong conviction that the weakness of our balance-of-payments position and its cumulative effect over the last several years has now reached a point where our strength as a leading world power has been impaired. Now, whether that is called the prestige of the dollar or given some other label is immaterial, but I think there is a very real substance here that we must weigh very carefully.

Representative REUSS. Congressman Brock?

Representative BROCK. I have enjoyed this very much. I share your quest for a Holy Grail. I am not sure we are going to get it this year. Just a couple of questions to clear my own mind up.

Professor Kindleberger, in reading your remarks and listening to the questions that Mr. Reuss asked about limiting the gold cover, am I correct in assuming that you essentially would just as soon be without the gold standard, period?

Mr. KINDLEBERGER. Well, sir, if I may refer to my paper before the Joint Economic Committee on Contingency Planning, I tried to differentiate myself rather sharply from my good colleague and friend, Emile Despres, who took a much more aggressive position on this. I would abandon gold with great reluctance—let me scratch the word “great,”—with reluctance, because I think it is a useful system, but on the other hand I don’t want it to be made a fetish. I am inclined to think that the gold standard—the gold exchange standard—is an excellent standard. You could easily substitute for it a pure exchange standard. You could not substitute for it a pure gold standard the way Mr. Rueff and Mr. de Gaulle want. Nonetheless, I would not move aggressively forward or push to change the gold standard. I would use gold as long as we can. This means at the same time that I don’t want to do anything which would be very harmful to the national income of the United States, let’s say, or the national income of the world in order to protect the gold position.

Representative BROCK. If we were to remove the gold cover behind the dollar on domestic currency, which would free some \$12 billion, and if 3, 4, or 5 years down the road our balance-of-payments position had not improved, and we had the \$3 billion in actual reserve to meet our international obligations, then you would be again under the pressure which a gold cover has today of creating some doubt about the capacity of the United States to meet its obligations; would you not?

Mr. KINDLEBERGER. Yes. Well, if I may say so, I think that what the United States really has behind the dollar is its productive capacity—capacity to turn out goods and services, food, machines, and so on. The value of the dollar is what a dollar will buy, not an ounce of gold for every \$35. In the long run if we were to lose all our gold, I would not be distressed. Well, there are some nuances here. I might be distressed but I would not be desolated.

Representative BROCK. Would it be fair to say that you would be more distressed by the policies which led to that loss than you would by the loss itself?

Mr. KINDLEBERGER. Well, I would be certainly distressed by our failure to get agreement in the world as to what a good international monetary system is, because I think this is the nub of the issue. What is the best monetary system for the world? How will we operate it?

How will we have enough confidence in each other as countries, so that we don't start to discipline each other, get up on our high horse, and withdraw from discussions because our sovereignties are infringed, and so on? I think we are in this world. You have got to keep on going. And what we have got to do is to make the system work. I am an empiricist rather than an ideologue about this. I want the system to work and I think the system works best as a gold exchange system now. I think the system works best in the long run as an exchange standard, not a gold standard.

Representative BROCK. Isn't it true that a gold exchange standard rather than the system we now employ would impose much greater and important direct restraint upon our domestic economy insofar as our latitudes adopt expansionary policies at a given time which might lead to an outflow of currency.

Mr. KINDLEBERGER. Well, I would say this. That any system of international adjustment gives you constraints on your capacity to operate an independent monetary and fiscal policy. Many academic economists want a flexible exchange rate to achieve independence. They want to say that there shall be no limit from the frozen balance, because the balance of payments would always balance. I think such a system would be subversive of the kind of world that we are trying to create, a world with growing trade between countries as well as growing trade within countries. I think the United States could stand it well enough, but I would not be happy with it. As one who perhaps puts a greater emphasis on the international position as opposed to the national position, I have always opposed flexible exchange rates which I think are nationalistic.

Representative BROCK. Mr. ROOSA, if I can interpret broadly Dr. Kindleberger's remarks, I think he feels that some of our problems today are created by some of the legislative restraints that have been imposed upon us in the past, especially the interest equalization tax. You came before us before urging the imposition of this tax. You suggested, as you said earlier, that it be temporary. I am beginning to wonder if it isn't about as temporary as the suggested temporary nature of the corporate surcharge back in World War II, for years without amendment. How long can we afford to put our short-term objectives ahead of our long-term interest? I think when we put the interest equalization tax on previously, we had a positive return on previous investments of something around \$3.3 billion, and yet we continue to curtail American development overseas. Aren't we reducing our capacity to meet our obligations sometime 5, 10, or 20 years down the road? When do we stop this process?

Mr. ROOSA. If I may coin a phrase, I am delighted you asked that question. It gives me a chance also to answer the figures that Professor Kindleberger used a while ago. The aim of this complex of things, in which the interest equalization tax is included, was never to stop altogether all foreign investment. It certainly had the effect of largely stopping portfolio investment. The complex of all measures taken together has been, as he indicated, not to pull back the totals severely. It kept them from rising at a time when a crescendo of acceleration had been recently underway. And when continuation of that crescendo would have soon been earsplitting. So that what

we are looking at in the overseas investment position of the United States is a position that has, through all of our travail, continued to increase. The improvement, as noted in your paper, Charlie, the improvement in our further overseas investment, even in the last 3 or 4 years, has been greater than the average over the previous 15, so that it is important to distinguish between something that is in its overall implications completely prohibitive and something which has the effect of slowing down. There is no question that the more foreign investment we can have, the more we will in the long run gain through the balance of payments in future earnings, and yet there is no question in the minds of General Motors that if they could double their size each year they would not make a tremendous amount more and sell all over the world. But there are restraints on size for them as there are for the United States. Digestion rates will impose some limits. And that is why it was necessary, through these temporary measures, to impose some check on the outflow, the rate of outflow of foreign investment, taken overall.

In reply to your specific question as to how long will the interest tax have to be continued, I may have to show you how self-serving I can be. It is fair to say, I believe, that if the voluntary program for the banks could have been imposed 1 year sooner, we would have had an actual balance in our overall accounts in 1964 (my last year here). After all, remember we had a current account surplus of \$8 billion in 1964. It was a tremendous outflow of additional bank funds, a great spurt in direct investment, and a continuation of heavy governmental payments abroad that used up that surplus, and left us still with a deficit, although to be sure a deficit smaller than in earlier years.

We have gone through the succession of new events year after year, each accounting for the major character of the new deficit in each year, and so long as these recur, until we have reached the stage where we are able to return to a current account surplus at something like the magnitude of 1964—at least in the magnitudes of \$6 and \$7 billion instead of the present under \$4 billion—we won't be able to free in the full sense the U.S. capital markets from the present interest equalization tax or the other restraints. It is not at all impossible to restore that kind of current account position, but it takes a recognition of the priorities in other policies to do it.

Representative BROCK. I think what I am basically concerned with is the fact that it seems to me that the old cliché, we need trade not aid, is pretty applicable in the world today, particularly, with developing nations, and unless we can find ways of increasing the productivity by capital and technological talent, that we are going to continue to have to utilize the route of our neighbors is not in my way of thinking as productive to the people as the development in productivity.

I would like to ask one question. In the area of the domestic economy, when you have—as many have described it this year—a cost-push situation as opposed to a demand-pull, is it not possible, if that is a true situation and let me say I am not sure that it is, I think it is partially true in a way, is it not possible to have an expansion of our money supply without too much change in the interest rates? What I am worried about is the inflow of short-term money that occurred, that I think the professor was talking about last year

through our interest rate policies, and I am somewhat concerned with your policies and prospects of a dramatic outflow of this same money going the other way. Isn't it possible for the Federal Government to expand our monetary supply without too much change in the interest structure?

Mr. ROOSA. Yes. There are two questions there. First, as to the fact of the situation, and I would quite agree with your appraisal, while there are many things at work, the principal generating cause of additional inflation this year is on the cost-push side. That, however, having been set off regrettably by any one single thing, the airline mechanics settlement last summer, has picked up steam to the point where now it is a virtual impossibility to conceive of any thing preventing this spreading through the entire economy for one round. All we can hope is that the surrounding conditions in terms of the potential for demand-pull inflation, those surrounding conditions will be kept under sufficient check so they won't be creating an environment in which, once we have gone through one round, we pick up immediately with another and the spiral goes on further.

I think myself that the Council's report on the guideposts this year is a splendid statement, and I think it is the only honest and honorable statement that could be made in the face of what was clearly a failure of economic policies last year. We talk about the failure of fiscal policies. The real failure was the failure in incomes policy. In the United States and we need the three—money, fiscal, and incomes policy—we need the three going together, if we are going to really achieve a balanced influence from the Government on the course of the economy.

I think the Council took the right course in the face of this. They had to back away. They knew it would be silly to try to contrive a guidepost that could fit what was built in and bound to occur this year. But they did the best they could to preserve the integrity of a sound proposition, that productivity on average over time determines the rate at which the economy can afford wage increases. It is because I want to see productivity increased in the same way that you do that I hope, I would like to think, that the one tax change that would not be temporary was the investment credit, and I sincerely regret that anything was done about it.

Representative REUSS. At this time I would like by unanimous consent to make a part of the record at this point an article submitted by Senator Symington written by F. E. Aschinger, "The Building of an International Monetary Machinery," in the *Neue Zurcher Zeitung* of Zurich. Copies of this article will be made available to you gentlemen and Senator Symington asks that you comment on it.

Without objection that will be included.

(The article referred to follows:)

#### THE BUILDING OF AN INTERNATIONAL MONEY MACHINERY

(By F. E. Aschinger)

The deliberate creation of synthetic international liquidity is currently the paramount problem in the minds of those concerned with worldwide monetary matters. In view of today's realities, this is somewhat odd, since there is general agreement that the world is now suffering rather from an excess than from a shortage of international liquidity. Another widely accepted opinion is that

the problem of creating synthetic reserves will become acute only once the reserve-currency countries—particularly the United States—have succeeded in eliminating their balance of payments deficits over the long haul. Hence there would seem to be no particular hurry to create a system of synthetic reserves designed to someday supplement the dollar as a source of international reserve creation. This is especially true since there is as yet no end in view to the long series of United States payments deficits; furthermore, the preliminary technical groundwork for the creation of a reserve plan has already progressed so far that, given the necessary political agreement, the actual mechanism itself could be worked out relatively rapidly.

Hence there are hardly any sound reasons why, during the annual conference of the International Monetary Fund in September, many voices were raised urging all possible haste in setting up such a scheme and demanding that the project must be fully worked out by next year's IMF meeting or that else it would be too late. Even the premise put forward by the IMF administration, that the establishment of such a reserve plan could eliminate existing uncertainty about the price of gold, is not very convincing. For the current insecurity concerning the future of the monetary system comes less from uncertainty about the creation of a new kind of reserves than from the continuing American balance-of-payments deficits and the dangers which they create for the present system of reserve currencies.

Among the industrial nations, it is those countries plagued by chronic payment gaps which are stressing the urgency of setting up a new reserve system. Rightly or wrongly, this fact has awakened the suspicion that, despite all their protestations to the contrary, those countries regard the creation of synthetic reserves as an opportunity to at least partially cover their deficits. This explains why, quite aside from the conflict between France and the United States, there is a certain mutual distrust among the members of the Group of Ten concerning the aims of some of them in pursuing this far-reaching project. Openly stated, Continental European circles harbor an oft-expressed fear that the Anglo-Saxon powers together with the developing nations could gain control of the uses to which such a reserve mechanism might be put, and that as a result the "money machine" could easily become an international "inflation machine." Any attempt to evaluate the difficulties and prospects of the planned monetary reform must be based on a recognition of this situation.

#### THE TEN AND THE IMF

Until very recently, negotiations on the creation of synthetic reserves were limited to the Group of Ten nations, with France's position creating notable difficulties. The most substantial difference between France and the others is that the French Government would like to eliminate the dollar's function as an international reserve currency, while the rest emphasize that the dollar should continue to exercise its reserve function alongside the new monetary reserves to be created. The press conference held by French Minister of Finance Michel Debré on September 30 made it difficult to tell whether the difference of opinion over the necessity and desirability of a new kind of reserve units is fundamental or rather tactical in nature. A few days earlier, in his speech before the plenary session of the IMF conference, Debré had fired a broadside against the principle of synthetic reserves *per se*. But at his subsequent press conference he showed himself more flexible, laconically rejecting an increase in the price of gold and indicating that his country would, if necessary, consider the question of a new reserve project. In the light of these statements, it would appear that France is interested in playing a moderating role in this matter, in order to prevent such a system from being too hastily conceived and applied and thus getting out of hand. If France would limit itself to this braking function, its opposition could be useful and constructive. At any rate, in addition to numerous exaggerations Debré's speech before the IMF contained many home truths which needed saying.

Earlier this year, when the Group of Ten held its conference in The Hague, it stated as a body that it would continue to study the problem of the creation of new reserves, and moreover that it would carry on discussions on this subject with the IMF executive directors. This brought the preparation for a reserve mechanism into a new phase, in which the developing nations would be included in deliberations. At the more recent IMF meeting in Washington, the interest

and attitudes of the developing countries vis-à-vis the liquidity problem constituted the central theme. There was general consensus that all countries are interested in seeing a smoothly functioning monetary system and that the interests of all countries must be taken into account in the creation of a new reserve system. At the same time, the industrialized nations also stressed the importance of the second principle which had been laid down in The Hague resolution: namely, that a reserve mechanism would in the final analysis be dependent upon financial cover from a limited number of countries which play a key role in the functioning of the world monetary system, and that these countries must therefore be given a decisive voice in the creation and utilization of an international reserve apparatus. The Hague Declaration also stated that this could be best accomplished by a procedure in which suggestions for the creation of reserves would be examined both by the limited Group and the Fund. The required majorities and voting procedures would have to pay adequate heed to the above-mentioned two principles; this was seen as an essential prerequisite for agreement on the creation of new reserves.

#### THE TUG-OF-WAR BEGINS

This view of the matter met with strong resistance among the emergent nations at the IMF conference. In more or less sharp form, nearly all the representatives of these countries insisted that a reserve mechanism must be universal in nature, that no group of nations must be allowed an overriding voice in its operation, that all countries must be given equal consideration in the allotment of reserves, and that the kind of reserves used must be uniform. The developing nations reject the idea of a reserve system which would be created and administered by the Group of Ten, and under which the member nations of the Ten would channel part of the assets to the IMF for redistribution to other IMF members in the form of drawing rights. In the opinion of these countries, the new reserve mechanism must be incorporated into the structure of the IMF itself and decisions on the creation, operation and periodic review of such a system should be made exclusively by the International Monetary Fund's authorities—that is, by representatives of all countries concerned.

The formula worked out at The Hague, calling for double majorities and voting procedures, received little overt defense from the representatives of the Ten during the IMF conference. In fact the British Chancellor of the Exchequer, who had just returned from a conference of Commonwealth finance ministers in Montreal, had been so influenced by the wishes of the developing countries that in his speech before the IMF he clearly retreated from The Hague position. He stated that, instead of establishing criteria and procedures for majority voting, efforts should be made to reach informal agreement between the Ten and the emergent nations on the establishment and application of a new reserve system.

The statements by US Treasury Secretary Fowler also lack any reference to The Hague decisions. Among American circles one may even hear the view expressed these days that The Hague Declaration went too far in its concern to institutionalize the key role of the industrialized nations in a new reserve system. This same view is held by some circles in the IMF's administration. The heads of IMF and various countries, even some of the Ten, appear to be aiming for a solution under which the formal decision-making functions in the new reserve system would go to the International Monetary Fund, while the actual importance of the Ten would find its expression on a more informal level. This trend, however, will probably meet with reservations and opposition on the part of those members of the Ten who want to hold the key to the creation of a new monetary reserve mechanism in their pocket.

#### THE NEED FOR RECIPROCITY

The reluctance to drop the idea of a double majority system has been strengthened by the attitude which is being displayed by various developing countries toward a new reserve mechanism. Many emergent nations seem unaware that, however it is conceived, such a mechanism involves a system of mutual credit commitments, in which each partner must be prepared to temporarily place goods and services at the disposal of the other on credit, and that such a system can function only on a reciprocal basis, that is, if the balance-of-payments positions change. These young countries tend to regard the idea of a reserve plan as a

system under which manna would fall from the heavens, an opportunity to obtain increased development aid. Although a few of the more advanced emergent nations have come to realize the need for currency reserves as a kind of equalization fund for balance-of-payments fluctuations, the majority of them do not yet understand this.

For years, various industrialized nations have quite correctly promulgated the principle that the creation of additional monetary reserves must in no way be tied to the question of development aid. And there has been loud applause for the thesis that newly-created reserves must serve only as a temporary equalizer for balance-of-payments fluctuations, and not for the long-term transfer of goods. But today there seems to be at least a partial retreat from these principles, reflected in a consideration of possible direct participation by the developing nations in the creation of new reserves and the admission that these countries cannot be expected to adhere to the rule of reciprocity. To the objections that the granting of capital aid to the developing nations is not consonant with the purpose of deliberately creating additional reserves, and that such a system cannot function well without sufficient reciprocity, the mollifying argument is being brought forward that the emergent nations represent merely one-fourth of total international liquidity, so that if the industrialized nations adhere to the rules of the system, it will be able to operate properly anyway. This dispute will no doubt be the subject of much spirited debating in the future, both within the Group of Ten and between the Ten and the larger community of the IMF.

#### JUST A PRELIMINARY SKETCH

There was notably little discussion during the IMF meeting of what form the synthetic reserve should take. This may be partly due to the technical nature of the problem. But it is also in part explained by recognition of the fact that similar results may be obtained whether the reserves are created by granting additional automatic drawing rights to the IMF or by means of newly created reserve units, or "owned reserves." With few exceptions, most speakers expressed a clear preference for some form of reserve units or a mixed system. The administration of the IMF also seems to favor the creation of special reserve units. If any solution is reached at all, it may be assumed that it will to a great extent be embodied within the IMF.

However, it seems extremely doubtful that a complete reserve plan will be ready by next year, in keeping with the wishes and urgent demands heard at the Washington conference. If the Group of Ten required so much time just to set down a few general principles, it may be assumed that the widening of talks to include all IMF members will slow down the pace of negotiations even further and will multiply the abundance of technical and political problems to be overcome. The projected talks between the Ten and the International Monetary Fund will be merely consultative discussions, during which no decisions will be made. The Ten and the IMF will have to agree between them in which direction they wish to move. The construction of an international money machine has not yet passed the stage of preliminary sketches, and it is by no means certain that the imposing structure dreamed of by many will ever be built.

What is more probable is that, when America's payments difficulties have finally been ironed out, thus bringing up an immediate necessity for additional monetary reserves, gradual pragmatic steps will be taken within the existing framework of the International Monetary Fund. This would by no means be a tragedy. Far more urgent than the problem of liquidity, which today is at most a cloud on the horizon, are the problems of worldwide inflation and the persistent balance-of-payments disturbances. These most serious matters should not be overshadowed by excessive emphasis on the question of liquidity.

(Mr. Roosa's comment on the preceding article was later supplied and appears below:)

Aschinger's specific questions and reservations concerning the creation of a new reserve asset are all well put and, in my view, were broadly valid at the time he wrote. Enough has happened, or been clarified, in the succeeding four months, however, to contradict his underlying theme—that this reform is being pushed ahead too fast.

I believe that a new reserve asset is needed and hope that the major elements of a plan can be agreed before the end of this year. I think agreement on the

outlines of a plan can and should remove one important source of speculation against the \$35 price—the unrest created by the view that the members of the IMF will be unable to agree on a plan and that consequently the price of gold will go up by default. I am convinced, however, that no plan could or should provide any escape for the United States from the discipline imposed by the balance of payments. Nor can a new reserve asset be allowed to become a means of providing aid to emergent countries. The fact that the highest current priority ought to be given in the United States to our own present balance of payments deterioration (as Aschinger stresses) should not, however, alter the desirability of pressing forward with monetary reform as rapidly as possible.

(The comment below was subsequently furnished by Professor Kindleberger:)

Mr. Aschinger makes three points: (1) that there is no need for increased international liquidity; (2) that plans for increased international liquidity should be kept distinct from aid to the less developed countries; and (3) that other problems such as worldwide inflation and persistent balance-of-payments disturbances are far more important than fears of a shortage of liquidity. In general I agree. I would, however, like to qualify my answer.

There are two types of international liquidity: one is the supply of primary money, such as gold; the other is access to credit. Most of the discussion turns on the first. It is this question which is unimportant. But the second aspect of liquidity is of vital concern. Countries need to be able to borrow to restore their supply of international purchasing power, so that there must be an international capital market to provide liquidity against credit for normal uses; and when financial crises supervene, as sometimes occurs, there must be facilities for rediscounting to support the country or countries in trouble. The I.M.F. was designed for the first purpose. It has gradually been converted some distance toward the second, with the provision of General Agreement to Borrow, etc. The Group of 10 discussions aim at the first type of liquidity. Much more important in my judgment is the maintenance of the Basle-type arrangements, and the Euro-dollar market, which make it possible for countries to get rapid, flexible, vital access to credit when their liquidity is threatened.

On the second point, it would be useful and important if the world were suffering from unemployment to use international spending as a way to create real assets in the less developed countries and monetary reserves in the developed. In a world of full employment, however, it must be recognized that the provision of real assets to the less developed countries costs real resources. In the second place, it is useful to recall the important theorem that any clearing mechanism will break down if the participants divide clearly into persistent creditors on the one hand and persistent debtors on the other. The proposal to tie new international liquidity to aid to the l.d.cs. involves making the latter persistent debtors, and the developed countries persistent creditors. After time, the creditors are unwilling to keep on extending credit to the debtors, or in an international monetary system, to continue to regard as good money claims on countries that seem unlikely to be able to repay their debts.

Thirdly, I would tend to agree with Mr. Aschinger that the problem of inflation is more important than new means to provide international liquidity. When he comes to persistent balance-of-payments deficits, however, I would want to withhold my approval of his views until I knew better how he measured surpluses and deficits and whether he makes the distinction which I find critical between the balance of payments of a producing enterprise, and that of a bank. Banks, as I have pointed out, are not in deficit when they increase their financial claims and their financial liabilities, so long as they have a suitable ratio of quick assets to total deposits. The United States in my view is a bank. I do not think it is in deficit.

Representative REUSS. Mr. Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman. I would like to state to both witnesses that your presentations were interesting, stimulating, and helpful matter and I appreciate it very much.

Professor Kindleberger, in your statement, a sentence appears: "Surplus of the continental European countries are therefore not earned but borrowed." My question, sir, is: Can we turn that sentence

around and say the deficits of America are therefore not lost but loaned?

Mr. KINDLEBERGER. Yes, sir. That is in fact my point, that the United States, in acting as a banker, in lending long and borrowing short, does not have a real deficit. The Department of Commerce definition seems to me to be appropriate only to, and here I would agree with Senator Symington, a very inadequate firm which does not have much credit and does not get much trust.

Representative MOORHEAD. Professor, the thing that has always concerned me, that a bank or a firm usually keeps two sets of accounting figures, an income sheet and a balance sheet. Now would I be correct to say that over the past few years if we, the United States, kept our books the way a business does, that we have been making money, we have been earning on our income sheet, but the concern would be that our balance sheet, and this can be disputed, at least this is the question we should be asking ourselves, whether our balance sheet is distorted because all of our assets are long term, long payout, whereas our liabilities are in the short field. Is that it?

Mr. KINDLEBERGER. Yes, exactly. In terms of, say, our balance sheet, we have been increasing our net worth each year. Our net worth has been going up in terms of added assets, claims on the rest of the world, productive assets, and we have lent abroad not only some of our substance, but also we have borrowed abroad at short term in order to lend at long term, therefore paying either little or no rates of interest, and getting, earning assets. So we have gained as far as that is concerned on the balance sheet.

As far as the income statement is concerned, you could say that we are still all right there, because we have a current account surplus. We are solvent. There is no question about solvency, long-run solvency. It is a question about short-run liquidity. We present our balance of payments as if tomorrow all our creditors were going to present their demands on us immediately.

Representative MOORHEAD. So is it your judgment that our balance sheet, although that is where the dispute would be, is sound, and I would take it, Mr. Roosa, that this is where essentially you would disagree with Professor Kindleberger, is that correct?

Mr. ROOSA. Not quite. The position that I take is this. First of all, I think he is wrong in saying that our balance-of-payments accounting always proceeds on the assumption that all demands are immediately exercisable. On the contrary, the position from a balance sheet point of view is simply to ask whether the total of our demand liabilities as they are increasing are so distributed and so held that we as a banker or a firm have a reasonable likelihood of expecting they will stay there, or whether there is an increasing chance that the short liabilities we owe are going to be exercised, in which event we have to have something short and useable with which to make payment. And so the main point that I am stressing is that we have, in a sense, as if we were General Motors, invested year after year in long-term investment, plant, and equipment of a heavy kind, and we have done it against 90-day paper, and for a variety of reasons.

If there is some disturbance among our creditors, and they need the funds, quite apart from the question of simple confidence in us, there

will be times when that 90-day paper is going to be exercised, and if General Motors does not have in hand or readily available through credit the liquidity with which to meet those demands, then the way in which you prove what Professor Kindleberger said, and it is true, we are entirely solvent, we are beautifully solvent as a nation, but the way in which you prove it is to go into bankruptcy and then demonstrate on a declaration of assets. That is the point we can't reach. We just don't dare.

Mr. KINDLEBERGER. I must say that I don't know why Mr. Roosa said I was wrong in saying how we keep our balance of payments. The Department of Commerce definition of the overall deficit says that any increase in liability of less than a year is on the deficit side, below the line, and that any increase in an asset—short-term asset—goes above the line.

Now, when Mr. Roosa says that General Motors is building, let's say, long-term assets and 90-day notes, for Heaven sake, it is our short-term assets abroad that we are excluding from our definition. It is our short-term money in London of which there is a lot in the Euro-dollar market which we say we can't count on as an asset. That short-term money we have proven we can bring home because we brought home \$2 to \$3 billion of it in a month. And the notion that any balance-of-payments accounting which says all assets are frozen and all liabilities are what is the word, boiling, to use a Fahrenheit image, that is absurd, just silly.

Mr. ROOSA. Could I just ask Professor Kindleberger if he will submit for the record a T account analysis in which he would show how we last year brought home these dollars owned by us in Europe. Those were borrowed dollars.

Mr. KINDLEBERGER. Borrowed and owned both.

Mr. ROOSA. The amount we brought home that was owned of course was—

Mr. KINDLEBERGER. We can't separate them.

Mr. ROOSA. Was included, but I would certainly like to see a demonstration.

Mr. KINDLEBERGER. Look, Robert, some of the moneys that were brought home which were borrowed by American banks from American corporations which have deposits there. You know what a bank is like. You worked in one. Banks receive deposits and make loans.

Mr. ROOSA. Indeed I do.

Mr. KINDLEBERGER. And we went through the intermediation if you like of the Euro-dollar market, but most of that was American money, an awful lot of it was American money.

Representative MOORHEAD. Professor Kindleberger, is there any accounting internationally kept on this balance sheet and income sheet statement for the United States?

Mr. KINDLEBERGER. Well, the Department of Commerce does put out something it calls the International Balance of Indebtedness, which shows the total of assets to total liabilities, and the difference being net worth. They do that once a year.

Representative MOORHEAD. Does it break down into short and long?

Mr. KINDLEBERGER. Yes. They do that once a year.

Representative MOORHEAD. That would show us better than anything else?

Mr. KINDLEBERGER. On that score we have \$35 billion ahead, net worth, net claims on the rest of the world, \$35 billion, something like that. But a good deal of that is frozen. I am perfectly prepared to admit that if you have an oil well in Saudi Arabia, if somebody presents a chit and says he wants his money, you cannot liquidate that. But in addition to such oil wells and factories and securities of all kinds, we have also short-term funds, and some of them are bank funds in London in the Euro-dollar market. Some are corporate funds there. We have a lot of them.

Representative MOORHEAD. Professor Kindleberger, in your statement you talk about the question of the new international reserve unit.

Mr. KINDLEBERGER. Yes, sir.

Representative MOORHEAD. I can understand your position here that you don't want to kill the international capital market in order to get the new reserve unit, but do I understand that even if we maintain the international capital market, that you would really be opposed to a new international reserve unit or that you just don't think that is important?

Mr. KINDLEBERGER. It is the latter on the whole. I think the real way to get liquidity in flexible amounts the way you want it is through the international capital market.

Let me give you an illustration. Suppose there were no access to the international capital market and Italy wanted to borrow. Italy needed reserves because it was having a capital outflow the way it did in 1963. If you have an international reserve unit which adds \$1 billion worth of reserves every year. Italy at the most could claim \$75 million of that. This would be rather large, seven and a half percent of the total. You expect a very big percentage for the United States, and a big percentage for Germany, France, and Britain. Italy might claim seven and a half percent, \$75 million. If in a crisis Italy needs \$1.5 billion, the \$75 million it would get is derisory, just trivial. This does not solve their problem of meeting a financial crisis.

Now it may well be that the international monetary reserve unit is good for longrun banking for trade, but it does not give you the flexibility and the adaptability and the capacity to amass large amounts in a short time, which the international capital market does, as evidenced by the Italian case and by the American case.

Representative MOORHEAD. Yes, Mr. Roosa?

Mr. ROOSA. I wrote the same question in the margin that you have asked. There is absolutely no contradiction nor even a connection between these two points. I spent all of my life in Washington arranging just the kind of credit arrangements for the United States that others and we from time to time have been using, and I have nothing against them. In fact, I like to think that they are functioning better now than they were 5, 6, or 7 years ago, and there is absolutely no contradiction between these and their improvement on the one side, and the entirely separate question wrapped up in the issues for creating a new international reserve unit. The problem in terms of the unit is often disguised by people who look upon it as a panacea, a solution for all other sorts of things. I don't disagree with what Professor Kindleberger said about the Italian illustration at all. But that isn't what the idea of a new unit is intended to serve.

Mr. KINDLEBERGER. But sir, if I may say so, my attack is of this sort. Senator SYMINGTON. It what?

Mr. KINDLEBERGER. My attack goes along this line. The Secretary of the Treasury says we need a correction in the balance of payments of the United States. The only way to correct the balance of payments of the United States is to cut off the capital flow. We cut off the capital flow, then we will not provide enough reserves to the world. Therefore, we need the international reserve unit. You end up with the international reserve unit and no capital market, because you have cut the flow off. That is all I am objecting to.

If you were to do both that is fine. I have no objection to that. All I am saying is that creating the international reserve unit strikes me as being of lesser importance. I don't quite dare say secondary importance with my learned friend here, but almost secondary importance as compared with preserving the international capital market.

Representative MOORHEAD. Thank you, Mr. Chairman. My time has expired.

Representative REUSS. Mr. Roosa, back on the question of the investment credit tax. Suppose as the months of spring go by that Congress deems the overall economic situation to be such that there are soft spots in it, and that it doesn't want to risk the fall-off in consumer demand that would ensue from enacting the 6 percent across the board income tax increase. You have suggested that we ought to do something by about July 1 on the investment credit, because if you just let it go and you revise it next January 1, there is going to be what Walter Heller has called an "air pocket" in back of it.

Mr. ROOSA. Yes.

Representative REUSS. On the assumption I give, where the Congress feels that it shouldn't pass an across-the-board tax increase, would it not make sense to reinstate the investment tax credit as of July 1, and accompany that by an increase in the corporate income tax of a level about sufficient to recapture the \$1.5 billion which I believe are lost to the revenues per year by the investment credit?

If you don't do that, you are going to cause an interference with monetary policy, because the Federal Government will have to borrow \$1.5 billion which it otherwise would not have to borrow.

Mr. ROOSA. Yes. It depends on what the considerations are that have led the Congress to feel by that time that no tax increase should be enacted. And here we are just guessing. If the soft spots are found to be quite serious, then it may well be you should do it without the offset, and accept the deficit, the larger deficit, as essential. You could then borrow the needed additional money in short-term form to help avoid risks in the interest rate structure.

But I can also well imagine the situation that you have described. I can also imagine one in which it would be decided to put the surcharge on, and in order to assure that there isn't an implication of disparate treatment, there be some slight difference between the corporate rate and the personal rate when the investment credit is reinstated.

It seems to me that credit itself plays such an important part, not only in the stimulus that it gives to additional investment, but in the

stimulus that it gives to additional investment, but in the way in which it facilitates the cash flow and financing requirements of business firms, that dollar for dollar I would rather have the investment credit and a corresponding increase in the corporate tax.

Maybe you won't find many corporate treasurers who agree with that, but I think in economic impact, it is worth it.

Representative REUSS. You think you would get more productivity increase in dollar of tax bonanza?

Mr. ROOSA. I do.

Representative REUSS. Mr. Brock has another question.

Representative BROCK. If I might pursue the point, Mr. Roosa, that you raised at the last part of our colloquy, you, I think, agreed with the premise that we were entering into a period of cost-push inflation as opposed to demand-pull. Yet you said you feared the swinging backhand of the other, later on. I think that was your justification for the tax increase.

We had the Chairman of the Federal Reserve here, Mr. Martin, and he is tremendously concerned about what he called "the inventory overhang," the tremendous increase in inventory accumulation in the last year in the sense of needs apparently.

In the light of that inventory overhang, do you honestly think that the demand-pull is something that we have to concern ourselves too much with in the next 12 to 18 months?

Mr. ROOSA. I shouldn't pretend that I know enough really to answer that question, Mr. Brock, but my own working judgment on it is this. I have talked about the inventory overhang with Chairman Martin and a number of others, and I don't find too much disagreement in terms of appreciation of its present implications, but I don't see any reason yet to think this won't work itself through at least to the point where any serious snapback is overcome by the middle of the year, or perhaps even sooner, and I think that the continuation of increased income payments, the way they have been going, the present expectation of final sales to consumers projected by most of the people that I know in the retail trade, all point toward a working off of the inventory overhang.

Now the question that no economist can answer, and we all ask, and hold our breath over, is whether once an adjustment of this kind is occurring, a series of pervasive reactions may develop, and gain momentum of its own, and then cumulate with more downward pull for the economy as a whole.

It has to be at this stage a matter of judgment as to whether you see in the ingredients of it that kind of a buildup. For myself, I don't, and I would like to call attention to one thing.

You know the Council's Report says—and I am sure they are right, but I am not sure they are right enough—that great attention has been paid this year to the way in which Government orders were placed, in order to take account of their impact on the economy.

I am sure that has been done, but I would repeat, not enough, because a considerable part of the inventory overhang now is the technical result of the fact that for perfectly understandable and laudable reasons, Secretary McNamara has a different idea of how to run the Defense Department. He just doesn't want to be caught with a top-

heavy inventory, if there is any kind of change, either in his requirements or in the whole Vietnam commitment. As a result, the economy is peppered with last minute priority orders which cause a set-aside of civilian production, and the building up of excess inventory which has to be carried and financed, while the priority military purchases are passed through. There are dozens of such cases around the country, and much has been done to try to offset them. I am not being critical of them. I am just noting the effect.

It may be that this is an area where there is more that can be done to so use the real impact of Government spending programs to minimize the potential disturbances to the economy as a whole. If so, I hope it can be studied and done. At any rate, this accounts for goodness knows how much. In the nature of the inventory buildup, we see so little of it as finished goods and so much of it as raw materials and goods in process, that the presumption I think holds that a considerable part is explained by this and by the sui generis case of the automobile industry.

Representative BROCK. I think what I am concerned about is instead of the improper mix or balance of monetary and fiscal policy, but last year when we had the demand-pull inflation we used almost exclusively monetary policy in this period of imbalance in the credit sensitive areas of the economy. We got this sponge type of effect where your defense industry is going up, your housing industry is going down.

This year when we are shifting into a cost-push type of inflation, you come in with a tax increase, and I don't see how a tax increase is the proper fiscal tool to stop cost-push inflation. I just don't see the applicability in the current situation. I am concerned about the mix of monetary and fiscal policy.

Mr. ROOSA. Just as one final comment, the point I stress is that the cost-push is there. It's important. And in the absence of an effective incomes policy, the imposition of the guideposts in some effective way at this stage is unfortunately, if not paralyzed, at least impaired. That is no excuse I think for creating an environment in which there is an opportunity for the initial impulse of the cost-push to be amplified through the economy by an excess of total spending, total spending in which a considerable part of the potential excess arises from defense spending by the Government.

Representative BROCK. Thank you very much.

Mr. Chairman, I would like to submit for the record three questions to each of these gentlemen if they would respond for the record, so it won't take too much of their time.

Representative REUSS. Without objection, that may be done.

(The questions above referred to follow:)

1. Former Assistant Secretary of the Treasury Trued has suggested that the United States consider forming a "dollar bloc." Member countries would agree to follow certain rules with regard to their dollar holdings and, in return, would receive certain rights in the U.S. capital market not available to nonmembers. How do you regard this suggestion?

2. Negotiations for international monetary reform are going forward. However, do you believe adequate attention is being given

to the "overhang" of existing sterling and dollar balances? Do you think there should be an effort to get agreement on rules for the conversion of dollar reserves into gold? What form might such an agreement take?

3. How do you regard proposals which have been advanced under which the United States would continue to sell gold at \$35 an ounce but would alter its buying policy, either by not buying gold at all or by refusing to buy at \$35 an ounce, or at any other predetermined price?

(Mr. Roosa's responses to the questions referred to above follow:)

1. The Trued suggestion, as I understand it, related only to the possibility of forming a "dollar bloc" as a last resort, if all efforts to balance our international accounts and maintain the dollar price of gold should fail. In that extremity, which I trust we will never reach, the "dollar bloc" version of isolationism could be a plausible possibility. But for the reasons mentioned earlier in replying to Representative Reuss, I would regard this as an admission of defeat for the worldwide objectives that American foreign policy has been pursuing since World War II. I hope we can do better than that.

2. The "overhang" thesis rests on a mistaken premise. It assumes that there are large holdings of sterling and dollars that cause trouble because they are in short-term form, and that all of this potential for disturbance could be removed by inducing the holders to transform their holdings into long-term bonds. In fact, these short term holdings are in that form because the holders need internationally useable short term assets—they want a "vehicle" currency available for current use. They react in ways that seem to cause trouble where they think something risky is happening that might affect the value and ready useability of the currency they hold—sterling or dollars. They might be induced to leave a given currency altogether, but because their needs are for working funds they cannot be "neutralized" by any grand "conversion" operation that would leave them with only funded debt.

In connection with the adoption of a new international reserve asset, there will, quite appropriately, be an opportunity for spelling out the "rules of the game" that countries will be expected to follow. There may, in that setting, be a place for some further clarification of the ways in which other countries can reinforce the United States' capability for maintaining the \$35 price of gold. The form and substance of any such guidelines or procedures will be determined in large part by the nature of the new reserve asset arrangements, and I cannot predict those now.

3. I think the United States would very soon find that it had no gold left to sell, if it were to be a ready seller of gold at \$35 and a reluctant buyer. My various reasons for opposing this approach are summarized in my *Monetary Reform for the World Economy* (New York, Harper and Row, 1965), pp. 19-21.

(Professor Kindleberger's responses follow:)

1. *Formation of a Dollar Bloc.*—As I stated in a reply to a question put by Representative Reuss, I do not favor the formation by the United States of a dollar trading or financial bloc. Such a course of action may be necessary. If other countries turn away from the world economy with an international monetary system and capital market, what is left over may be little more than a dollar bloc. But this is a second- or third-best policy, rather than an optimal one. The best policy is to operate the gold-exchange standard, based on the dollar, to dismantle gradually the I.E.T. and the V.C.R.P., and to make it possible for all credit-worthy countries to participate in the international capital market, based on New York and the Euro-issues market. All that this requires in my judgment is an understanding by Europe and the United States that the balance of payments of this country is not in meaningful deficit.

2. *The "Overhang" of dollars and sterling. Rules on Conversion of Dollars into Gold.*—A distinction should be made between dollars and sterling. The dollar is used worldwide as an international currency. Sterling is used inside the sterling bloc and is held to a considerable extent in the Middle East. As already explained, I do not think that the dollar reserves of the world need to be converted to gold, bancor, I.M.F. deposits, or be funded. The dollar is the

world's medium of exchange, unit of account and store of value for international transactions. The French overhang has been removed. In the case of other countries, the remedy is better understanding of the usefulness of dollars rather than attempts to reduce their size. It is inefficient to have to convert reserves into media of exchange when the time comes to use them. The most efficient system is one in which the medium of exchange and the store of value are the same. This is the banking function within a country. I assert it is the same internationally.

As to whether the sterling overhang may usefully be removed, I have no clear view. It depends upon the stability of its deposits. There are two reasons why holders of sterling might draw them down: 1) because they themselves were running deficits which they needed to meet and chose to meet in sterling, paid to countries which did not normally hold sterling; 2) because they decide to hold their reserves in another form, for safety or for greater usefulness. On the latter point, for example, if Britain joins the Common Market some countries like Australia will find themselves trading more widely in the Pacific and may have less need to hold sterling and more need for other currencies.

In sum, therefore, I do not believe dollar overhang exists and needs to be removed. I do not have sufficient information to make a judgment on the position regarding sterling.

The second part of the question regards the desirability for rules on the proportions of international reserves held in gold and dollars to limit the conversion of dollars into gold. The official Treasury position seems to be that this would be unwise since any maximum agreed on ratio would quickly become a minimum ratio for other countries which hold now mainly dollars. No agreement among the major financial powers could be prevented from spreading to smaller countries. If this be the case, agreement should be for the greatest part informal and tacit. Perhaps such agreements now exist outside France. The United States, however, should stand ready to pay out gold to the full extent it is demanded of it, and to the last ounce of gold. It is this readiness to meet the requirements of the gold-exchange standard which, in the long run, is the best assurance that the country will not be called upon to do so.

As for the country which has been trying to put pressure on the United States by deliberately and overtly converting dollars into gold, France, no agreement would be possible with her, and none is now needed. The French balance of payments is now in disequilibrium and the French have even been borrowing dollars, through *Electricité de France's* issue of \$30 millions of Euro-dollar bonds, to replenish their dollar stocks.

*3. Proposals for Continuing to Sell Gold, but not to Buy.*—May I refer to my discussion of this question in the Joint Economic Committee's Compendium on Contingency Planning for International Monetary Reform? I may summarize that discussion here by saying that while I would not aggressively seek to change central-bank and hoarder views of the long-run prospects for gold by lowering the price or altering our long-standing commitment to buy at \$35 an ounce, I expect that gold will be demonetized in the long run, and the prospect does not appall me.

Representative REUSS. Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman.

Dr. Kindleberger, I think I know your answer, but would like it for the record. Would you say we have an excess of liquidity, or shortage of liquidity?

Mr. KINDLEBERGER. In the United States or in the world?

Senator SYMINGTON. In the world.

Mr. KINDLEBERGER. You may know the answer, sir, but I am not sure that I do.

Senator SYMINGTON. I think I know what your answer will be.

Mr. KINDLEBERGER. There are two criteria by which one chooses in the literature. One is whether the burden of adjustment is on the deficit or on the surplus countries. If it is on the surplus countries you have too much, on the other it is too little.

Another criterion is whether world prices are rising, stable, or falling. By that criterion you have too much, because world prices are rising. I am inclined to say that there isn't any country that I know of which is taking very general measures because of lack of international liquidity. On the other hand, the United States is taking governmental measures to restrict imports and to tie AID and to put on the interest equalization tax because of a fear of its lack of international liquidity. And I suppose on that score you would say that the United States is suffering from a lack of international liquidity, or what it thinks to be a lack of international liquidity, but on the whole, I think I will conform to your expectations and say that I don't think there is a serious lack of international liquidity in the world.

Senator SYMINGTON. The reason I ask is that the article by the senior financial editor the chairman was good enough to put in the record said, "There is general agreement that the world is now suffering from an excess rather than from a shortage of international liquidity."

Mr. Secretary, would you comment on that?

Mr. ROOSA. I think there has to be a distinction between the liquidity generated within countries by the combination of their own monetary fiscal policy, and the liquidity that is useable for settlement among countries.

I think in the first case, the liquidity generated, or to put it crudely, the money supply increases, in a good many countries around the world have been too great. Using the Kindleberger formula, price rises have occurred, significant price rises. Therefore, there has been too much liquidity.

But that isn't, as I see it, quite the end of the story. I don't believe that there is an absolute shortage of international liquidity at this time. But I think there is something very significant in the recent record. For the past 2 years on balance the central banks of the world, who still respect dollars as Professor Kindleberger says, nonetheless did not add to their dollar holdings, nor was there any net addition to the supply of gold available for monetary reserves.

Yet, year in and year out, there are going to be some countries who earn surpluses, hopefully more than the others running deficits. There has to be a supply of internationally usable liquidity so that the surplus countries can show some net gain from time to time.

Otherwise, you have the process breaking down, countries follow merchantist tactics where each one beggars his neighbors. So to provide longrun additions to the world reserves, basic official monetary reserves, we either have to look to a resumption in the holding of dollars in the future, and that may well occur, or we have to supplement that with some new means through the international monetary fund.

Up to now through these 2 years, virtually the entire supplement has come from the monetary fund, and yet in a form that arose because they were financing big deficits of the United Kingdom. We can't always count on that source of international liquidity.

Senator SYMINGTON. Thank you. My next question has to do with questions asked by Congressman Moorhead, it had to do with balance sheets and earnings statements, fixed assets and current assets.

One thing every business and bank has to take into consideration, and I presume also governments, is defaults.

Based on the history of financial relationships with Europe after World War I and World War II, and between those wars our relationship with Japan, and to a lesser extent the record of voluntary or involuntary defaults in Central and South America, wouldn't that enter into any relative satisfaction about lending long and borrowing short?

Mr. KINDLEBERGER. Sir, I tried to discuss this explicitly in my testimony and said that you have to worry about the character of the assets and the confidence in holding the liabilities. I expressed some concern, which I really feel, that Americans are tumbling over themselves rather like sheep to invest in Europe because it is very fashionable.

Profits have been declining for 4 years in Europe, and I see no reason, when profits have been declining for 4 years, for more and more companies to keep on adding to their investment over there. They are not going to make out on all of these investments.

I cited two cases, Machines Bull which GE bought with serious losses in the last 3 years and I cited Rootes, where Chrysler is trying to buy more of Rootes even though Rootes has lost money in the last couple of years.

I am concerned about the character of these assets, but on the whole I think we have done very well. The assets are splendid assets but we are moving into a situation where if we keep this up and keep on investing funds in long-term situations in Europe, it is not at all clear that we are not going to pick up a lot of lemons.

Senator SYMINGTON. You stimulate me to ask whether you think we have arrived at a point now where we should curtail, if not arrest, our long-term lendings abroad?

Mr. KINDLEBERGER. No, sir. If you believe in a private market economy as I do, you simply suggest to the market that maybe it is going too far, but I think it would be a terrible mistake for the United States to try to substitute its governmental judgment for the judgment of these investors.

Nonetheless, I call attention to Secretary Fowler's speech of December 1965, in which he said profits were declining. It didn't get much notice, but that is about as far as you can go.

Senator SYMINGTON. I was just asking what you felt we should do.

Mr. KINDLEBERGER. I speak my mind, sir.

Senator SYMINGTON. I certainly wouldn't want the Government get too far into such controls.

Mr. ROOSA, would you comment?

Mr. ROOSA. On the question of risks of default, I think this is very important in several ways. It is going to be a factor to consider if and when we try to do something in a multilateral way toward developing a new type of reserve asset, to work alongside the dollar. It is something we have to protect against.

It's clearly important in still another sense. That is, I think in retrospect now, it would be wise to chisel in stone one maxim for the Congress, since the executive branch never observes it. That is that no money is ever given as a grant. That it is always a loan, even if it is with no interest and with no specific maturity date, because there

are too many instances in even my lifetime in which grants have enabled countries to reach a position of strength, and then we had no possibility of reversal, of getting something back when it could be most useful to us.

Contrarywise, I think we should, therefore, recognize that in much of what is done, governmentally and nongovernmentally abroad, there will also certainly be defaults and losses, and that much of the foreign exchange that we talk about as being a potential asset in some of the less developed countries, arising out of the counterpart of Public Law 480 and so on, is virtually default money. (The conditions under which it could be used are so circumscribed.)

So that in tightening up our position, it is not only the defaults that have occurred but those that may occur, and the protection we ought to take against them that I feel are very important.

To go on as to whether we ought to impose some check now on foreign investment because of the risks involved, there I would agree with Professor Kindleberger. I think cautions have to be stated, and included in the cautions is one more of which our Canadian experience is the clearest illustration. We do have to respect as well as recognize the fact that other countries begin to wonder about their capacity to influence their own affairs when more than 50 percent of all manufacturing and extractive industry is owned outside, and it becomes a matter of statesmanship for the firm, as well as cost and risk, to take that into account.

Senator SYMINGTON. Thank you.

Representative REUSS. Thank you very much, gentlemen, for being so patient.

We will now stand adjourned until 10 o'clock tomorrow morning, when we will reconvene in this chamber.

(Whereupon at 4:30 o'clock p.m., the committee adjourned until Tuesday, February 21, 1967, at 10 a.m.)

# THE 1967 ECONOMIC REPORT OF THE PRESIDENT

TUESDAY, FEBRUARY 21, 1967

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

The joint committee met at 10:05 a.m., pursuant to recess, in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire and Javits; and Representatives Reuss, Moorhead, and Rumsfeld.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Donald A. Webster, minority economist.

Chairman PROXMIRE. The meeting will come to order.

Today we are privileged to hear three more distinguished economists who will be here to argue what we might call the public policy outlook, that is, the major policy decisions that face us in the year ahead.

Dr. Gerhard Colm is the Chief Economist for the National Planning Association, one of the great pioneers in the economics of full employment. He has been of tremendous aid to this committee, and has given us some excellent advice throughout the years.

Dr. Henry Wallich of Yale University is the former member of President Eisenhower's Council of Economic Advisers, and likewise has been most generous and perceptive in his comments, and of course, has a widely read economics column which I follow avidly.

Our third panelist this morning has not yet arrived. We expect him momentarily—Dr. Robert Lekachman. Although not so well known personally to this committee, he is known by reputation for his insight and for his ability.

Gentlemen, we are delighted to have you here this morning. The other members of the committee will be along shortly. We would appreciate it if you would limit your original statement to 15 minutes, and we will have more time for colloquy. I am going to ask Dr. Wallich to begin, followed by Dr. Colm, and Dr. Lekachman when he arrives.

## STATEMENT OF HENRY C. WALLICH, DEPARTMENT OF ECONOMICS, YALE UNIVERSITY

Mr. WALLICH. Mr. Chairman, I appreciate the opportunity to testify.

The Council of Economic Advisers is to be commended on the responsible and realistic stand taken in the report on a number of issues.

With respect to policy in 1966, the Council agrees that monetary policy was compelled to become too tight, in a year of pronounced

inflation. As I read the report, the implication is that fiscal policy was not tight enough. I would concur in the view that a tax increase early in 1966 was needed.

With respect to 1967, the Council seems prepared to give up last year's ill-advised attempt to push unemployment substantially below 4 percent. The policies the President recommends would keep unemployment approximately at its present level. I regard this conclusion, painful though it is, as realistic so far as it goes. In fact, it probably does not go far enough. The ultimate distressing lesson that the year 1966 taught us concerning the trade off between unemployment and inflation probably has yet to be spelled out.

The Council is to be commended also on its attitude toward the guideposts on wages and prices. It realizes that, with 3.3-percent inflation, it is not possible to ask labor to abide voluntarily by a 3.2-percent standard. At the same time, the economic truths inherent in the old 3.2-percent standard have been preserved. No new standard in excess of productivity gains has been set that would make labor believe, erroneously, that it could obtain real gains in excess of productivity growth.

Some parts of the report, on the other hand, invite dissent. The economic outlook for 1967, in my judgment, is painted in too glowing colors. The time shape of the outlook, with its expectation of a strong second half, seems particularly questionable. Since this analysis is the basis for a tax-increase recommendation, a forecasting error would be particularly serious.

The balance-of-payments problem is underplayed. If monetary policy were to become as easy as the President apparently would like it to be, large gold losses would have to be anticipated. Little is said about how this dilemma is to be met.

Budget information and budget analysis are seriously defective. On the basis of last year's performance, one can only conclude that the Council of Economic Advisers is not adequately informed by the Defense Department about the outlook for military spending. This seems to have been one reason for the wide underestimate that caused part of our troubles last year. Simultaneously, the administration—and this comment applies even more to the budget than to the Economic Report—is placing almost exclusive reliance upon the NIA budget at a time when the NIA budget has revealed itself to be defective in its appraisal of the economic impact of defense.

I shall now comment in greater detail on these points.

### THE ECONOMIC OUTLOOK

The Council's estimates of GNP components in 1967 may be considered optimistic on several counts, which however are for the most part within the range of judgment. But the forecast is strongly implausible in one particular: the assumed behavior of inventory. The Council assumes that excessive inventories will be worked off in the first half of 1967 and that inventorying thereafter will return to a normal rate. There is little evidence in past history that inventory adjustments can be completed in two quarters. Given the relative sluggishness of the advance that the Council forecasts, correctly in my view, for the first half of 1967, it is not even certain that much

headway can be made during that period in bringing down the present excessive rate of inventory accumulation. A postponed adjustment would have to be all the greater and longer lasting.

Inventory movements are large relative to other changes in spending outside the consumer area. Neither plant and equipment spending nor housing, nor even Federal spending, is likely to experience quarterly changes in annual rates exceeding \$5 billion, but inventory spending may well do so. Resting as it does upon a questionable appraisal of the most volatile factor in the economy, the Council's GNP estimate must be regarded with serious misgivings.

A further question relates to the recovery of housing. Substantial easing of monetary policy is required to get residential construction going again. Whether this ease will be forthcoming depends on capital flows in the balance of payments that are partly dependent on interest rates abroad. A question mark needs to be entered after the Council's housing forecast.

There remains the possibility that Vietnam expenditures will again be larger than anticipated. If indeed the pattern of 1966 should repeat itself, the Council's forecast will be valid at a minimum and a tax increase will be needed. There is no way, for an outsider, of appraising this prospect.

Adding up the components of the outlook, I am compelled to question the need for a tax increase even at midyear. Certainly it is wise to postpone its enactment until close to the beginning of the fiscal year. On present reading I would not believe that it should be enacted even then.

#### SPENDING CUTS

Even if inflationary pressures should mount sufficiently to require counteraction, expenditure cuts would present an alternative to a tax increase. Federal expenditures in the NIA budget, including for Vietnam, are scheduled to reach 21 percent of GNP, contrasted with 18 percent in recent years. After this as after any other war, expenditures are unlikely to return to their earlier GNP relationship. Hence the case for holding them down now is a good one if economic balance calls for restraint.

The quite unjustified view seems to have gained ground that cuts must necessarily and virtually exclusively fall upon the new programs in the areas of space, education, poverty, health, pollution, urban life, and the like. Clearly, almost all Federal expenditures are capable of being cut. The fact that a program has been going on without much change for many years seems more nearly a reason for examining it closely than for leaving it undisturbed. It may be more difficult to cut an old program than to block a new one, but it may not be better economics.

#### TIGHT MONEY IN 1966

The Economic Report indicates, correctly in my view, that in 1966 monetary policy went about as far as it could. Interest rates reached levels not observed for 40 years. The housing industry was seriously injured. Some observations to qualify these facts nevertheless are needed. Interest rates must be viewed with respect to changes in the price level to obtain what economists call the real interest rate.

Deducting a price increase of over 3 percent from 6 percent, the real rate for the year is seen to be about 3 percent. For a corporation deducting a 6-percent interest cost from its taxable income, the cost of money during the year was in effect zero or less. For a saver in the 50-percent bracket, the return on a bank deposit yielding 5 percent was negative. Money in 1966 was tight, but not expensive. The same calculations would not apply, of course, for those who made long term commitments at 1966 rates if inflation should let up.

The collapse of the housing industry, which is regarded as an indictment of the discriminatory nature of monetary policy, has in part very different roots. Housing in any event is bound to be more responsive to interest rates than corporate borrowing, because mortgage installments are a large fraction of the average family budget. The demand for mortgage funds thus is bound to be more elastic with respect to rising interest rates. Credit demands of corporations are inelastic because interest costs are a small part of total business costs. These are the facts of the market. It is not monetary policy so much that discriminates against housing as the nature of the market system.

The housing industry was further hurt by defects in the Nation's method of financing mortgages. A large part of home financing is done with deposits repayable on demand. In a period of high interest rates these deposits are likely to shift into higher yielding assets, causing tightness over and beyond the effect of high interest rates. What is needed to cure this situation is not a constraint on monetary policy, nor a ceiling on interest rates payable by competing intermediaries. Needed is a reform that would allow particular savings and loan associations to pay competitive interest rates in periods of tight money. The British system of extending maturities and thus raising the interest components of the monthly installment without changing the installment itself commends itself as a possible solution.

Very tight money in 1966 had the incidental effect of improving the balance of payments on the official settlements and probably also the liquidity basis. The fortuitous nature of these gains and the consequences of their possible reversal in 1967 need to be emphasized.

### UNEMPLOYMENT

The price experience of 1966 seems to show that unemployment below 4 percent is strongly inflationary. There remains the hope that the price impact may have been due to the rapid rate of reduction and the attendant demand shifts rather than the absolute unemployment level reached. Nevertheless, this is at best a hope. A more plausible interpretation of this experience is that, with the present price and wage setting habits of business and labor, even a stable rate of 4 percent unemployment would not give us even approximately price stability.

This situation confronts the Nation with a task of overriding urgency: to improve the shortrun trade-off between unemployment and inflation. The guideposts were an important device directed to that end. They are largely nonoperative now. Structural improvements in labor markets have often been pointed to as an important means of improving the trade-off. Rather than speculate on what more could be done, I would like to emphasize the great importance of making progress in this direction.

Recently it has become fashionable to argue that the short run choice of buying a little more employment by accepting a little more inflation is open to us also in the long run. If that were true, it would be difficult not to vote for less unemployment even at some cost in added inflation. It has been argued that such a choice need not lead to accelerated inflation, because the evidence of industrial countries abroad does not reveal accelerated inflation.

This is an illusion, encouraged by the fact that industrial countries restrain inflation whenever it threatens to accelerate seriously. By taking antiinflationary action, they usually also increase the rate of unemployment. The economic logic behind this interaction of wages and inflation is simple, and I hope that this committee, which has seen far more complex material presented to it, will permit me to summarize it. Past presentations before the committee have made reference to the so-called Phillips Curve which shows how wage increases are related to unemployment, becoming larger as unemployment is reduced. For making available to employers a very high percentage of the labor force, labor demands larger annual wage increases.

Unless one is to believe that labor is unconscious of inflation, one must assume that labor bargains for wage increases in real terms, not money terms. The real increases that labor can get, however, are limited by productivity gains plus such reduction of profits as is possible. In the long run, if the share of profits is to remain roughly stable, real wage increases cannot exceed productivity gains. That is the principle underlying the guideposts. Hence if nominal wage increases beyond productivity gains are granted, prices will rise and will reduce real wage increases back to the level of productivity gains. Thus the implicit bargain that led labor to make available a very high percentage of the labor force cannot be kept. Labor then will increase its demands in nominal terms and, if these cannot be met, reduce the labor supply offered.

There is thus only one point of long run stability on the Phillips Curve: that level of unemployment at which wage increases equal productivity gains. At lower levels of unemployment, profits will be squeezed or prices will rise. Since they cannot be allowed to accelerate, they will be halted by restrictive fiscal and monetary policies. To be effective, these policies will have to raise unemployment back to the level that equates real wage increases with productivity gains. This can be achieved at a stable rate of inflation, provided that rate is sufficient to reduce money wage increases to the level of productivity gains. It can also be done by halting inflation altogether, in which case nominal wage increases will equal productivity gains. In any event, there is no stable, long run level for unemployment but that which makes real wage increases equal to productivity gains.

### THE GUIDEPOSTS

The guideposts on wage and prices solidly endorse the view that in the long run labor cannot get real wage increases in excess of productivity gains, which is the principle I have just been trying to spell out. The best course of action for labor would be to stop trying to get above-average increases. The cause of maximum employment therefore would best be served if labor would stop trying. If business then were

likewise to accept the guidepost rules pertaining to prices, the trade off between unemployment and inflation would have been reduced to very favorable terms.

Following the rapid widening of profit margins and increases in the income share of profits in recent years, labor is sure to feel that some redress in its favor is in order. Speaking in terms of economics rather than equity, this proposition is questionable. Income shares, like the budget surplus, must be viewed at full employment. Below full employment, profits as well as Government revenues are below their normal proportions.

But in any event, the price rise of 1966 makes it unrealistic to ask labor to abide by a 3.2 percent standard. It is wise that the guideposts were not denatured by escalating them to some arbitrary figure without economic content. More general forms of counseling voluntary restraint, both to labor and to business, will have to be employed by the Government.

We cannot expect labor to accept the 3.2-percent guidepost realistically in a year in which the cost of living rose by 3.3 percent. This raises the question whether we should have moved to a higher guidepost. My view is no, because it would have obscured the economic truth underlying the guideposts without gaining, I think, very much, because the guideposts are not a powerful tool to prevent wage increases when demand is high.

With respect to the future, however, the possibility should be examined of making the guideposts more operational. A tax penalty could be imposed upon corporations that exceed the wage guideposts. This would make implementation of the guideposts depend on market factors, not on official suasion. Firms that could make more money by exceeding them would be free to offer higher wage increases. Since the tax would be paid by business, it would seem legitimate to apply it to violations of the wage guideposts alone, without attempting the administratively prohibitive job of applying it also to the price guideposts.

#### BUDGET INFORMATION AND ANALYSIS

It is urgent to prevent a recurrence of the events of 1966, by now familiar, that led to the underestimate of the defense impact. Both the magnitude of spending, and its duration, were inadequately reflected in the Council's forecasts. The NIA budget presentation, moreover, which is the principal basis of fiscal analysis, failed to reflect properly the impact of the defense buildup. It showed as increases in business inventories what actually was the processing of Government defense orders. The consequences are known.

This year's shift to almost exclusive emphasis on the NIA budget deserves to be viewed with skepticism. The NIA budget clearly is superior to the administrative budget as an analytical device. But its recent record of partial failure, together with the fact that the shift in emphasis is being made in a year when the administrative budget shows an embarrassingly large deficit, argues against acceptance of the NIA budget as our principal fiscal statement. Considerably more study of the pros and cons is needed before a decision can be made on this subject.

The NIA budget is seriously defective, and it is a questionable procedure to shift to it as the budget does during a year when it happens to show the low deficit while the administrative budget happens to show a large deficit. We ought not to be afraid of large deficits if they are properly financed. That is an essential condition. And we should not exalt the NIA budget any year where that happens to put a spuriously favorable look upon the whole budget situation.

### THE BALANCE OF PAYMENTS

In 1966, the United States lost some of the competitive advantages that relative price stability had been conferring. In 1967, some more will be lost. It is of little help, even if true, to say that our inflation is less than that of other major countries. To be fair and efficient, the automatic mechanism of balance-of-payments adjustment requires prices in the deficit country to fall while in the surplus countries they rise. If that is asking too much, stability in the deficit country is the minimum to be expected.

Prior to 1965, the United States could allege not only that it was holding prices stable, but also that it was making sacrifices on behalf of international adjustment in the form of lower income and higher unemployment. At present, the full employment and rising prices, the United States is making no economic contribution whatever to fundamental payments adjustment and is throwing the entire burden of adjustment upon the surplus countries. High short term interest rates, the interest equalization tax, tying of aid are stopgaps, not means of adjustment.

Thanks to these stopgaps, the balance of payments did not deteriorate seriously in 1966. It is worth noting, however, that beyond relying on stopgap devices, it was additionally necessary to employ a long list of window-dressing measures to make the deficit look smaller than it is. No less than nine such window-dressing devices, the repercussions of some of which already are coming home to roost, are identified in the Department of Commerce's balance-of-payments presentation for the first three quarters of 1966; they "improve" the results for the period by \$856 million.

If, as seems likely, we are now running out of such devices, and if short term funds should flow back as interest rates fall, dangerous new pressures upon the balance of payments must be anticipated. It is difficult to see how they could be met except by new controls, presumably in the area of private foreign investment, harmful as they would be in the longer run. What supports foreign confidence in the dollar now is the conviction abroad that this country will sooner go to far-reaching controls than to devaluation. But controls undermine the usefulness of the dollar and in the long run, therefore, its strength as well.

It is in the nature of a payments deficit, unlike inflation or unemployment, that the country experiencing it feels no pain. The pain comes later, when the consequences must be faced in the form of tight controls or a devalued currency. For this reason, the payments deficit attracts little attention. Sacrifices to end it are ruled out as unacceptable. Even when sacrifices are proposed, such as the 6-percent income

tax surcharge, they are not defended on balance-of-payments grounds, although these now present a better justification than does the domestic outlook.

I believe that the domestic economy will be soft enough, even without a tax increase, to bring some improvement in the current account of the balance of payments. Hence I see no urgency from this point of view for a tax increase.

The situation is very grave. We have lost some of the benefits that price stability has been giving to us. It is useless to say that our prices are rising less rapidly than those of other countries. We are the deficit country. Our prices properly should fall. That is asking too much. They ought to at least remain stable.

To say that we are inflating less than others is saying very little indeed, since at the time we are no longer contributing to balance-of-payments adjustment by keeping the economy under wraps; we are really making no contribution to adjustment at all except by various forms of market intervention, such as the interest equalization tax and a very temporary effect of high interest rates that attracts hot money. All we are doing now is throwing the principal burden of adjustment on the surplus countries. This reflects itself in their refusal to permit us progress toward international monetary reform.

I am concerned about the number of statistical devices we have been using to dress up the balance of payments. I count nine different types of devices in the survey of current business alone, and no doubt there are others. These things conceal the underlying facts without making them any better. It is basically on balance-of-payments grounds I would say that a tax increase can still be supported at this time.

If I, nevertheless, don't support a tax increase now, it is because I see the economy sufficiently soft to achieve most of the benefits that would come from a tax increase, even without one, that is, I see a slackening of imports and improvement of exports.

I also see a continuation of relatively high interest rates, in order to keep the hot money here. That in turn contributes to the prospective weakness of the economy.

Taking these things together, with interest rates not much lower than the present and no tax increase, we would probably be doing, on the inflation and balance-of-payments front, as much as can be done in a year of cost—push inflation. But I do consider the balance of payments a primary source of concern, and I have three proposals to deal with it.

1. Keep short-term interest rates sufficiently high to prevent outflow of short-term funds, but within this constraint seek to making interest rates as low as possible. Low interest rates are better than high.

2. Remove the 25-percent reserve requirement for Federal Reserve notes in order to make our reserve more maneuverable; and

3. Adopt the complex of measures that will be needed to end inflation and resume the improvement in competitiveness. Thank you very much.

Chairman PROXMIER. Thank you very much, Mr. Wallich, for an excellent statement. I must call attention to the fact you exceeded the time limit by 5 minutes, but I very much appreciate what you have

said. Mr. Lekachman, as I announced before you came in, we would appreciate it if you would try to confine your initial statement to 15 minutes if possible. You will follow Dr. Colm, who is our next witness.

Dr. Colm has a little more detailed statement, and I am sure he will abbreviate it to some extent.

### TESTIMONY OF GERHARD COLM, CHIEF ECONOMIST, NATIONAL PLANNING ASSOCIATION

Mr. COLM. Mr. Chairman, indeed, my statement is a little bit longer, and if I am permitted to—

Chairman PROXMIRE. Your entire statement will be printed in the record.

Mr. COLM. Thank you, Mr. Chairman.

I appreciate very much the invitation to participate in this year's hearings. I find it a bit difficult as an economist to diagnose the situation in a way which could be the basis for policy action. It is easy to give advice on economic policy when there is a clear threat of a recession. It is easy when there is a clear threat of inflation. We have, as everybody recognizes, at the same time recessionary and inflationary tendencies.

The inflationary tendencies emanate from the budget. Instead of reading figures, I would like you to take a look at the first table presented to you in the appendix to my statement (see p. 893). That is the Federal budget in national income accounts terms. It breaks it down by half calendar years.

Whatever measurement one uses, and this is the national income accounts, in the movement they are not so different, the table shows that we had the greatest increase in the second half of 1966, continued increases during the year 1967, and continued increase also in the first half of 1968—calendar 1968.

The increase according to the budget figures is declining. But we have an increase. We have quite a bit of change in composition, particularly the transfer payments will rise in the second part of the calendar year 1967 because of the recommended increase in social security benefits. We have the sharpest decline in national defense expenditures—pardon me, in the increase in national defense expenditures. The increase was from the first to the second half of calendar 1966, almost \$8 billion; from the second half of the year 1966 to the first of 1967 this is projected at \$5 billion, \$2.5 billion from the first to the second part of the calendar year 1967.

Here I may pause, coming to the same question raised by Dr. Wallich. Last year we had the experience that defense expenditures were grossly underestimated, as the chairman has repeatedly emphasized. Apparently, no such repetition can be expected this year, because there is no such unrealistic assumption made that the war may end by the middle of the calendar year 1967.

We have a planning assumption of continued war and continued present strategies. Taking this assumption, I still—being a layman in this field—share Henry Wallich's concern that the increase by \$2.4 billion is a very small one, and under this assumption, I would

count at least on the possibility that expenditures may turn out to be larger than now estimated.

I emphasize this is not a statement of what will probably happen. This is a planning assumption. In my personal opinion it is more probable that over the period of a year and a half, something will change, whether it's escalation, or as I hope, deescalation, but for planning purposes, it would not be wise to count either on the one or the other, because if that happens, all bets are off, and different policies would be needed anyway.

Under this planning assumption, I would at least keep in mind a possibility that defense expenditures will turn out higher than are now estimated.

If you will look again at table 1, at the deficit figures estimated in the national income accounts, we see during 1966 the swing from the substantial surplus to a deficit, from surplus \$3 billion to minus \$2.5 billion. The deficit will go up in the first half year 1967 to \$5 and to \$7 billion, in the second half of calendar year 1967. This means, of course, a somewhat arbitrary division of the fiscal year estimates into two half year periods. I don't go into the method as to how we did that, but this assumes smooth development throughout the fiscal year.

This deficit has been estimated without consideration of the income tax surcharge. The conclusion is that the budget, without that surcharge, is of an expansionary nature and would possibly in part offset recessionary tendencies emanating from the private sector of the economy.

Henry Wallich made the remark that the NIA budget is not entirely satisfactory. From the point of view of economic analysis, within the structure of an accounting system, I think it is great progress that the President has adopted this as the main system, also giving data on the other, but pushing this system. Nevertheless, I agree with Mr. Wallich that we should look at more data than this.

If you turn to my table 2 (p. 894) you will find various other measurements there. If you want to be sure, referring to the credibility gap, the budget which is printed for everybody to read has in point the most honest figure which can be produced, and is called the gross expenditures. No deduction, no trick is possible here.

I have excluded intragovernmental transactions, but the first time gives you an absolutely gross figure from which no back door financing can be deducted. It amounts to \$205 billion for the fiscal year 1968. The budget has that for everybody to see.

But there are some other items which are not reflected or not fully reflected in the national income accounts budget. One is the capital transactions. It is entirely correct not to include the financial capital transactions right within direct spending. I think it's an advance to separate them, but by emphasis on the national income accounts budget, we are going to forget that there are these financial capital transactions, which do have an effect on the economy.

You see in table 2, for instance, that in the fiscal year 1967 we have a very substantial increase in direct loans which is not reflected in the national income accounts. These are reflected in the consolidated cash statement which is also given, and I think it is also of significance. But there is one type of transaction which is not reflected in any budget: That is the guarantees and insurance of loans. You will see

from table 2 that in 1968 this figure shows a very substantial increase, particularly in the field of housing and urban development.

If we disregard these figures, we just don't get the full picture of what the Government is doing in stimulating or dampening economic developments.

I reach the conclusion that the budget in the broader sense will contribute to expansion during the rest of the calendar year 1967 and into 1968 calendar year, and even with the enactment of the surtax, I would guess that there is still a moderate expansionary effect from the budget on the economy.

I say I guess. Unfortunately, we cannot in any manner add direct spending, loan transactions and guarantees into one figure and then give the computation of the total net effect on the economy. We have to make a separate computation for the effect of each, and the statement I have made is of the nature of a probability statement.

We have the fact that from the private sector, in contrast with the public sector, recessionary tendencies emanate. If you will look at table 3 (p. 894), you will see that for the whole period from 1960 to 1965—perhaps you might look at the lower part of the table which gives index figures—the private demand has increased in real terms, that means in constant dollars, by 27 percent from 1960 to 1965, and an increase of 20 percent in the public demand during the same time period. We had very active fiscal policy increases in expenditures and tax deduction in this period, but these measures have so stimulated the economy that the private sector has increased by more than the public sector.

If you will now look in table 3 where we are comparing the fourth quarter of 1966 with the third quarter, you see a reversal. Here the private demand is virtually stagnating. There is an increase of one-half of 1 percent, while the public sector in that quarter still increased by 3 percent.

I don't want to go into a discussion of the recessionary factors. They have been discussed at length during these hearings and I have nothing particularly to add. But I want to point to two different interpretations that are given to the recessionary factors which are now visible. The one is the interpretation to which Mr. Wallich referred, which is in a way the basis for making the recommendation of an increase in taxes in spite of recessionary tendencies; namely, that the recession is mainly caused by the restrictive credit policy. Once these restrictive policies are relaxed and the budget effect, particularly of the increase in social security benefits, becomes effective there will be a turn-around in the economy by the middle of the year, so that possibly not only recovery but also inflationary pressures would be resumed.

There is, however, also a more pessimistic interpretation, which assumes that over the recovery period 1960-65 some imbalance developed in the economy. You will see, for instance, in table 3 that from 1960 to 1965 personal consumption increased by 25 percent; fixed investment excluding residential by 37 or 38 percent. That is interpreted as an imbalance which sooner or later had to be corrected by a decline in the increase of capital investment. This adjustment was aggravated by the effect of credit policy.

I don't want to go into the merits of these two interpretations because I would like to reserve, with the chairman's permission, a few minutes for my policy conclusions. But I want to say that I feel at this time policies should be formulated on the assumption that either of these interpretations, or most likely some combination of the two, may turn out to be right.

I do feel that we are in a situation where it could be hazardous to base short-term policy decisions on short-term forecasts, as Henry Wallich has suggested. I think we have to consider the uncertainties of the situation and whatever assumption we make, we have to calculate what the effect would be on policy if our calculation is wrong. That is the guiding principle, I think, for making policy recommendations under conditions of extreme uncertainty.

I will, with the chairman's permission, make remarks (1), on the tax recommendation and (2), on the guidelines. On the tax recommendation, as I go through the various arguments, I come out in favor of the President's recommendation of asking Congress to prepare the legislation now. I think that this is the most prudent course of action.

My main argument is not the economic forecast—it's the possibility that defense expenditures turn out to be higher than they are now estimated. If somebody tells me, as my friend Henry has suggested, that we don't know anything about these future expenditures, because we are not experts, I say I am not an expert in making a forecast, but I know that nobody knows, and so I want to do the prudent thing.

I think it will be much easier in June, when the legislation is prepared, to say it wasn't needed and then drop the proposal, than suddenly be surprised again by increased expenditures—or perhaps by a stronger economic development than is now anticipated—and start the process of tax legislation only then.

Therefore, I think it's very wise to ask for such measures now. Actually, that gives President Johnson something which President Kennedy tried to get and Congress didn't give him—and I think Congress shouldn't give the President—namely, discretionary power to change tax rates. This is one way of getting a certain flexibility without really surrendering the power of the purse to the executive branch.

I do think also that once we have the new survey of business intentions for plant and equipment in March, that will be the time for taking another look at the investment tax credit and for making a decision as to whether or not that credit should be reinstated earlier than under present legislation. Sometime before the effective date of the tax increase I hope there will be a brief period of hearings by the tax-writing committees, and I also repeat the recommendation that at such hearings, besides the witnesses from the administration and from outside, there should also be testimony coming from the Joint Economic Committee.

In this connection I look again at what your Subcommittee on Fiscal Policy recommended in May 1966 under the leadership of Mrs. Griffiths. I am sorry she isn't here, but I would be happy if she reads the record. I think the recommendations which her subcommittee of this committee made stands up very well today.

Second, the price guideposts. I want again to skip most of what I have in my prepared testimony. I tried to make the case as to why in my opinion the guideposts are essential in our economy of imperfect competition, and in which—and here again I differ with my friend, Henry Wallich—adjustments via unemployment take such a long time to work themselves out. If we relied on that mechanism, we would have unemployment of such a size and duration as I think our society would not accept as tolerable.

Chairman PROXMIRE. Thank you very much. Are you through?

Mr. COLM. Mr. Chairman, if you will give me 2 minutes.

Chairman PROXMIRE. You are such a brilliant economist and you are such a help to this committee that I hate to interrupt you, but you are 10 minutes over. So you go ahead and finish up if you can within 2 minutes.

Mr. COLM. The guideposts in my opinion are essential but I think the administration had no choice except to drop their numerical aspect. This means a weakening and a retreat, at least that is the way it has been interpreted. The administration apparently counts on continuing the policy of talking to business and labor. The Council in its report is proud of the fact that they have been involved in perhaps 50 cases of price increases during the last year.

I believe that shows the need for a more orderly procedure for implementing the guideposts. I recommend again what I discussed before Congressman Reuss' subcommittee at one time, that we need a mechanism, for instance, the establishment of a price-wage-productivity board, possibly under the policy direction of the Council, but with administrative independence, or possibly as is now being discussed, in the Commerce-Labor Department. This board would make a study whenever the President declares an industry is crucial for stability, and then submit a factfinding report to the President, who with his recommendations could submit this to the Congress. Then possibly a subcommittee of this committee could examine the application of the guideposts to specific industries and thereby strengthen the procedure.

I think at the moment the guideposts, in spite of good language in the report, have become weak. I think only with such an implementation, will it make sense to have no general numerical guideposts, but something spelled out for individual industries.

Thank you.

(The prepared statement and appendix of Mr. Colm follow:)

#### PREPARED STATEMENT OF GERHARD COLM<sup>1</sup>

I appreciate very much that the Chairman of this committee has asked me to participate in this year's hearings. In accord with his wishes I shall concentrate particularly on the public policy issues raised in the 1967 Economic Report of the President.

It is relatively easy to give advice on economic policy when there is a clear threat of a recession or when there is a clear threat of inflation. Ours is presently a situation in which we have at the same time recessionary and inflationary tendencies. We are in the position of a surgeon whose patient has appendicitis and heart trouble. If he operates on the appendix the patient may die of his heart trouble. If the surgeon takes care of the heart trouble and does not risk

<sup>1</sup> Dr. Colm is Chief Economist of the National Planning Association, Washington, D.C. His views do not necessarily represent those of the Association.

surgery the patient may die of peritonitis. In using a medical simile to illustrate a point, let me add that the patient with whom we are concerned enjoys a basically quite good constitution. This we should not forget when considering what treatment to recommend for his ailments.

In order to evaluate the adequacy of the fiscal and economic policies proposed in the Budget and Economic Report we should appraise the relative strength of the inflationary and recessionary forces. In order not to disappoint you, let me admit right now that we can at best consider certain probabilities and then discuss the fiscal and economic policies which are most appropriate, recognizing the elements of uncertainty in the evaluation of both the inflationary and recessionary tendencies.

#### I. INFLATIONARY TENDENCIES EMANATING FROM THE BUDGET

The Budget, as it has been transmitted to Congress, provides for a continued rise in expenditures, but at a pace which is slowing down. The slowdown is particularly pronounced in defense expenditures. The annual rate of increase was \$7.8 billion from the first to the second half of calendar year 1966. According to the estimates implied in the fiscal 1968 Budget, this rate of increase will go down to \$2.4 billion from the first half to the second half of calendar 1967 (see Appendix Table 1). This committee has been assured that the defense expenditures for fiscal 1968 present a more realistic estimate than the one transmitted a year ago. This year's estimate is based on the assumption of continuing the war in Vietnam and is intended to reflect future military requirements resulting from present war strategy. Such a planning assumption expresses neither our wishes nor a probability statement. It is the most useful planning assumption, if at the same time contingency plans are developed for the case of war escalation and especially for the, I hope more likely, case of de-escalation of the war. Even though I am not an expert on the financial requirements of military plans it appears to me that under the assumption of continued war the projected flattening of the increase in defense expenditures may turn out to be on the low side, although I do not mean an upward revision of the magnitude which was experienced for the fiscal year 1967. I repeat, my impression that the expenditure estimate for defense may be low relates to the assumption of continued war with no end in sight, which means continued replacement of used-up matériel.

The revised 1967 Budget shows a substantial upward revision also in the non-defense activities of the Federal Government, especially if measured by the administrative budget. This is due in part to a failure to sell as many assets as was estimated, and to the effects of rising interest rates on the Budget, but also in part to actions of the Congress and administrative changes in various programs. Several members of the Congress have expressed their conviction that the non-defense budget could and should be substantially reduced. I do not claim to have any more insight into the political considerations of the Congress than into military requirements, but in view of the relative tightness of programs with which I am familiar, and in view of the economic and social significance of the nondefense programs, I regard it as a prudent assumption that in the final analysis reductions of and additions to proposed nondefense expenditures may offset each other.

In evaluating the economic impact of these expenditures it should be noted that the proposed increase in social security benefit payments is likely to be immediately translated into substantial increases in demand for a great variety of consumer goods (the recipients being a group which tends to spend almost all its disposable income). The large increases in military procurement and in the Medicare programs that made for most of the increase in the fiscal 1967 budget had a narrower effect which created bottlenecks and had probably a lesser impact on the growth in total Gross National Product in real terms (see Appendix Table 1).

Expenditures show the largest over-all increase from the first to the second half of calendar 1966. It was also during this period that a swing occurred from a substantial budget surplus to a budget deficit (in NIA terms). Deficits—without adoption of the proposed income tax surcharge—would continue to rise from \$2½ billion annual rate in the second half of 1966 to \$5 and \$7.3 billion in the first and second half of 1967. Thus, looking at projected Federal expenditures, revenues (under existing legislation), and deficits it appears that the

Budget (NIA) would continue to be an expansionary factor, but the increase in deficits would decline.

The NIA budget is a better instrument for considering the interrelationship between budgetary and economic developments. Transactions in financial assets, e.g. purchase or sale of mortgages, are not directly shown. Furthermore, none of the budget concepts reflects the government insurance and guarantee of private loans. Financial transactions and insurance and guarantee programs each differ from direct spending in their economic effect. Their effect is reflected in residential construction or other items appearing in the private sector of the accounting system. The Government's role in bringing about these effects is, however, not indicated in the national income and product accounts. A substantial increase in direct loans is estimated for fiscal 1967, an even larger one for fiscal 1968, especially for programs in the field of housing and urban development. Thus the role of these indirectly stimulating activities of the Federal Government seems to be on the rise (see Appendix Table 2).

It is not possible to add together direct Government spending, direct financial capital transactions, and guarantees and insurance programs of the Government. The economic effect of each of these measures requires different methods of estimation.

Without going into technical details I conclude that the Federal Government's operations as envisaged in the Budget and Economic Report are likely to add to purchasing power and over-all demand especially during the second half of this calendar year and the beginning of next year, if the proposed surcharge on income taxes is not adopted. Even if adopted, I believe there would still be some net expansionary effect emanating from the Federal Government's operations.

## II. RECESSIONARY TENDENCIES IN THE PRIVATE SECTOR

For judging the appropriate fiscal and economic policies for next year much depends on the interpretation that is given to the recessionary tendencies which are observable in the private sector of the economy. Since they have already been discussed at great length at these hearings I do not need to repeat the factors of strength and weakness which are now observable. The level of economic activity is very high, but the outlook for unemployment is still too large, although low in contrast with most of the recent period. Nevertheless, the existence of recessionary tendencies is generally recognized.

We have experienced an extraordinary period of recovery from 1960 to 1965 with an increase in total production of goods and services by 26% (constant 1958 prices). Actually, the increase in final demand in the private sector was somewhat larger than that in the public sector (see Appendix Table 3). In 1966 the steady recovery growth changed into a boom under the simultaneous impact of a rapid rise in Federal expenditures, particularly for the war in Vietnam, and in fixed business investments. The Government used only very mild fiscal restraint to dampen the boom; the monetary authorities felt that the main responsibility for preventing inflation and a deterioration of the balance of payments rested on their shoulders. They stepped hard on the monetary brake. The effect at the end of 1966 was that growth in final demand in the private sector came to a virtual halt, while demand in the public sector continued to increase (see Appendix Table 3).

There are two different interpretations of these recessionary tendencies.

The first attributes the recessionary tendencies mainly, if not exclusively, to the effect of the restrictive monetary and credit policy. Lack of expansion in private demand with a simultaneous rise in military procurement in process of production resulted in a spectacular increase in business inventories. We are in a period in which the large inventories have a dampening effect on production. This explains the temporary slowdown in economic activity. However, the relaxation in credit restraint which is now under way and the expansionary impact of Government activities will make themselves felt before long. Therefore, an increase in activity and possibly the pressure of demand inflation are likely to be resumed, perhaps by the middle of calendar 1967. This appears to be the projected shape of economic development used for rationalizing the July 1, 1967 effective date of the proposed surcharge on the income tax in the face of present recessionary tendencies.

There is, however, a somewhat more pessimistic interpretation of the recessionary forces which assumes that during the long recovery period from 1960 to 1965 some imbalance has been developing within the economy. Outlays for fixed business investments (excluding residential construction) in 1965 were 38% above the 1960 level (constant 1958 prices) compared with a 25% increase in consumption. This may suggest a tendency of capacity to be overextended relative to consumption. (This need not be the case, particularly as the level of business investments had been *relatively* low.) The 1966 boom has further added to the discrepancy between the build-up in capital equipment and the increase in personal consumption. Thus, these observers say that some setback in business investments was due sooner or later. In their view, the slowdown in business investment has been aggravated, but not caused, by the restrictive credit policy which was pursued throughout most of 1966. This means that relaxation of credit may not be sufficient to restore the previous long-term rise in business investment.

I personally believe that at this time policies must be formulated on the assumption that either one of these interpretations, or, most likely, a combination of the two may turn out to be right.

### III. GOVERNMENT FISCAL AND ECONOMIC POLICIES

#### 1. THE TAX RECOMMENDATIONS

The President's recommendation for a surcharge on individual and corporate income taxes appears justified under the following assumptions.

(a) The proposal for a tax increase improves chances of obtaining approval for economically and socially desirable expenditure programs. (This assumes that there is a choice between a severe cut in the nondefense programs and a tax increase.)

I believe that the relative merits of expenditure programs in contrast with the demerits of additional taxes can be evaluated only in the perspective of long-term goals and priority decisions. Such decisions are in the final analysis a political act. However, the economist can contribute relevant information to aid in making this political decision. While it is always possible and desirable to run any organization with less waste and less expense, I do not believe that, let us say, a \$4 billion cut in expenditures could be made in the 1968 Budget without considerable harm to the nation's longer-range social and economic objectives. In this perspective, contributing to the financing of the Vietnam war by a relatively modest, temporary surcharge on income taxes appears justified to me. I emphasize that this is my personal judgment, which may be only on the borderline of a statement that could be supported by rigorous economic reasoning.

(b) The proposed tax increase is justified if the first of the two alternative interpretations of the current recessionary tendencies discussed before is correct, and a resumption of economic expansion and inflationary pressure is likely to occur in the middle of the year.

My personal feeling concerning the present recessionary tendencies would combine an element of this first interpretation with the somewhat more pessimistic second alternative. I am not convinced that relaxation of credit alone would stimulate resumption of vigorous expansion. Therefore, I believe that some additional arguments in favor of the tax proposal are needed.

(c) The proposed tax increase can be defended on the ground that this is the price to be paid for a considerable relaxation of credit.

I believe that credit restrictions were aggravated because of the conviction of the monetary authorities that the burden of preventing inflation and deterioration of the balance of payments rested mainly on their shoulders. Considering the harmful effect of the credit restrictions on some particularly vulnerable sectors of the domestic economy, e.g. housing, I share the opinion that a better fiscal-monetary mix in the anti-inflation program would be desirable. I do believe that a policy which includes the relatively mild tax increase plus relaxation of credit could about offset each other in their impact on the generation of purchasing power as a whole, with a better balance among component parts. I recognize in this consideration that the relaxation of credit itself has to be appraised not only from the point of view of its effect on the domestic situation but also on the balance of payments.

(d) The tax proposal is justified if there is a likelihood that expenditures for Vietnam during the latter part of calendar 1967 may be larger than estimated under the policy assumptions made in the Budget.

Under present policy assumptions expenditures for Vietnam may be larger than estimated or they may be smaller, in case of a de-escalation. Actually, it takes more time to deliberate the tax proposal, and to prepare legislation and administrative implementation than to rescind a tax increase. If there is a considerable chance that expenditure may turn out higher than now estimated I think it is advisable to prepare now the tax legislation for enactment (or dropping) at a time when more knowledge is available about the actual financial requirements for war and the course of economic development. For the case of de-escalation a more comprehensive program is needed, which I hope is in process of preparation.

Considering these various aspects, I would recommend that the tax-writing committees of Congress start working along the lines of the President's recommendation. If the forthcoming surveys on business investment intentions should bear out the pessimistic expectations of some observers I would also recommend that consideration be given to an earlier re-instatement of the investment tax credit than provided by present law. I would also recommend that the tax-writing committees plan hearings at a time before the tax increase is to become effective in order to decide whether conditions warrant going ahead with the tax increase. At these hearings representatives of the Government and the Joint Economic Committee should be heard.

## 2. THE PRICE-WAGE GUIDEPOSTS

Price and wage determinations are made by the parties directly concerned in their particular interest. In a competitive market economy the particular interests of business and labor coincide to a large extent with the general or national interest. In some cases, however, there may be a conflict. This conflict arises because we do not have a fully competitive economic system, neither in business nor in labor. Also, the time lag in the adjustment process is such that relying, for example, on labor market conditions for correcting cost-raising wage settlements would probably require long periods of adjustment and lead to larger and longer-lasting unemployment than are regarded as socially tolerable.

Here we are concerned with the problem of cost-push inflation, which may start with some increase in either the price of the basic raw materials or wage costs.

Some people deny the possibility of a cost-push inflation because in their view no *general* price rise is possible unless money in circulation increases. This in my opinion is a truism but does not explain anything about the causal nexus which sets the price rise into motion. We know there are many events that may give a stimulus to price rise which in order to affect the general price level have to be validated by monetary expansion.

Considering cost-push inflation does not mean that every price rise which is brought about by an increase in costs needs to be translated into an increase in the price level, nor is every such price and cost increase unjustified. Let us assume a union demanded a substantial increase in wage rates, and management grants the increase but at the same time increases the prices of the products—in this case the general public pays the price for the increase in wage rates. If labor in that particular industry had been receiving submarginal wages and had been living below what is considered a decent standard of living, there is justification to raise wages and prices in this industry but to have some other group get a lesser increase in wages and in the standard of living. Let us assume, however, that the industry had before an adequate wage level and demanded an additional increase which would push the cost of production up. If management grants the increase but at the same time increases the prices of their products—in this case an action in the interest of the parties directly concerned would violate the general interest in price stability. The original idea of the guideposts was to establish criteria for identifying wage increases which would be the result of market power and would violate the public interest in reasonable price stability.

The guideposts were formulated on the assumption that demand inflation would be prevented by fiscal and monetary measures. They were only meant to deal with a use of market power in violation of the public interest. Price stability was assumed except for a price rise caused by the exercise of market

power. Therefore, the problem of treating general cost-of-living increases was not even mentioned.

This assumption of *basic* price stability has become unrealistic since 1966. Therefore, it has been suggested that the guideposts should be modified so as to grant a cost-of-living adjustment in addition to an adjustment for national productivity gain. Even an allowance for *expected* cost-of-living increases has been demanded. The Government has rightly shied away from a general sanctioning of this proposal; for a complete and prompt cost-of-living adjustment tends to compound inflationary pressures. In an inflationary situation equity considerations make it indeed imperative to allow for some cost-of-living adjustment. If, however, the Government's monetary and fiscal policy fails to promote a dynamic balance between demand for and potential supply of goods and services a rise in the price level may be regarded as a crude and undesirable substitute, say, for a tax increase. A complete and prompt cost-of-living adjustment would exempt the protected groups from this tax substitute, and that would mean a much heavier burden would be imposed on the unprotected groups.

National programs, including monetary and fiscal policies, antimonopoly policies, foreign economic policies, policies related to Government inventories, should contribute to reasonable stability of the price level. However, I also believe that the Government has to issue criteria which help to distinguish between price and wage determinations which are in accord with the objective of price stability and those which violate this objective. Thus I am convinced that the guideposts serve an essential purpose in an economy in which there is possible conflict between the exercise of market power and the general interest.

I welcome that the Economic Report has forcefully restated the principles of the guideposts and re-emphasized the need for having them. I agree with the statement that some cost-of-living adjustment in wages is needed. I also agree that under present conditions no one figure separating inflationary from desirable wage-cost increases could be mentioned, be it the old 3.2% or a new 5 or 6%. There are labor groups which have, and other groups which do not have, automatic cost-of-living adjustments in their contracts. It would be impossible to have one percentage apply to both groups. Also, the Council expects now a price rise of 2.5% for the current year over last year. They would formulate now a new guidepost with that figure in mind. However, if prices were to rise by more than expected, how soon would the guideposts have to be modified again? Also, the exceptions in the interests of occupational and geographical mobility have become much more important now that a high level of employment has been reached and more scarcities for labor have developed than were previously the case. Also, in the absence of a numerical criterion for warranted and unwarranted price increases it would appear that wages are dealt with differently from prices. For all these reasons I think the Council was justified in not giving any numerical criterion to separate what would be regarded as an excessive and a non-excessive increase in wage costs.

The dropping of the numerical wage guidepost criterion has, quite naturally, been interpreted as a weakening of the guideposts. Also, in the Economic Report nothing is said about the implementation of the guideposts in the future. Does the President believe that the present necessarily vague formulation will really have an effect on any business decision or union demand? Apparently, it is intended that the present practice will be continued by which the President and/or the Chairman of the Council talks to business managers and union leaders when a price or wage action is threatening or one has been taken which violates the guideposts. With the present guideposts outlined only in general terms most of the time of the Council members and a great deal of staff time could be absorbed by spelling out what the guideposts mean for specific industries, considering all the factors involved. The Council states in the Economic Report that they have been involved in the price rise of about 50 separate industries in 1966. This demonstrates that the guideposts are taken seriously; it demonstrates, to my mind, even more convincingly that there is a need for some more orderly procedure for the examination of price and wage actions imminent or taken in specific industries. I feel even more strongly than before that for the Council to continue this "fire brigade" function would distract the members and the staff from their other primary functions. Instead, I believe it would be desirable to set up a price-wage-productivity board—under the policy guidance of the Council, or possibly in a combined Commerce-Labor Department. The

President could declare certain industries as crucial for economic growth and price stability. Then the price-wage-productivity board might establish special committees to spell out what the general guideposts mean for these industries. Fact-finding reports of such special committees would be submitted to the President, who, after consultation with the Council, could, if he feels it necessary, pass the reports on to the Congress. A subcommittee of the Joint Economic Committee could then examine the interpretation of the guideposts for specific cases, the actions taken by business and labor, and in extreme cases may recommend legislative measures. I recognize why the President would hesitate to set up a mechanism which by some might be misinterpreted as edging in on price and wage controls. To avoid this misinterpretation would require an educational effort which should not be an impossible task.

This particular recommendation, which is in line with the proposals that have been repeatedly recommended by leaders of the National Planning Association for many years, might not be the best possible solution. I feel, however, that the dropping of the numerical wage guidepost necessarily appears as a retreat, just at a time when, for a large number of workers, contracts are coming up for negotiation, and when cost-push inflation might become critical under conditions of a weakening economy. An arrangement such as I have proposed, spelling out the principles stated in the Report, would not weaken—it might even strengthen—a policy designed to give where necessary a voice to the general interest in the determination of prices and wages.

IN CONCLUSION

As far as I know, every witness from Government or private life appearing before this Committee has emphasized that we are in a situation of great uncertainty both for political and economic reasons. In such a situation it is hazardous to determine a definite course of action for a time any distance in the future. It is much more important, I believe, to make arrangements for policies which permit a prompt response to conditions as they unfold. I have discussed from this aspect the recommendations for the surcharge on the income tax, the relaxation of credit restraint, and price-wage policy. We are moving at present at a very high level of economic activity, and we need to be ready to deal with recessionary developments and inflationary developments, either from the demand side or from the cost side. And we also have to have plans ready for the case of prolonged war or, hopefully, for the case of a settlement or de-escalation of the war in Vietnam.

APPENDIX

TABLE 1.—Federal budget, national income accounts

[Billions of dollars, annual rate]

	Calendar years						Increase		
	1965—		1966—		1967—		1966 II over 1966 I	1967 I over 1966 II	1967 II over 1967 I
	I	II	I	II	I	II <sup>1</sup>			
Federal expenditures (total).....	119.9	126.6	135.3	148.8	158.4	166.6	13.5	9.6	8.2
Purchase of goods and services.....	65.0	68.6	72.9	80.7	86.5	90.1	7.8	5.8	3.6
National Defense <sup>2</sup> .....	48.6	51.6	55.9	63.7	68.9	71.3	7.8	5.2	2.4
Transfer payments.....	31.1	33.8	35.1	38.0	41.6	45.9	2.9	3.6	4.3
Grants to State and local government.....	11.0	11.3	13.8	15.3	14.3	15.9	1.5	-1.0	1.6
Net interest paid.....	8.6	8.8	9.4	9.8	10.2	10.4	.4	.4	.2
Subsidies, net.....	4.2	4.1	4.1	5.0	5.8	4.3	.9	.8	-1.5
Federal receipts <sup>3</sup> .....	124.5	125.3	138.5	146.3	153.4	159.3	7.8	7.1	5.9
Surplus (+) or deficit (-).....	+4.6	-1.3	+3.2	-2.5	-5.0	-7.3	-5.7	-2.5	-2.3

<sup>1</sup> Assumes steady increase over fiscal year 1968.

<sup>2</sup> Allows for adjustment factor consistent with national defense expenditures in national income accounts budget.

<sup>3</sup> Excludes receipts from proposed income tax surcharge.

Source: "Economic Indicators," January 1967.

TABLE 2.—Budget receipts and expenditures, fiscal years 1965-68

[Billions of current dollars]

	Fiscal years				Increase from previous year		
	1965	1966	1967	1968	1966	1967	1968
<b>Expenditures:</b>							
Gross (excluding intragovernment transactions).....	145.8	161.3	187.1	204.9	15.5	25.8	17.8
National income accounts.....	118.3	132.3	153.6	169.2	14.0	21.3	15.6
Consolidated cash.....	122.4	137.8	160.9	172.4	15.4	23.1	11.5
Loans made directly.....	8.0	8.0	10.7	10.1	-----	2.7	- .6
Loans repaid.....	6.2	7.8	10.3	10.8	1.6	2.5	.5
Sales of financial assets and participation rates.....	1.6	3.0	3.9	5.3	1.4	.9	1.4
Increase in guarantees and loan insurance.....	91.4	99.2	105.5	115.2	7.8	6.3	9.7
Housing and urban development.....	55.7	62.1	67.2	75.2	6.4	5.1	8.0
<b>Receipts:</b>							
National income accounts.....	119.6	132.6	149.8	167.1	13.0	17.2	17.3
Consolidated cash.....	119.7	134.5	154.7	168.1	14.8	20.2	13.4
<b>Income tax:</b>							
Proposed surcharge (individual).....	-----	-----	-----	3.4	-----	-----	3.4
Proposed surcharge (corporate).....	-----	-----	.2	1.3	-----	-----	1.1
Accelerated corporate tax.....	-----	-----	-----	.8	-----	-----	.8
User charges.....	-----	-----	-----	(.3)	-----	-----	(.3)
<b>Surplus (+) or deficit (-):</b>							
National income accounts.....	+1.3	+ .3	-3.8	-2.1	-.9	-4.1	+1.7
Consolidated cash.....	-2.7	-3.3	-6.2	-4.3	- .6	-2.9	+1.9

<sup>1</sup> Includes receipts for proposed surcharge tax.

Source: "The Budget of the U.S. Government," 1967 and 1968.

TABLE 3.—Gross national product

[Billions of 1958 dollars]

Item	Calendar years		Seasonally adjusted annual rates	
	1960	1965	3d quarter, 1966	4th quarter, 1966
Personal consumption.....	316.1	396.2	418.3	418.5
Fixed investment—				
Excluding residential.....	47.1	64.9	73.0	73.8
Residential.....	21.9	24.1	20.5	17.9
Purchase of goods and services:				
Federal Government.....	51.4	57.8	65.5	68.2
State and local.....	43.5	56.3	59.4	60.6
Change in business inventory.....	3.5	8.8	9.1	13.2
Net exports.....	4.3	6.3	4.2	4.7
Domestic final demand:				
Private.....	388.5	494.0	520.8	523.5
Public.....	94.9	114.1	124.9	128.8
Gross national product.....	487.7	614.4	649.9	657.0

*Index of gross national product*

[Constant (1958) prices]

	1965 (1960 equals 100)	3d quarter 1966 (1965 equals 100)	4th quarter 1966 (3d quarter 1966 equals 100)
Personal consumption.....	125.3	105.6	100.0
Fixed investment—			
Excluding residential.....	137.8	112.5	101.1
Residential.....	110.0	85.0	87.3
Purchase of goods and services:			
Federal Government.....	112.4	113.3	104.1
State and local.....	129.4	105.5	102.0
Net exports.....	146.5	66.7	111.9
Domestic final demand:			
Private.....	127.1	105.5	100.5
Public.....	120.2	109.5	103.1
Gross National Product.....	126.0	106.8	101.1

NOTE.—Parts may not add up to total due to rounding.

Source: "Economic Report of the President," January 1967.

Chairman PROXMIRE. Thank you, Mr. Colm.

Mr. LEKACHMAN, you have a statement that would probably exceed the speed limit, too. Let's see if you can do a little better. At this rate you will be 15 minutes over and we will have too little time for questions.

**TESTIMONY OF ROBERT LEKACHMAN, PROFESSOR OF ECONOMICS,  
STATE UNIVERSITY OF NEW YORK AT STONY BROOK**

Mr. LEKACHMAN. I will endeavor to follow a business cycle peak rather than to continue the ascent. I feel greatly privileged to appear before this committee whose work I have long respected. This morning I shall speak very briefly about the economic outlook and somewhat more extensively about desirable economic policy.

In general I concur with the Council's forecast, although I have a sense that it is shaded somewhat toward the optimistic side. I would prefer to concentrate on the employment situation and some of the policies which are capable of improving it.

I suppose that the optimism of the Economic Report was in many ways justified. The employment situation has in the last year improved significantly.

The economic situation as far as employment is concerned has certainly improved, not only in the aggregate, but for most subgroups, even for most nonwhite subgroups, and the Council almost inevitably draws an optimistic inference from this. However, it takes the dangerous position that a 4-percent rate of unemployment is in effect not only reasonably consistent with most definitions of full employment, but one which, if improved upon, will cause painful effects upon prices.

I would like in particular, on this point, to read one excerpt from the Economic Report which concedes, it appears to me, more than ought to be considered.

Low unemployment encourages entry into the labor force. Some people, especially women and teenagers, who would be interested in working if jobs were plentiful, do not actively search for jobs when they believe none are avail-

able. At such times, these persons are considered neither as employed nor unemployed, and are not counted in the labor force. When job opportunities improve, they enter the labor force, seeking and frequently finding jobs. The evidence of 1966 suggests that nearly 500,000 of "hidden unemployed" or "discouraged workers" entered the labor force.

The Economic Report then adds that:

Probably, additional workers, who did not respond fully to improved job opportunities last year, will enter the labor market if it remains buoyant.

However, if, as seems most probable, the decline in hidden unemployment was made possible only by a decline in general, measured rates of unemployment, then acceptance of the present level of unemployment implies a most disheartening consequence, nothing less than halting the flow into employment both of persons now officially defined as out of work and those who belong to the hidden unemployed.

I suggest that we are not quite as devoid of social invention or of resources as to be unable to do something, partly for the unemployed who remain and partly for the 32.7 million individuals partially coincident with the unemployed, who are defined currently as members of the poverty stricken. And I summarize my own policy preferences, which I regard also as economic possibilities, whether or not they are political possibilities is a rather different question, under these headings.

First. In the first half of the year we should continue to ease credit and supply a modicum of fiscal stimulus to an economy which, the defense sector aside, is displaying some serious weaknesses. We should in the second half of the year raise taxes but primarily to finance at adequate levels Great Society programs and desirable further innovations which I shall specify under the third and fourth headings.

Second. We should finance at least at the levels authorized by the 89th Congress, model cities, rent supplements, Teachers' Corps, education, and poverty programs.

Third. Whether income supplements take the shape of family support allotments or a negative income tax, we should make a start more substantial than the appointment of a presidential commission toward the replacement of the present patchwork of public assistance formulae by a rational and human system of general assistance to the poor.

Fourth. We can afford at least to begin in another area, that of public service employment, with the Federal Government as the employer of last resort. The report last year of the National Commission on Technology, Automation, and Economic Progress estimates that \$2 billion might finance 500,000 public service jobs.

Let me say a word of amplification, particularly about the third and fourth of the points that I make. The decision to alter tax rates ought to rest very substantially upon how generously we fund Great Society programs and what progress we make toward the actualization of the two ideas whose time will surely come. That is to say, income maintenance and residual public employment.

I suggest somewhat optimistically conceivably, that most of Great Society programs enacted in recent years have won a measure of public acceptance, or at least are on the way to such acceptance, and that the new thrust of public policy in the immediate future is probably

going to center upon income maintenance, Government as a residual employer, and the third point, which I do not mention here, the issue of revenue sharing with the States. I shall speak only in fact to the first two.

Not speaking particularly as an economist, I think that income maintenance could scarcely have avoided becoming a public issue, once Americans became sufficiently productive so that the elimination of the financial component of poverty became possible. The estimate is common, both in the Economic Report and in last year's Automation Report, that for about \$11 billion or so, we could lift all families and individuals now below the poverty line above that line.

How can a society capable of totally eliminating financial poverty at the expense of a redistribution of a mere  $1\frac{1}{4}$  to  $1\frac{1}{2}$  percent of its gross national product long refrain from doing so?

Possibly it is this uncomplicated human perception as much as the specific arguments in favor of income maintenance that has united such men of usually disparate opinions as the League for Industrial Democracy's Michael Harrington, Yale's and the New Frontier's James Tobin, and Chicago's and Conservatism's Milton Friedman. But the rational arguments are exceeding powerful in addition. Of these, the first and most significant concerns freedom of choice. A welfare client may well be a poorer judge of what is good for him than a trained social worker. This is the inevitable conclusion of the social work profession. All the same, the welfare client may be a good deal better pleased with his life if he is permitted to satisfy his own pattern of preferences. Indeed, a welfare client allowed free use of his income may arrive in time and of his own volition to a desirable standard of expenditure, even by the criteria of others. A person on welfare does not by the fact of his misfortunes cease to be an adult eager to exercise whatever liberty of choice an exiguous income permits him.

By itself the libertarian argument is a sufficient ground for the substitution of income maintenance for the patchwork welfare administration techniques. And there are two more reasons at the least for supporting the change of approach. One is the simple fact that trained social workers are too few in number and too burdened by the administration of complicated, semipenal regulations to offer the assistance that their clients might conceivably benefit from and that current social welfare theory believes to be indispensable.

A second argument is related to our good luck in possessing ready at hand two much more efficient mechanisms for the handling of transfer payments, the social security system and the Internal Revenue Service. The social security system could readily administer a scheme which focused upon family allowances, a version of income maintenance now in effect in Canada and strongly supported for the United States by former Assistant Secretary of Labor Daniel P. Moynihan. Alternatively, the Internal Revenue Service could graft a negative income tax upon the existing tax structure. Few would advocate income maintenance primarily upon efficiency grounds. Still, it is reassuring to realize how neatly efficiency and social compassion here coincide.

Income maintenance, however important as it is for the large group of individuals who are by reason of age, disability, family situation, unable to participate usefully in the labor force, is not a full answer to the problems of the unemployed poor who are capable of work, willing to work, but unable by current employment criteria to find acceptable jobs. It is here that the appeal of government, the Federal Government essentially, but not necessarily only, as an employer of last resort, is I think very, very strong.

Everybody who has been in a hospital or a park or a school or a museum is aware how chronically short-handed these institutions are, how short of service, how unable to meet the needs of the people who use them. The Automation Commission, what is more, had prepared for it an analysis of the public service jobs that could be filled using current criteria of need, and the total divided among education, national beautification, welfare and home care, medical institutions and health services, and so on, is over 5 million jobs—5,300,000.

We should all gain from the access of human care and attention, the sheer increase in the quantity of social kindness that filling these jobs would entail. The men and women who did the work itself would regain the dignity and the sense of participation which are in our society inseparable from the performance of useful work.

Can we afford the \$2 billion necessary for the creation of these half million jobs? No economist could say that we lack the resources. Whether we also possess the wish is not for an economist to say.

What I have concluded, with a generous use of public funds, is with the statement of the cost of desirable shifts which I have noted. Increase of Great Society programs to earlier authorized levels, public service employment, and an initial movement toward income maintenance—\$10 billion, which has inevitably the appeal of a good round number, and this is the one which I conclude with, pointing out once more, however, that it is involving a redistribution of only about 1¼ percent of gross national product, or a bit more, and considering also that \$10 billion amounts to half the reduction in taxes that has taken place in the last 3 or 4 years.

I suggest that we have become, fortunately, accustomed to using fiscal policy, tax policy, as a means of stabilizing the economy. I think it is probably desirable that we get used to using the tax system also, even raising taxes at the Federal level, in order to accomplish desirable social objectives of which this year the two most desirable are a further reduction of unemployment and some alleviation of the amount of poverty.

That does finish my statement.

(The entire statement submitted by Mr. Lekachman follows:)

#### PREPARED STATEMENT OF DR. ROBERT LEKACHMAN

Whether or not the official forecast of Gross National Product, employment, price behavior, and balance of payments improvement will turn out to be reasonably accurate is this year particularly difficult to be certain about. The usual tribulations involved in estimating the volatile behavior of the market for capital goods and consumer demand for durable items such as autos and household furnishings are this year aggravated by fluctuations in credit policy, uncertainty about the time that the investment tax credit will be restored, and continuing weakness in a number of important markets, notably automobiles.

We cannot be certain, moreover, that residential construction, a major victim of 1966's credit squeeze, will return to something approximating the levels of the early years of this decade, in the second half of the year. Inevitably the largest of all unknowns is the scale of our Viet Nam operations. If peace or substantial de-escalation comes to pass, then the national argument will center upon the appropriate stimuli to aggregate demand. If further escalation occurs instead, then we shall quite probably require much larger tax increases than the six per cent surcharge sought by the President.

In so fluid an economic and political situation, forecasting is a hazardous occupation, to be approached only with trepidation and fear of error. For myself I find the *Economic Report's* forecast in the main plausible, if a bit optimistic about the behavior of investment and construction markets. Accepting with the reservation specified the *Report's* framework of expectations, I shall next address myself to two of the issues which the *Economic Report* and the President's own *Message* raise: what is an acceptable rate of unemployment, and what policies should be followed toward the structurally unemployed and the poor—two partially coincident groups.

Optimism about our recent achievement is not impossible. Indeed one supposes that in an official report it is scarcely to be avoided. In 1966 nearly two million additional men and women found jobs, the largest single year gain of the current extraordinarily long business cycle expansion. Thus it was that unemployment fluctuated between 3.7 per cent and 4.0 per cent during the year, and averaged 3.9 per cent. We have not done as well since 1953. Even the details have a cheerful ring. The half-million decline in average unemployment improved the situation of all races, every age group, and both sexes—with two exceptions only. Nonwhite females between 14 and 19 years of age, and nonwhite females over 45 years of age failed to participate in the general decline in unemployment rates. By contrast only five years ago, general unemployment was still averaging 6 per cent.

Our progress has been sufficiently substantial so that the *Economic Report* can speak of the attainment of full employment. The exact words of the claim merit quotation: "The unemployment rate reached a 13-year low of 3.9 per cent. At that level, demand finally matched supply in most labor markets, a situation which economists define as essentially 'full employment.'" Hence the *Economic* advocates "a concentrated attack on the causes of 'structural' unemployment ment in the current year. Although in the longer run, the *Economic Report* advocates "a concentrated attack on the causes of 'structural' unemployment . . . if we are to move toward continually lower unemployment while maintaining reasonable stability of prices", the writers of the *Economic Report* assert that for the time being we have reached maximum employment at tolerably stable, or, at worst, acceptably rising price levels.

With all respect to the distinguished members of my profession who are serving as members of the Council of Economic Advisers, I am constrained to make a much less optimistic judgment of our situation. I am concerned above all with the continued prevalence of high rates of unemployment among Negroes and Puerto Ricans. All the nonwhite rates of unemployment remain at levels which would define a national crisis if they applied to whites as well. For adult white males 20-44 years of age, 1966's rate of unemployment was only 2.3 per cent but for nonwhite males it was 5.3 per cent. White male teenagers suffered 9.9 per cent unemployment but the rate for nonwhite teenagers was 21.2 per cent. And 31.1 per cent of female nonwhite teenagers were unemployed. It is inadequate comfort that these rates were lower in 1966 than they were in 1965 because unless general unemployment further declines in 1967, it is unlikely that further improvement in the nonwhite unemployment situation will occur. In short the implication of general rates of unemployment consistent with the Council of Economic Advisers' present definition of full employment is painfully if not intolerably high incidence of unemployment among some age and color groups.

Worse still it is likely that high as the measured rates of nonwhite unemployment are, they still underestimate the full scope of unemployment. The *Economic Report* itself underlines this probability in these words:

"Low unemployment encourages entry into the labor force. Some people, especially women and teenagers, who would be interested in working if jobs

were plentiful, do not actively search for jobs when they believe none are available. At such times, these persons are considered neither as employed nor unemployed, and are not counted in the labor force. When job opportunities improve, they enter the labor force, seeking and frequently finding jobs. The evidence of 1966 suggests that nearly 500,000 of 'hidden unemployed' or 'discouraged workers' entered the labor force."

The *Economic Report* then adds that "Probably, additional workers, who did not respond fully to improved job opportunities last year, will enter the labor market if it remains buoyant." However, if, as seems most probable, the decline in hidden unemployment was made possible only by a decline in general, measured rates of unemployment, then acceptance of the present level of unemployment implies a most disheartening consequence, nothing less than halting the flow into employment both of persons now officially defined as out of work and those who belong to the hidden unemployed. It would be sufficiently tragic to give up on this problem if the limitations of our national resources compelled us to do so. It is reckless as well as tragic to surrender when the means of coping with the problem are securely within our grasp.

#### APPROPRIATE POLICIES

There are, by official definition, 32.7 million members of the poor in the United States. Approximately three million persons are unemployed and an undetermined additional number are among the hidden unemployed.

What can we do in 1967 to assist these fellow citizens? I can summarize my own preferences under four headings:

*First:* In the first half of the year we should continue to ease credit and supply a modicum of fiscal stimulus to an economy which, the defense sector aside, is displaying some serious weaknesses. We should in the second half of the year raise taxes but primarily to finance at adequate levels Great Society programs and desirable further innovations which I shall specify under the third and fourth headings.

*Second:* We should finance at least at the levels authorized by the 89th Congress Model Cities, rent supplements, Teachers' Corps, education, and poverty programs.

*Third:* Whether income supplements take the shape of family support allotments or a negative income tax, we should make a start more substantial than the appointment of a Presidential Commission toward the replacement of the present patchwork of public assistance formulae by a rational and humane system of general assistance to the poor.

*Fourth:* We can afford at least to begin in another area, that of public service employment, with the federal government as the employer of last resort. The *Report* of the National Commission on Technology, Automation and Economic Progress estimates that \$2 billion might finance 500,000 public service jobs.

Let me offer a brief amplification of my position. It is by now generally agreed that, whatever their merits, specific programs addressed to the alleviation of structural unemployment stand a chance of success only when aggregate demand is high and the economic climate is buoyant. Certainly as I speak before you the economy seems too precariously poised on the verge of a recession which several of your witnesses believe already here either to raise taxes or reduce public spending. Whether in the second half of the year the rate of economic expansion will increase is highly conjectural. Sheer prudence implies the wisdom of the President's refusal to seek a tax increase now. Whether in July we should raise taxes does indeed depend upon the economy's condition in the middle of the year. However, it should depend still more upon the level of spending, nondefense as well as defense, that we judge nationally appropriate.

Or to put the matter in other words, the decision to alter tax rates ought to rest very substantially upon how generously we fund Great Society programs and what progress we make toward the actualization of two ideas whose time will surely come. These two ideas are, to repeat, income maintenance and residual public employment. We shall make a very grave collective error if we slow social progress in 1967 either because we exaggerate its financial cost or underestimate our capacity to meet this cost. The plight of the cities is especially difficult. From New York City downward in scale, city administrations are yearning for additional revenues which they are ill-equipped to raise by

their own efforts. The Model Cities legislation has stimulated serious efforts by concerned Mayors to grapple with their communities' complex problems. It would be nothing less than a disaster to snatch from the cities the funds and the hopes so recently held out to them.

Medicare, general aid to education, regional development and manpower retraining: these are for the most part the completion of a generation-old agenda. One hopes that these and the poverty programs have either won or are on the way to winning the same community acceptance as social security has achieved in the last three decades and the New Economics have acquired in the last five years.

On that possibly optimistic assumption, I shall proceed to the comparative newcomers, yet to take their place as part of the accepted arsenal of public policy. Income maintenance could hardly avoid becoming a public issue once America society became sufficiently productive so that the elimination of the financial component of poverty became possible. Last year the National Commission on Technology, Automation and Economic Progress estimated that a mere \$11-12 billion would raise all individuals and families now below the poverty line above that line. How can a society capable of totally eliminating poverty at the expense of a redistribution of a mere 1½ per cent of its Gross National Product long refrain from doing so?

Possibly it is this uncomplicated human perception as much as the specific arguments in favor of income maintenance that has united such men of usually disparate opinions as the League for Industrial Democracy's Michael Harrington, Yale's and the New Frontier's James Tobin, and Chicago's and conservatism's Milton Friedman. But the rational arguments are exceedingly powerful in addition.

Of these the first and most significant concerns freedom of choice. A welfare client may well be a poorer judge of what is good for him than a trained social workers. This is the inevitable conclusion of the social work profession. All the same the welfare client may be a good deal better pleased with his life if he is permitted to satisfy his own pattern of preferences. Indeed a welfare client allowed free use of his income may arrive in time and of his own volition to a desirable standard of expenditure, even by the criteria of other. A person on welfare does not by the fact of his misfortunes cease to be an adult eager to exercise whatever liberty of choice an exiguous income permits him.

By itself the libertarian argument is a sufficient ground for the substitution of income maintenance for case-by-case welfare administration of aid. And there are two more reasons at the least for supporting the change of approach. One is the simple fact that trained social workers are too few in number and too burdened by the administration of complicated, semi-penal regulations to offer the assistance that their clients might conceivably benefit from and that current social welfare theory believes to be indispensable.

A second argument is related to our good luck in possessing ready at hand two much more efficient mechanisms for the handling of transfer payments, the social security system and the Internal Revenue Service. The Social Security System could readily administer a scheme which focused upon family allowances, a version of income maintenance now in effect in Canada and strongly supported for the United States by former Assistant Secretary of Labor Daniel P. Moynihan. Alternatively the Internal Revenue Service could graft a negative income tax upon the existing rate structure. Few would advocate income maintenance primarily upon efficiency grounds. Still, it is reassuring to realize how neatly efficiency and social compassion here coincide.

Income maintenance is a nearly ideal approach to the problems of the large numbers of welfare recipients whose incomes place them below the poverty line either because age, family situation, or disability excludes them from gainful employment, or, though they hold jobs, adult male workers are unable to earn enough to support themselves and their dependents. However, by itself income maintenance fails to cope with the difficulties and the needs of individuals who, although eager to work, are by current market definitions unemployable. Here the notion of the government as employer of last resort has much merit.

The first merit is the concrete social gain realized by the performance of work in the public sector which badly needs the doing. Hospitals, parks, schools, museums, and other public institutions are notoriously crippled by the shortage of human hands. This qualitative, impressionistic judgment is supported by the

estimates which were prepared for the National Commission on Technology, Automation and Economic Progress. Their conclusions are summarized in this table:

*Estimate of Potential Source of New Jobs Through Public Service Employment*

<i>Source of employment</i>	<i>Job potential (millions)</i>
Medical institutions and health services.....	1.2
Educational institutions.....	1.1
National beautification.....	1.3
Welfare and home care.....	0.7
Public protection.....	0.35
Urban renewal and sanitation.....	0.65
<b>Total</b> .....	<b>5.3</b>

We should all gain from the access of human care and attention, the sheer increase in the quantity of social kindness that filling these jobs would entail. The men and women who did the work itself would regain the dignity and the sense of participation which are in our society inseparable from the performance of useful work.

Can we afford the \$2 billion necessary for the creation of these half million jobs? No economist could say that we lack the resources. Whether we also possess the wish is not for an economist to say.

What I have said implies a financial cost. For the next fiscal year, my policies would bear these price tags:

	<i>Billion</i>
Restoration of Great Society programs to authorized levels.....	\$3
Public service employment.....	2
Initial movement toward income maintenance.....	5
<b>Total</b> .....	<b>10</b>

Can we afford this much? \$10 billion is a redistribution of only 1¼ per cent of GNP. Or again, consider that we have in the last three years reduced taxes by some \$20 billion each year. At worst this program would require tax increases of half that amount. If de-escalation or recession requires us to think once more of major fiscal stimulus, here is a desirable way to apply stimulus without raising taxes at all.

As a nation we are accustomed to raising our taxes in order to finance our military security. It is not wild to think that we might acquire if not this year very soon the equally desirable habit of increasing our taxes in order to meet our social needs.

Chairman PROXMIRE. Thank you very much Professor Lekachman. Dr. Wallich, you said in your remarks:

The Council of Economic Advisers is not adequately informed by the Defense Department on defense spending.

Are you referring to the estimate that was made early in the year of the cost of Vietnam for fiscal 1967 and how far they were from the mark?

Mr. WALLICH. That is the basic and overt estimate. It is also the impression from simply reading the newspapers, but I cannot refer to any particular quotation that neither the Budget Bureau nor the CEA can say very much about the outlook for expenditures.

Chairman PROXMIRE. Nor the Congress. The public and the Congress are not informed; is that correct?

Mr. WALLICH. That is correct.

Chairman PROXMIRE. What can we do about this? We proposed years ago that there be quarterly budget reports and quarterly estimates. It would seem to me that at least in something as uncertain

as the Vietnam war, and, also, these other estimates that were off by a high percentage, and a very large amount, and this I suppose was because of the necessary change in monetary policy, or at least the change in monetary policy, under these circumstances wouldn't it be essential or prudent economic policy for the Council, the Budget Bureau, and the Congress as well as the public to be informed quarterly? Can you see any reason why this would be particularly difficult?

I am not saying that they can estimate it precisely. But they can make increasingly more accurate estimates as time goes on. They could come closer to it if they update their estimates. Say you have an estimate in mid-April and mid-July and mid-October.

Mr. WALLICH. I think this certainly can be done after a fashion as you say, Mr. Chairman. It can't be done perfectly. It cannot be done perfectly at any time, even at yearend. Unfortunately, we have moved in the opposite direction by dropping the usual midyear budget review last year. The proper direction is to go toward a frequent review of the budgetary situation, or some continuing routine updating.

If I may add this, the Congress itself could help by having some sort of general overview of the budget rather than an appropriation process which only at the end of the congressional session pulls together what really has been voted.

Chairman PROXMIRE. You see, even in the appropriations process, this reestimate would have been invaluable to us. If, when we make our appropriation decisions, which the Senate doesn't make until late in the year, and it hasn't gone to conference, so it hasn't been resolved, if we could have an up-to-date estimate of what overall expenditures are, this would make I am sure a profound difference on many Senators as to how they feel about appropriations, and often our tax legislation is postponed until toward the end of the session, and maybe it properly should be, when we have all the facts available to us. The prospects of getting a tax increase last year would have been much better if we had had this realistic estimate.

Mr. WALLICH. The Budget Bureau does keep some sort of running scorecard on what has been voted so far. I don't see why that can't be extended to a statement of just where the next year's budget now stands, combined with a reappraisal of revenues in the light of the latest GNP forecasts.

Chairman PROXMIRE. You see, their answer to this, and when I pressed this, both in this committee and also in the Appropriations Committee, is that they did tell us that their estimates would probably be off. There probably would be a supplemental. They probably would come in with some more. But they never gave us a figure. Without a figure it is very, very hard to make any kind of prudent decisions on spending and taxes.

Mr. WALLICH. As a former bureaucrat, Mr. Chairman, I suppose one way of helping this process along is not to blame them too hard when they make a mistake.

Chairman PROXMIRE. Let me ask another question. You indicated, and I am quite shocked as I have the greatest respect for you as an economist, but I was shocked when you indicated that maybe the Council of Economic Advisers was even going a little high or being a little optimistic, let me put it that way, indicating we could have 4-

percent growth and 4-percent unemployment—close to 4-percent unemployment—without unacceptable inflationary pressures.

I think you are first, or one of the first economists, who has indicated that. And at the same time, you couple this with what I think is a very realistic analysis of our present economic condition; that is, you say it is quite soft and we have to be concerned about it. You oppose a tax increase for this reason.

I would like to call your attention to the fact that the latest Economic Indicators which I just got a minute ago show that in October we had consumer prices at 114.5; November, 114.6; December, 114.7; January, 114.7. Wholesale prices were 106.2 in October, they are 106.2 now. You have referred to the various indicators that are soft. We have unemployment now at 3.7 percent, and we have had unemployment on a stable basis for more than a year. It has been much lower in Europe; it has been much lower in the past in the United States without much inflation—1953 is a good example.

Why do you feel that we can't press a little lower without unacceptable inflation?

Mr. WALLICH. This puts one in a position of seeming to be anti-social and I hope I am not. I don't believe the present lull in prices will last. It is the result of a previous spurt. The demand-pull I think is largely off. We are moving into the phase of the cost-push.

The Council expects 2.5 price increase. I would think we would be lucky to get away with that. Three percent seems more plausible. I base this simply on the assumption that we are going to have 5 to 6 percent wage increases, namely, the normal productivity gains which may well be less in a year of economic flattering out, plus something like the price increase. So we will have 3-percent productivity or less, plus 3-percent price increase, hence wage increase 6-percent. I don't see how that can fail to push prices up some.

Chairman PROXMIRE. But in a cost-push situation, you are arguing that we have to be careful about having excessive demand exert a pressure on prices. You see, it is beyond me to understand how an analysis of the 1966 situation can come to any kind of firm conclusion that we can't get unemployment down much below 4 percent without unacceptable inflationary pressures, in view of the nature of the price increases.

Food was responsible for a great deal of it. Services, and one-third of the increase in services was because of increased mortgage interest cost. Medical costs were another aspect not susceptible to monetary-fiscal restraints. I submit that none of these are very sensitive to the kind of fiscal or monetary policy that would damp down demand, and within the cost-push situation it would seem to me that the argument would be weaker.

Mr. WALLICH. I think you are very sound in arguing that we need not restrain demand in 1967, and that in one reason why I would go slow on the tax increase. But as far as getting little inflation with 4-percent or less unemployment, I would like to go back to some statistics developed by Professor Samuelson and Professor Solow. They computed the trade-off between unemployment and inflation, and they found that, for the pre-World War I and for the 1920's, at something like 4 percent unemployment, we probably had approximate price stability, if my memory serves me.

They also found that for the period thereafter and for the postwar period particularly, if we wanted 4-percent unemployment, we would have a higher rate of price increase. We couldn't have anything near stability.

I would add that the belief that we can steadily and stably buy lower unemployment by tolerating more inflation is not realistic because it assumes that labor is blind to the inflation.

Chairman PROXMIRE. Isn't it very important that you pay attention to the changes in the economy, the rate at which the economy is expanding? One of the reasons it seems to me we had very stable prices in 1953 is we had had a low level of unemployment, just as we have had now for a year.

It would seem to me that under present circumstances where we have held unemployment down below 4 percent for a year, that we could proceed to get it down to a goal of maybe  $3\frac{1}{2}$  or perhaps even lower, and this is so enormously important in terms of providing for growth, providing for jobs, for people who need jobs. This is such a vital policy decision that I do want to press you on it.

Mr. WALLICH. There is the hope that what caused inflation last year was not the level of 4 percent but the speed with which we got to that level, plus the demand shifts from civilian to defense, for instance. That always tends to push up prices.

We don't know. Some years hereafter we will be able to estimate this. My own suspicion is that we are reaching here for an explanation that would be nice if it were true, and it may deceive us. Since we are under the gun as far as the balance of payments is concerned, I think we can't afford to take many chances here.

Chairman PROXMIRE. I would like to ask Professor Lekachman this. You came out for a tax increase to pay for a substantial expansion in the Great Society programs. Many of us are very sympathetic to many of your suggestions, especially in the area of providing training opportunities, and so forth. But to be realistic, I frankly don't think there is much chance of getting a big jump in these programs this year.

Now on the assumption we don't get these additional appropriations—supposing we don't get them, Professor—under these circumstances would you still favor a tax increase, or would you feel that in a year when we are increasing social security perhaps by 20 percent if we follow the President's recommendations, in a year where because of the war situation it may be especially difficult to get the Great Society contributions we need, would it not be wise to forgo the tax increase, if this could put sufficient pressure on the labor market so that more people would be pulled in, and as you indicated very properly, this is the kind of thing that does pull them in, and would provide the kind of training and the kind of opportunities in employment that otherwise wouldn't be there?

Mr. LEKACHMAN. I was speaking, Senator, to what I thought was desirable. If I now address myself to what is possible, I think you are quite correct in inferring that given the probabilities of unlikely increase in the President's recommendations, and indeed possible decrease in these recommendations, that my own position brings me to oppose a tax increase.

Chairman PROXMIRE. Under those circumstances, you would oppose the tax increase?

Mr. LEKACHMAN. I would oppose a tax increase. I would then rely upon—as your remarks suggest—I would rely upon a continuation of fiscal stimulus to do some further good in labor markets, and have some desirable effect in reducing unemployment. And I would add on that point that insofar as our very real balance of payments are concerned, I should be more inclined to pursue Sherman Maisel's suggestion in a speech of a month or so ago, that we should address ourselves to specific policies aimed at the balance of payments. What I am suggesting in effect is that if our employment policies do in fact tend to aggravate our balance-of-payments difficulties, then if need be, we should impose additional controls on the outflow of capital, or indeed that widely unpopular notion, some control on the movement of tourists abroad.

I think, in other words, that it is possible for us simultaneously to decrease unemployment and to cope with the balance-of-payment situation, quite possibly using a series of ad hoc measures addressed to the balance-of-payments situation.

Chairman PROXMIRE. Thank you. My time is up. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

I welcome the general theme that runs through much of your testimony, gentlemen, that we ought to do everything we can, and more than is proposed to be done, to keep prices as stable as possible, not only for domestic but for international economic reasons.

In that connection, I am struck by two events in the current news that a number of oil companies, including notably Standard Oil of Indiana, which have been enjoying a fantastic profit level—fantastic enough to cause Standard of Indiana to take advertisements in the Wall Street Journal bragging about their unprecedented profit picture—these companies are now in the act of raising the price of gasoline to the consumer by I believe about a cent a gallon.

Another current item is that American Motors will later on today lower the price of its American line by \$150 a car, which is a very substantial price decrease.

Chairman PROXMIRE. If the Congressman will yield at that point, it is my understanding it is up to \$234 a car—the Rambler American.

Representative REUSS. Is that so? That is even more public spirited. In any event, if the Joint Economic Committee had medal powers, I would certainly award the Medal of Honor to American Motors, and a booby prize to Standard of Indiana and others that are being irresponsible.

I would hope that out of these two examples, which happen to occur at the same time, there could be some expression from Washington that American Motors is moving in the right direction and Standard of Indiana is moving in the wrong direction. I would hope that this might induce consumers to buy their gasoline, particularly in the midwest, at an unheralded filling station which isn't raising prices, and I would hope also that consumers would tip their hats to American Motors by buying some of these excellent Rambler Americans, which will shortly be priced at \$150 to \$240 less a motorcar.

Would you gentlemen put your agile minds on how we might, consistent with our free market system, take advantage of this example of good behavior and bad behavior?

Mr. LEKACHMAN. I am afraid that the only thought that comes to my mind is a skeptical one. American Motor's sales have been in an unhappy condition for some time, and although I think they have taken a very realistic step in reducing the prices of the American line by either of the two numbers referred to here, I would feel a wave of admiration still greater if General Motors had reduced its prices, or Ford. I think they can be congratulated on reacting to the realities of their market position.

Representative REUSS. Let us hope it will shame the "Big Three" into similar action. I note that automobiles is one of the industries listed by the Council of Economic Advisers last year, when I asked them about it, as eminently eligible for price decreases, because their productivity trend has been exceeding the national average. Incidentally, the same is true of gasoline.

Mr. LEKACHMAN. Yes.

Representative REUSS. They both should be reducing. Standard of Indiana has the gall to increase its price, and I notice the Council of Economic Advisers is not doing anything about this. It has shoved it off on the Department of Interior.

Would anybody else like to comment? Mr. Wallich?

Mr. WALLICH. I think the guidepost rules are very clear here. A company is entitled to raise prices when its profits are inadequate or when it needs capital. I don't think either case applies here. Unless we get to a behavior pattern of corporations that disregard an immediate market situation that allows them to take advantage of a temporary scarcity to raise prices, we will never have stable prices. We have to get a behavior pattern in which companies observe voluntary restraint in time of strong demand, because they also exert market power in order to prevent reductions in prices when inadequate demand ought to produce a reduction.

The way to get this behavior, if we cannot get it by suasion, is to encourage excess capacity. What I said about labor applies here, too. It applies equally to industrial excess capacity if we can get companies to operate below what they call the preferred operating rate, which seems to be the rate at which they can raise prices, we will have a better chance at stable prices.

Representative REUSS. Well said. I would hope that the authorities in Washington could make a dramatic case history out of the oil and American automobile examples, and thus perhaps, having educated the public, a stream of consumers would be honoring American by buying their less-expensive motorcar, and equally beat a path across the street to the gasoline station which, contrary to Standard of Indiana, was not raising its prices.

Let me turn to another subject. This is a problem which I think all of you have touched on, of how we get an adequate money supply and at as reasonable an interest rate as possible, in order to avoid the terrible slowdown in housing, and at the same time don't embarrass our international balance of payments and even domestically create easier money than the rest of the economy, other than housing, needs.

As our institutions are now set up, the only real way you can get enough money to the housing industry to validate a mortgage rate structure which people can afford, if they want to buy a house, is by making money easier, generally, and this does not help our international balance of payments, and it may create easier money than we need even for domestic purposes, as was evidenced last year and the year before for a time, when credit was used to build up unnecessary inventories, and perhaps to validate some capital expenditures which may not have been particularly necessary, at a time when housing was being squeezed.

In places like Mexico and France, to name two countries that come to mind, they don't go into a decline over this problem. The central bank simply tells the banking system that the banking system must devote a minimum—in Mexico's case, I believe 30 percent of their credit facilities—to housing, and by doing that, they thereby see that other elements of the economy not so currently meritorious don't get an excess of credit.

The Fed tried the reverse of this in a very timid way last September, when it sent a letter to the banks saying "Don't lend so much to the wrong people." They didn't say who the "wrong people" were, which would have been more helpful if they had. But I suppose they meant people who are building up inventories excessively, or making capital investments which are socially a lot less desirable than housing.

But what can we do? I think Henry Wallich took a stab at it in his statement this morning by saying the building and loan associations ought to get more long-term capital, but one of the difficulties there is that they have to charge more on their mortgages if they were able to compete, and that would in and of itself, I am afraid, produce a chilling of the housing industry.

But I would welcome any comments any of you may have on this, and specifically what is so awful about what they do in Mexico?

When I was down in Mexico a few months ago, I saw homes being built all over the place at low cost and not so low cost, at a time when Mexico had a tight money situation. Why are we so helpless, Mr. Wallich?

Mr. WALLICH. I think it is probably wise for a government to interfere in the structure of credit supply. If it is a national decision that housing be subsidized, as we do in effect in many ways, then let us create that supply structure.

It is another question whether we should have the central bank from time to time going into the market and saying, "We know better than the market. We will allocate resources to housing and take away from something else." This may sometimes lead to good decisions. Evidently, the Fed thought that it knew something about that when it issued its letter. At times, this ad hoc intervention may not lead to good decisions. If we have a market system, I would say, let the market system do the detail work.

I say this, particularly, because the trouble last year came from a basic structural defect and not from any particular malfunctioning of the market. That structural defect ought to be remedied. A proposal to that effect is combined in my statement. I don't think it would raise mortgage costs per month. It would not even raise them in the

long run, if interest rates just fluctuate instead of going permanently to a higher level.

Representative REUSS. By this structural defect, I take it you mean the inability in the recent past of savings and loan associations, which are par excellence the contributors to housing, to attract long-term investments like CD's, and so on, and I agree this is a structural defect which ought to be remedied.

But, if you had had that structural reform, I think all you would have had is the bank and the savings and loans competing to see who could pay the highest interest rate for this money, which is all right—I'm for it. But I think you would have priced homebuilding out of the market, and I think in addition to that—and I don't sweep that suggestion from the table—we really need some method of seeing that housing, which is certainly regarded as desirable, gets built. And our existing structure is full of subsidies and good thoughts, but it doesn't come to grips with the central \$64 question of how much interest you have to pay on your mortgage.

Mr. WALLICH. Congressman Reuss, housing tends to get stopped out of the market earliest. It is in the nature of the market that the party with the most elastic demand loses out. We try to counteract this by subsidy legislation.

One part of our subsidy legislation actually makes the situation worse, and that is the ceilings on VA and FHA guarantee and insurance. It is designed to be a protection to the homeowner. He isn't supposed to pay more interest. The result of this protection is that he gets no mortgage at all. If we could make that ceiling more flexible, we would have a better flow in times of high interest rates.

As for making credit unavailable, I think if we tied the loan rate to the deposit rate, then mortgages made at times of very high rates would come down in interest as the interest rates on deposits declined, and you would, over the years, bring them down to a more normal level. So people would be less concerned about making contracts at times of very high interest rates.

Representative REUSS. My time is up. Perhaps I shall have a chance to return.

Chairman PROXMIRE. Senator Javits?

Senator JAVITS. Gentlemen, first let me apologize for not being here when you made your statements, but I have been brought up to date on them, and I have just one question I would like to inquire of Mr. Wallich, and one from Mr. Lekachman.

Mr. Wallich, I regard with the greatest interest the statements you have made in which you deal with guideposts, to which I have also been addressing myself.

I notice the suggestion for a tax as a penalty imposed on corporations that exceed wage guideposts. That would contemplate, would it not, that the guideposts would begin to be mandatory, and that therefore you would, or I ask therefore would you be espousing a planning operation really, something which, generally speaking, the American people have not looked at with favor.

In order to make it one question, I know you are well able to keep up with it, may I add also the question as to what you think about a restoration of the system of economic goals for which the Eisenhower

administration—I think perhaps when you were in office—used the so-called Wriston Commission.

Mr. WALLICH. Senator Javits, on the guideposts, if my suggestion in the testimony looks like planning, I am certainly chagrined, because that was not my intention. On the contrary, I view the present form, or the recent form of administration of the guideposts, as a kind of near planning, because it involves confrontations of the Government with industry, and with labor. It is an ad hoc intervention, not sanctioned by legislation.

If we had a tax, and I visualize a surcharge on the income tax, not a payroll or production tax which would be passed on in the price, then the decision to abide by or disregard the guideposts would simply be a reflection of market factors. If an industry very badly needs to attract labor, if it badly needs to avoid a strike, then it will make a wage offer above the guideposts. The firm knows this will cost it something, but it will be worth it. In other words, the economic calculus would prevail.

It would seem to me that that would be closer to a market mechanism than what we have been doing in the last few years. I realize that this may be difficult to implement administratively. I am somewhat encouraged by the apparent fact that during the Korean war period, when we did have a wage freeze, which was mandatory and which in normal times one would totally reject, above-ceiling wage increases apparently were disallowed in some cases for income tax deduction.

On the economic goals, I am of two minds, frankly. I think a nation is well advised at the legislative and administrative level to know what it wants to do. I am concerned that the Government might impose upon 190 million people, or more now, some goals that the majority likes and the minority not. There are some goals that I would certainly favor.

If, for instance, price stability were to get an adequate representation among these, along with economic growth, full employment, balance-of-payments stability, I would say that would be a good distribution of goals. We ought to move in that direction.

In the long run, we should move toward a more social conception of goals, so that we would give people some minimum kind of support. I would lean toward the negative income tax rather than a fixed minimum. That is something in the future toward which we should work. If this is the concept of goals, I would certainly favor it.

Senator JAVITS. Would you then structure into the Government this guidepost idea?

Mr. WALLICH. I think the guidepost idea, Senator, is what a free market would do anyway. If the market were really free and perfect, labor would move very flexibly. It would not be possible to have high wage increases in one place and a low wage increase in another. Wages would rise equally across the board. That is what the guideposts say.

Likewise, prices would behave as the guideposts say. The big hitch is that we have a business cycle. At times demand is too strong, and pulls wages and prices up out of kilter with the guidepost rules.

It is the business cycle and market imperfection that make reality diverge from the guideposts. But I do not despair that we can move

closer toward the ideal by a learning process, not as a result of an "arm-twisting" process.

Senator JAVITS. I think Mr. Colm wished to make a comment.

Mr. COLM. May I be permitted to make comments on both questions you raised, Senator? When Henry Wallich first mentioned to me this tax idea, I was very much intrigued by his suggestion, because we are all seeking some solution which injects the public interest in reasonable price stability into a process, which does not accomplish this automatically in a fully desirable manner, and this is certainly an intriguing idea.

But thinking it over, Henry, I have come in a way to a negative answer, reluctantly, even though I liked it at first. The reason is that it makes a tax dependent on an administrative decision.

The guideposts are not and should never be rigid. Even if we didn't have an inflationary situation, if we had the 3.2 percent productivity, we had lots of exemptions in the formulation of the guideposts. In a way, this tax proposal takes the one numerical figure too seriously.

Now, I would think quite differently if Henry would join forces with me and agree with me in the establishment of a price-wage-productivity board, which would have hearings, which would have a procedure for examining the situation of an industry, and then spelling out the guideposts for that industry, where we have the public record as to exactly what the considerations are.

If you then have something which is geared more to a particular industry, I think some of my objections would weaken. I am not sure that they would then entirely disappear.

As we have it now, where we have really no numerical guideposts, and even if the Council had proposed 5 percent or something, it would not be effective under present conditions, I do not think it is a feasible solution.

Second, I would like to respond to the Senator's reference to the report of the goals of the Commission which was started under President Eisenhower. The National Planning Association, with which I am connected, has taken this proposal very seriously. We have picked it up. We have a Committee on National Goals, working on a quantitative evaluation of the goals which can be quantified.

I do not agree with Mr. Wallich's answer that even if this were done by a Government organization, it would impose decisions on the people. I think one of the big events in the American democracy over the last decades is—and we owe it in part to the Russians and I think they should be thanked for that—that we got a public discussion going on national goals, and a procedure by which current policy proposals are related to goals or to what extent they conflict with other goals.

Let's say we now have the SST proposal. We have in the Government a planning and programming and budgeting system; but this is mainly related to the missions of individual departments, and to the budgetary costs. In spite of President Johnson's announcement these agency goals are not related to national goals as to what private endeavor is doing and what effect is on private activities—let's say what the SST would prevent us from doing—I mean absorbing talent which otherwise could be available for something else.

I am not saying anything pro or con on this particular program. I just say this is the kind of consideration that would be feasible, if you have some established alternative goals, and available what the costs in dollars and manpower of these alternative goals are, both in the private and the public sectors.

I think personally, Senator Javits, that this is a logical and necessary supplementation of the PPB system, which we now have virtually adopted and that is also being adopted by some State and local governments.

Senator JAVITS. Mr. Chairman, my time is up, but I think Mr. Lekachman wanted to pitch in on this. Before he does, Mr. Chairman, I would like to make a request of the panel. I would like in writing for the record, and I ask unanimous consent that it may be included, the opinion of each member of the panel as to whether we ought to give the President the power to raise or lower the tax to the 6-percent limit, that is the 6-percent ceiling limit, within a modest period of time, say for 1 year.

Chairman PROXMIRE. Without objection that will be answered in the transcript.

(Responses to the above query were received from witnesses Wallich and Colm and are included in the record at this point.)

(Response of Henry C. Wallich as requested by Senator Javits concerning discretionary power for the President to make certain limited changes in tax rates:)

The proposal to give the President limited power to make temporary changes of a limited kind in income tax rates for anticyclical purposes has always struck me as a sound one. In past testimony before this Committee, I have supported it. Nevertheless, two circumstances now compel me to raise a question concerning its advisability.

First, the Administration failed to propose a tax increase last year when, in the view of many economists, it would have been desirable. This suggests that, even if the President did possess the power to make limited tax changes, he might not use it. Apparently the political obstacles are of a nature that makes the action too costly to take unless people have previously been exposed to rising prices and high interest rates and in this way have come to look upon a tax increase as a lesser evil. By the same token, the power to cut taxes might be overused, i.e. it might be instituted in circumstances that do not fully warrant the conclusion that stimulation is strongly needed.

Second, such tax changes as have been instituted in the last year or so, including the removal and subsequent reimposition of excises, the suspension of the investment tax credit, and also the present proposal for a tax surcharge, do not accord with the idea of a simple and uniform anticyclical tax change. The tax action should be the same whether the move is up or down. In that case it will be neutral in its distributive effect, so long as there is an even chance for a rise and a cut in taxes.

Any social group that feels especially injured by a rise will be especially benefitted by a fall, and vice versa. Moreover, only if tax changes are of this simple symmetrical sort can frequent disturbances of the tax structure as a whole be avoided. Chairman Mills recently has referred to the inadvisability of frequent tax changes. This applies eminently to be varied changes that have recently been made or proposed. They do unsettle the tax structure, thereby affecting the value of assets and contracts as well as preventing the taxpayer from gathering stable experience in making out his taxes.

The unsystematic form or recent and proposed tax changes raises a question also concerning the feasibility of quick tax changes by the Congress. Prior agreement on such changes, to be implemented quickly when the time comes, seems a possible alternative to presidential discretion. I would support it provided it could be put on a systematic basis. But that precisely seems difficult to achieve.

As a further alternative, delegation to a nonpolitical body deserves to be considered. This might be the Federal Reserve, or some other group that would have to be established with a degree of independence from political pressures. The usual objection to such procedure, that it is undemocratic, seems to me beside the point. It is true that tax changes are not purely a technical matter, but contain a political element. But the same is true of many decisions that today are made by the regulatory agencies of the Government and even by the Judiciary. If the Congress retained a right to veto the action of this group, it is hard to see how serious damage could be done.

(Letter from Gerhard Colm responding to Senator Javits' request:)

NATIONAL PLANNING ASSOCIATION,  
Washington, D.C., February 28, 1967.

JOINT ECONOMIC COMMITTEE,  
Senate Office Building,  
Washington, D.C.

GENTLEMEN: The following is my response to the question raised by Senator Javits as to whether the Congress should authorize the President to raise or lower the income tax within the limits of 6 percent for a specific period of time, e.g. for one year.

I agree with the objective of this proposal, namely to expedite limited changes in the income tax in response to actual or expected changes in economic conditions. It may well be that delegation of authority to the President to make such changes within specific limits is the only feasible solution. However, it appears preferable to me if a method could be worked out by which the Congress would share with the President responsibility for such changes without causing undesirable delay.

My preference is based on the following reasons:

- (a) It is politically desirable to have Congress directly share responsibility for changes in the tax burden even if they are of limited size and duration.
- (b) If the President has sole responsibility for such action he might hesitate or even fail to act for political reasons, particularly when an increase in taxes is involved.
- (c) There are not many cases in which the President recommended a change in taxes to Congress but in which action was unduly delayed because of protracted Congressional deliberation.
- (d) Not all economic conditions require the identical change in tax measures. There may be situations in which a change in both individual and corporate taxes, or in only either one, is warranted. In other situations a change in excise taxes may be desirable. If there is an authority to make changes only in one particular way the President may use this authority even though under the circumstances a different type of tax change may be desirable.

I believe that the recommendation made by the Joint Economic Committee's Subcommittee on Fiscal Policy in May 1966 (see pp. 16 f.) suggests one possible procedure for prompt legislative action.

I suggest that the tax-writing committees consider and propose to the Congress stand-by legislation providing for up- and downward changes in tax liabilities, leaving open the effective date and, perhaps, stating only a maximum percentage of change, leaving the exact ratio of change within these limits open. In case of need the effective date and the exact ratio of the changes could be adopted by a Joint Resolution recommended either by the President and/or the Joint Economic Committee after hearings which should not exceed, say, one week. If the hearings are held by the tax-writing committee, separately or jointly, the views of the Joint Economic Committee should be heard at the hearings.

I recommend experimenting with such a method of Executive/Legislative cooperation before considering the delegation to the President of the power to make such changes by decree.

Sincerely yours,

GERHARD COLM.

Senator JAVITS. If the Chair desires Mr. Lekachman to address himself to the questions, it is fine with me.

Chairman PROXMIRE. You mean the previous question?

Mr. LEKACHMAN. The previous question, yes.

I want to make just a comment or two on the guidepost issue rather than the goals question that was raised.

It seems to me that the record of other countries, besides ourselves, with formal boards of review, has not been entirely encouraging. The English record has not been good. The Dutch system, after some years of success, broke down. And I am not encouraged, in other words, by proposals to increase the formal administrative machinery for application.

There are two other comments I just want to make very briefly. One is that as is conceded everywhere, the guideposts have been, practically speaking, inoperative in the downward direction. Corporations don't reduce their prices when application of the guideposts would suggest that they do so, and this is another way of saying that there is an inflationary bias built into the guideposts, given present arrangements.

The second comment is simply this: That the guidepost mechanism, for better or for worse, is a conservative mechanism. It assumes that the distribution of income between property and labor is a reasonably satisfactory one and the guideposts in effect sanction that division.

Chairman PROXMIRE. Congressman Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

First, Senator Javits, I wonder if in the question that you suggested be answered in writing about the power to raise and lower taxes, that we make it very clear that it might be answered in an either/or situation. In other words, it might be that we grant the President power to raise taxes, but do not grant him the power to lower taxes or vice versa.

Senator JAVITS. Oh, yes. Mr. Moorhead, my office will write a confirming letter.

Representative MOORHEAD. Thank you.

Professor Wallich, I would like to continue the discussion that you were having with Congressman Reuss about the variable interest rates on housing mortgages. First, sir, would it be your idea that the monthly payment would, except in the case of a very wide fluctuation, remain constant, and the amount attributable to interest and principal would be the thing that would vary?

Mr. WALLICH. Yes. That is how they work it in England. A man finds that if interest rates go down, his mortgage is shortened, and if they go up, it is lengthened. If interest rates fluctuate, he doesn't much care.

Representative MOORHEAD. Do you know, sir, if under the present law the banks and/or the savings and loans in the United States could make such contracts?

Mr. WALLICH. Yes, I think they could. I have had some correspondence as a result of what I wrote about this, and if it's an overt contract and not as in the case of one California savings and loan association, something that the borrowers didn't know about, then there seems to be no reason why this should not be done.

There are some technical problems. One is that the mortgage may not be easily negotiable. But so far as I can find out, this is not a serious impediment.

Another question is how one gets the savings and loans to reduce deposit rates when the time comes, so that rates on mortgages will also go down and the period can be shortened. One can to some extent rely on the market. Lenders will not be able to write high-interest-rate mortgages. But it is conceivable that some kind of legal tie would have to be established between mortgage rates and deposit rates. No doubt there will turn out to be a lot of special cases, grace periods on deposits, and so forth, that will require definition to make it equitable and make it firm.

Representative MOORHEAD. Professor Lekachman, I was very much interested in your suggestions in your testimony about the negative income tax and the Federal Government as the employer of last resort. I wasn't quite clear as to the interrelationship of the two ideas. I can think of it as an either/or proposition. I can think of a combination where you would say anybody who is employable should be employed and put to work, and only those people such as let's say mothers with small children should be granted the negative income tax. But what is the interrelationship? Who would come under one program and who would come under the other?

Mr. LEKACHMAN. I was thinking of two groups, Representative Moorhead, with some coincidence between them I can see. But the two groups I had in mind were individuals whose practical chances or even desirability of offering employment to was not very great.

Many of the elderly, who are getting social security payments, which leaves them in precarious condition if they accept employment; many families of small children headed by women; individuals who are handicapped mentally or physically, not to the point of institutionalization. There are other categories. These individuals it seems to me now get various forms of either social security or welfare payments. In many cases the amounts are inadequate, and these people would be natural candidates, it appears to me, for some form of income maintenance.

Now there is another group of individuals who are currently unemployable, that is to say by labor market definitions in effect, market definitions. They can't get jobs. And what I among many others, have been speculating about is the fact that there is coinciding with this pool of personally unemployable a large number of public service jobs requiring rather little skill and training, which might readily be filled, the missing nexus being cash and in fact a program which would supplement public service employment in a great many areas.

So I don't think of these programs as substitutes for each other. I think they are supplements. In one case, one is addressed to the relief simultaneously of poverty and unemployment; in the other case, to the relief of poverty alone.

Representative MOORHEAD. In connection with your testimony, Professor Lekachman, I certainly want to reecho your sentiments about the Model Cities Program. I certainly agree with you it would be nothing less than a disaster to snatch from the cities the funds and the hopes so recently held out to them.

I think that we have stimulated the mayors into activity, and if we deny them this assistance which we almost promised them, why I think it would be very discouraging to the morale of the city officials and, more importantly, the city dwellers.

I notice with some interest that Mr. Colm and Mr. Lekachman gave relatively little, if any, attention to the problem of the balance of payments, whereas Professor Wallich, I think, stressed this very heavily. Was this because you wanted to address yourself strictly to domestic economic problems, or do I infer that the two of you considered the balance-of-payments problem considerably less serious than does Mr. Wallich?

MR. LEKACHMAN. I consider them quite serious, Mr. Moorhead, but at the same time I suppose my difference with Mr. Wallich is primarily this, that I want to minimize the effect that our balance-of-payments situation has upon other policies, particularly domestic social programs, and being of this mind, I would be far more inclined to concentrate on doing something directly upon balance-of-payments situations in the way of specific controls, or enlarge present controls rather than to allow present domestic policy to be seriously affected. But I don't think that I differ with Mr. Wallich with the seriousness of the problem. It is undoubtedly a great problem.

Representative MOORHEAD. Mr. Colm?

MR. COLM. I pretty much agree with what my colleague, Mr. Lekachman, has been saying. The reason why I didn't elaborate on that was in part because I knew Mr. Wallich would be on the panel. He has given it more thought. It happens not to be my field of specialization.

I agree that it's a serious problem. I am more concerned with the long-range problem, with the competitiveness of the American economy. Productivity is the basis for our high wage level relative to other countries. We have the long-term tendency that productivity travels much faster from country to country than in the past; for example, in Japan you find steelworks which are as modern as the most advanced American steelworks. We are only surprised by the statistics. They still employ about three times as many workers relative to output, and this is probably because of the relatively low wage level. But I think there are serious problems.

I also agree with Mr. Lekachman that for a short term we may use more specific devices. I express perhaps more of an emotional feeling, but I think I could rationalize it. It doesn't make sense to me that we should have mass unemployment in order to solve our balance-of-payments problem. That would be a sort of admission of inability to deal with the problem, and I cannot believe that the only solution consists in depressing our economy, thereby depressing imports and giving allegedly an incentive to exports.

I cannot agree with that philosophy, though I cannot elaborate on the technical consequences of that statement.

Certainly as I have stated in my prepared testimony, the balance-of-payments considerations are a restraining factor on credit relaxation, but I think particularly for housing that does not apply. In part as an answer to the previous question by the Chairman, I think more money is being made available for housing even though the interest rate is still very sticky. Making money available for housing at lower interest should be possible without any drastic effect on the balance of payments.

Representative MOORHEAD. Thank you.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Moorhead. Congressman Rumsfeld.

Representative RUMSFELD. Mr. Chairman, I apologize to our three distinguished guests for being tardy. I had a meeting of the Science and Astronautics Committee.

I understand, Dr. Wallich, that you indicated that you favored removal or reduction of the gold backing now required on Federal Reserve notes. Is that correct?

I would also like to have comments from the other two gentlemen on this question.

Mr. WALLICH. Yes. That is something I think we ought to do. The true purpose of the gold reserve is to be used for international payments and to back the dollar internationally. The domestic backing has lost much of its original significance, which was to convert notes into gold coin.

It serves an indirect purpose in restraining fiscal and monetary policy, but that same purpose is served by using it exclusively for international purposes. The Government is on notice that when we run out of this reserve, we will be in a pretty desperate situation with devaluation or tight exchange control our only alternatives.

I would not say that removing the limit does not take some constraint off the Government. The fact that they are moving toward a limit rather than being able to operate against a \$13 billion reserve does create some added pressure to put the balance of payments in order. I don't think that that gain is worth the drawbacks that we have from maintaining the limit. It raises a doubt in the mind of the world as to what will happen as we approach the limit. Will we pull the plug on the dollar and devalue, or will we remove the limit?

Since in practice I feel very confident that we would remove the limit if we got close to it, we might as well remove it now that we are still \$3 or \$4 billion away from it.

Representative RUMSFELD. Thank you.

Is that roughly the view of our other guests?

Mr. LEKACHMAN. I agree with Mr. Wallich in general and in particular I think on this issue, an unusual position for one economist to find himself in with another.

I think that quite rightly Mr. Wallich pointed to the fact that the limitation has lost its meaning. We don't have an internal gold standard. This was one principal meaning of this. And I think also on the specific point that we would create an unnecessary crisis for ourselves if we retained the limit as we approached the point where our flexibility came into question.

It would be a wholly unnecessary financial crisis, and we have enough unavoidable ones without adding one that we needn't face at all.

Mr. COLM. This is a strange case of consensus among three economists.

Representative RUMSFELD. Thank you. I would also like, if we could have in the closing minutes here, another comment from each of you. We have had testimony from among others, Walter Reuther, to the effect that escalator clauses are not inflationary. I would like a

comment from each of you on whether or not you feel that escalator clauses are or are not inflationary?

Mr. WALLICH. I think Mr. Reuther must have been arguing on the assumption that there are wide profit margins that permit absorption of above productivity wage increases. Moreover, with respect to his own industry, productivity increases may well be above average, so that it would be possible even without reduction in profit margins to absorb normal wage increases, plus an escalator.

But for the economy as a whole, it seems perfectly clear that escalator clauses will be inflationary, unless we are to assume that profits can be continually squeezed. The guideposts made very clear that labor as a whole, if income shares are to be maintained, cannot get wage increases in excess of productivity gains. If those are 3 percent and we give labor 7 percent, then the only way to get back to the 3 percent that labor can get is to have inflation of 4 percent. That would be the result of escalating.

If then, we further escalate the 7 percent to 11 percent because of the 4-percent inflation, what we do is to escalate the inflation as well as wages. I see no alternative.

Mr. LEKACHMAN. I think, in general, I agree with Mr. Wallich once more on the effect of escalator clauses, but I would stop short of saying that because they have an inflationary tendency they are necessarily to be resisted at all cost. They do embody a measure of protection. If you like, you can even think of a series of labor contracts containing escalator clauses as putting some pressure upon the Government to use the kind of fiscal policies which would make them inoperative.

I don't think that that is necessarily what Mr. Reuther had in mind, but it might be indeed an effect of such a widespread writing of contracts.

Mr. COLM. I don't know what Mr. Reuther had in mind, but there is one fact. The way the escalator clauses are written and operated, they do put a timelag between the price rise and the wage increase. To that extent, whether they are inflationary or not may be a question of semantics. They are more inflationary than if there were no wage increase. But they are a factor slowing down the transmission of the price rise through the economy.

For instance, the British during the war managed the price index to make the most use of this price lag, so that actually apparent escalation was actually a mechanism designed to slow down inflation. Some of the unions oppose the automatic escalation because they think by reopening negotiations they can get more, trying to anticipate future price increases. This would certainly be more inflationary.

We also should consider why we have price increases. If we have a price increase because of lack of fiscal measures, then the price increase acts in a way as a crude substitute for a tax. And the more groups are protected, the smaller those are, who find that they have to carry the burden. In that respect, I would say full cost of living adjustments add to inflationary pressure. But much depends on the mechanism of how they operate, the time lag between the actual price rise, the reporting of the index, and the application to the next payment.

There is the factor of slowing down. I must admit I am trying to make some sense of the statements that Mr. Reuther made, because I know he is a very intelligent person.

Representative RUMSFELD. Thank you, gentlemen; and thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, Mr. Rumsfeld.

Dr. Wallich, I would like to follow up on something that I let you escape from the last time we talked. That is the soundness of following fiscal and monetary policies for the purpose of restraining inflation, that is by keeping the unfortunate consequences which you and I recognize—that unemployment would remain at a very high level.

When we have no analysis and no agency that I know of in or out of Government that I know of trying to make analysis of the impact of this restraint on specific commodity prices. In other words, it seems to me that we are talking through our hat.

Governor Martin, when he appeared before this committee, said that they had no idea what restraint, monetary restraint, what effect it would have on particular commodity prices. His agency made some kind of a study years ago for the Commission on Money and Banking. Indeed they do have a general feeling that monetary restraint under demand-pull circumstances will keep prices down, but he couldn't give me any documentation, let alone qualitative analysis. He couldn't break it down in the food category and in the medical category, the interest rate category, that would give us any kind of a precise picture.

Now, isn't it desirable, if we are going to have a better economic policy in the future, in view of the enormous importance and the weight to be placed on restraining inflation, the burden of unemployment that we impose on the country in doing so, that we have at least an effort to try and get at the effect of these policies on specific commodity prices?

Mr. WALLICH. I think this is a very good thought. All I can do is to respond with what little knowledge there is, which is probably very familiar to you, Mr. Chairman. As you know, monetary policy works principally against investment, and there principally against housing, and, to a smaller extent, against borrowing by small business, perhaps State and local. It touches least, plant and equipment spending.

Fiscal policy works principally against consumption. Therefore, if we are going to talk about the impact on commodities, then I suppose fiscal policy is the first thing to study—what happens to prices as demand is reduced.

This resolves itself, I suppose, into a question such as this. If a tax increase were to be introduced now, what are the personal budget items that consumers are most likely to cut back on? And to that, I think a competent economist could give quite a few answers, because we know the behavior of people with respect to their household budget as their income rises or falls.

Chairman PROXMIRE. Then we would want to relate that, wouldn't we, to the particular situation. We would know, for example, to reverse it a little bit because this is so clear in my mind, if we do have an increase in social security benefits, much of which will be spent on

food, that particular aspect of the expenditure would not necessarily be inflationary, because at least our assumptions have been that food prices are not very responsive to increases or decreases in demand. They are more responsive to production factors, Government policy factors, and so forth.

Mr. WALLICH. It seems clear to me that economic analysis increasingly will move into this direction of dividing up problems, looking at specifics, particular sectors, particularly commodities. I haven't heard the suggestion made, but it seems to me an eminently sensible one.

Chairman PROXMIRE. Thank you very much. I would like to pursue another question that has been raised with you two or three times today. I would like to pursue it in a different way.

As I listened to your testimony this morning, I got the impression, which surprised me a little, that you were siding with Walter Reuther and with Alvin Hansen in accepting incomes policy at least to some extent, because you—and I think very wisely and properly—talked about real wages. Not money wages, which is something that most economists haven't paid as much attention to as they should, in talking about wage-price guideposts.

Now, as Hansen argued it, if we had a real wage guideline, we would, for example, in this year, forgetting about any catching up, and took, say, the 3.2-percent productivity factor, and then took the assumption of the Council of Economic Advisers on a 2½-percent increase in the cost of living, we might have a guideline this year of 5.7 percent.

What this would do would be to keep labor's real income in line with its productivity increase, and the argument by Dr. Hansen was that this would not be inflationary in his view.

At the same time, this is tying wages to a cost-of-living escalator in a real sense, or at least you might say this, and you would argue that to do so is inflationary.

Mr. WALLICH. Well, you are quite right, Mr. Chairman. I lean toward an incomes policy, and I do think that the guideposts are incomes policy. It happens to be one that keeps income shares constant.

I think the proper way to read these income shares in history is to look at periods of high employment rather than low employment, because shares fluctuate over time. The labor share rises with unemployment and falls as unemployment declines—that is in booms it is lowest. Like the full employment budget, I would like to look at full employment income shares as the norm.

Now to do as my distinguished teacher, Alvin Hansen, proposes, and I realize that I disagree with him at my peril, would single out for protection a single sector. Something happened last year that somehow raised food prices and service prices. These are calamities that befall everybody. Why escalate one particular sector? Why not also—

Chairman PROXMIRE. No, no, I don't want to be rude, but I think you are shifting the scenery on me a little bit. What he talked about was not past. He wouldn't take the 3.3 percent increase in the cost of living we had last year. He would do one of two things. He would either take the estimate of what we are going to have this year, or what he might do consistent with what he said is simply have an escalator so you would have a reflection of what actually happens this year.

You have the productivity increase of 3.2 percent and then you would have whatever cost of living you have this year. Therefore, labor wouldn't get anything except compensation for its real productivity increase. In other words, that it would be paid in real wages, not money wages.

And you are dead right when you pointed out the impossibility, the perniciousness really, as far as labor is concerned in having a wage guideline this year that doesn't have any recognition at all of the cost of living in it, or having it last year where you had a 3.3 percent rise in the cost of living, a 3.2 percent guideline, so that labor's real income went down, if they abided by the guideline, at a time when their productivity was increasing.

Mr. WALLICH. I suspect if we did what Hansen proposes, that is put in a 5.7-percent guidepost, and it were abided by, it wouldn't change anything. Prices would rise sufficiently to reduce the real increase to what productivity permits.

That is indeed the meaning of this action. And so labor is likely to end up no better than it would otherwise be. But what it would do is to make sure we would get a substantial price increase which then the following year would again justify a further above productivity increase in wages, and so on.

Chairman PROXMIRE. The estimates are that now this year you are going to have settlements in the area of 5 or 6 percent. Many people think it is going to be higher. Income guidelines would provide for, say, a 5.5 or a 5.7-percent increase, which would mean perhaps that the wages wouldn't be higher, and also you would have a more equitable principle involved.

You would have more effective public pressure on those who happen to have strong unions or weak employers or a situation in the industry that would permit wages to go up excessively, and you would have greater equity throughout the economy.

Mr. WALLICH. How would we ever end the inflation then? It seems to me at this rate the inflation will continue at 3 percent or thereabouts.

Chairman PROXMIRE. I can't get it through my thick head why the wage increase is inflationary as long as it is keyed to real productivity increases. That is what it would be keyed to. Otherwise, it isn't related to it.

Mr. WALLICH. It is keyed to that, but it also assumes that prices will rise by the difference between the guidepost and productivity gains. In other words, if the guidepost is 5.7, and productivity were 3.2, which I think is too high, prices will rise 2.5. So we have a 2.5 percent price increase, and we continue next year with wages on the same basis, and we have another price increase. By what process is inflation ever going to come down?

Chairman PROXMIRE. What we have had in the last 4 or 5 years is a steady increase in prices, low but modest up until last year, around 1½ percent or 2 percent. You had a guideline principle that was enforced by some unions.

The result was that you had wages that conformed increasing far less than profits. And you had an inequity developing in the economic system because of it. I am not sure that you would necessarily

have less inflation than you would have had if you had had a modest escalator.

You would then have been able to preserve the guideline principle on a sound basis, the basis which I understood you to argue that it should be keyed to real income and not to money income, because money income is pernicious.

Mr. WALLICH. The German Council of Economic Advisers has struggled with this problem because they have had high rates of inflation for longer than we have had, and the system they recommend is to sort of deescalate gradually, not to raise wages by productivity plus past inflation, but productivity plus some part of the past inflation. If they do this over a period of years they think they can get down to stability.

Chairman PROXMIRE. Did you want to comment, Dr. Lekachman?

Mr. LEKACHMAN. If I might for just a moment, Mr. Chairman. This is the first I heard of Professor Hansen's proposal, but it seems to me in listening to the discussion of it, that there is something that is implicit in this, and that is that there be a much firmer application of the price guideposts.

Chairman PROXMIRE. That is exactly right.

Mr. LEKACHMAN. Than up to now.

Chairman PROXMIRE. He said we should have administered prices more effectively controlled than has been done in the past. And if we didn't do it, administrative price powers is the element that is going to be unsettling, inflationary, and disturbing.

Mr. LEKACHMAN. If we could do that, I am not enormously hopeful about the administrative possibilities, but if we could do that this it seems to me would then tend to solve one of the problems of the existing arrangement.

If some firms raised their prices and others did not, when prices were rising in general, in effect, the real prices of some firms would go down and should go down on the assumption that these are the firms with exceptionally high productivity experience, and very likely high profit.

In other words, you can restore some implicit flexibility to the price system if you could, which is the central question in my mind, if you could develop the administrative mechanism more firmly to hold prices to permissible increases.

Chairman PROXMIRE. I would like to ask Dr. Colm one other question. Dr. Colm, you indicated you thought it would be wise for the Congress now to give the President the authority to increase taxes on July 1. Do I state your position correctly, or did you indicate you felt we should pass a tax increase as the President suggested?

Mr. COLM. I did recommend the tax legislation, with an effective date of July 1, and hearings before the effective date which would make it possible to reconsider this decision, either at the initiative and the recommendation of the President to drop it, or by the initiative of Congress.

Chairman PROXMIRE. What disturbs me about your proposal is that these hearings would be by the tax writing committees, and without as much economic emphasis as they ought to give it. In other words, if they would rely on what you also refer to, which really disturbs me—

you refer to the notion of budgetary considerations; that is, if our expenditures exceed our revenues, that this should be an important element in determining whether or not we should have the tax increase in July. I would assume that this would not be the important element.

The important element would be the state of the economy, because clearly if the state of the economy is bad, you are going to have a bigger deficit, and a much worse argument for a tax increase. Therefore, we should not be concerned as far as this particular tax increase is concerned with the budget deficit.

What you should be concerned with is the impact of the tax increase on the economy. If it is soft, we should not have it. And if it is expansionary, as you expect it might be in the second half, we should have it. Is that right?

Mr. COLM. Mr. Chairman, I am delighted to hear you argue this way. That is the way we economists have been arguing for sometime, and we are happy that so much of this so-called new economics has found more response.

But I do think there is a difference between a deficit which is caused by an unexpected increase in expenditures, and a deficit which is the result of a lower income and therefore a fall in revenues.

You are absolutely right, it would be paradoxical or perverse if we have a larger than expected deficit because of a fall in economic activity, then to increase taxes. I mean that was proposed in 1932 and I thought we have learned something since then.

As your statement has indicated, we all have learned a lot since then. But what I am concerned with is that if there is the outlook for defense expenditures much larger than anticipated, then we may need the tax increase, and I think we agreed, at least Mr. Wallich agreed with that, and I am not so much—

Chairman PROXMIRE. Yes, but even still, Dr. Colm, even if there is a supplemental that comes down and we find that we are off by \$5 billion in the Vietnam war, it is the state of the economy it seems to me that must be the determining factor, regardless of the expenditures we have to take into account, whatever impact these expenditures are going to have on the economy. But even if the expenditures are as you say greater than we thought they would be, unless we recognize exclusively, really exclusively the effect of that tax increase and what it is going to do to the economy and what it in terms of inflation and employment, and so forth, is, it seems to me we will be making a serious error. Isn't that correct?

Mr. COLM. I couldn't agree more with your principle, Senator. The point which I would make is we should be concerned not with the state of the economy in June 1967 but what it is likely to be during the next 12 months, and if then—I thought I was rather tolerant with respect to what deficit our economy could absorb. Now with the present defense estimate, we expect a national income account deficit of I think it was something like \$6 to \$7 billion without a tax increase.

If we now have on top of that a larger than expected increase in defense expenditures, I think we would have to expect some old-fashioned demand inflation during the year—

Chairman PROXMIRE. It has a tendency to increase demand inflation, there is no question about it. Why should we not wait then until

September or October? The situation is so uncertain now. Congress isn't to go home until the fall. Wouldn't it be wise under these circumstances rather than having an effective date of July 1, when economists do disagree on what the situation is going to be, and I think a preponderance of economists before this committee have indicated they don't agree with the Council's optimism on the last half of 1967.

Under these circumstances why shouldn't we wait another 3 or 4 months and take a later look at the economy?

Mr. COLM. That is an offer to compromise, Senator. Perhaps the tax legislation should be written with the effective date to be supplied later by joint resolution of Congress.

What my concern is, Mr. Chairman, is the decision under conditions of uncertainty. I know if things turn out as they did last year, and I don't expect a repetition of that, but even if there is a smaller change in the defense budget, and the nondefense budget, if that becomes apparent, and then the forecast is for inflationary pressure—if then the Congress starts considering a tax bill that takes time. Therefore, I think it would be prudent to have a tax bill written, and perhaps put the effective date in later, or if not needed, drop it.

This is only a kind of insurance. In my opinion, it is a better way of getting the flexibility than the delegation of power about which Senator Javits asked us to write a statement. I think under present conditions this would be a substitute for something Congress at this moment I think would not be willing to give the President; namely, discretionary power. I don't think Congress should.

Chairman PROXMIRE. Dr. Wallich?

Mr. WALLICH. The argument of uncertainty on which I agree with Mr. Colm seems to me to argue both ways. One could also say: let's pass a tentative tax reduction in case there is a de-escalation of the war, since we don't know what is ahead, and another possible increase.

These two approaches don't really convince me. I think we ought to take advantage of the situation to put tax changes on a permanent flexible basis. I must say I am profoundly disillusioned by the experience of last year, which seemed to show that had we had presidential discretion, it would not have helped.

Perhaps it's asking too much to expect the President to put in a tax increase before there has been plain and obvious evidence that the people are hurting from inflation and high interest rates. On these grounds, the proposals that were evolved by Mr. Griffiths' committee seem to me perhaps more hopeful, and I would also weigh rather highly the point I think made by Mr. Mills, that one shouldn't tamper too much with the tax system by too many different kinds of changes. These are unsettling.

We ought to have one single kind of change that goes up or down, whatever the situation requires, but avoid the mixture of flexible fiscal policy plus some kind of reform that we would like to introduce at the same time. I think that is what Mr. Mills objects to.

Chairman PROXMIRE. I want to thank you gentlemen very much. I do have one question that the staff asked that I ask Mr. Colm. On the wage-price-productivity board, when you appeared before the Reuss subcommittee their feeling was that you asked for a factfinding board,

and today you seem to ask for a decision by the board. They would have hearings and make a decision. Have you changed your view in the meanwhile?

Mr. COLM. No, I have not, Mr. Chairman. I may not have made this clear in my brief—unfortunately not so brief—summary, I still feel that the board should make a factfinding report, and submit it to the President.

Chairman PROXMIRE. Action on the facts would still be voluntary.

Mr. COLM. The President in consultation with the Council then, if he feels that that is warranted, would make a recommendation to Congress of his own. The board would make a factfinding report about how the principles of the guidelines, spelled out by the President and the Council, do apply to this particular case, and what would follow from the guidelines.

Chairman PROXMIRE. Thank you very much, and I thank all of you gentlemen for a most enlightening and interesting morning. I appreciate it.

The committee will resume its hearings on Thursday morning in room 318, the caucus room of the Senate Office Building at 10 o'clock. We will hear from two experts on wage-price guidelines.

(Whereupon, at 12:35 p.m., the committee adjourned until Thursday, February 23, 1967, at 10 a.m.)



# THE 1967 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 23, 1967

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

The joint committee met at 10:05 a.m., pursuant to recess, in room 318, Old Senate Office Building, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Sparkman, and Percy; and Representatives Patman, Bolling, and Reuss.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Donald A. Webster, minority economist.

Chairman PROXMIRE. The Joint Economic Committee will come to order.

This morning's hearings will be the last for our extensive and very profitable inquiry into the President's Economic Report and the major current issues in our economy. Let me take this occasion to reiterate the committee's profound appreciation and gratitude to the witnesses for the excellent insights and analyses they have given us. It has been a most stimulating experience.

Today it is fitting that we close with testimony from two outstanding experts on one of the crucial issues of economic policy, that of wage-price stability. This Nation must resolve the wage-price question if it is to deal successfully with the requirements of the Employment Act. Our members and the Congress as well as the public are deeply concerned about this issue and we look forward to this morning's testimony.

Our first witness will be Prof. Carl A. Auerbach, of the Law School of the University of Minnesota, and our second witness will be Jules Backman, professor of economics at New York University. If there is no objection, I shall revert to the practice adopted on Monday of this week when 1 hour and 15 minutes was allowed to each of the morning's witnesses. If that is agreeable I shall ask that Professor Auerbach testify first, with the additional request that you limit your initial statement to 20 minutes. If you can do so, we can devote more time to the colloquy.

If you want to skip over part of it we will put your full statement in the record, and I might add for the record that Professor Auerbach is an old friend of the chairman and an old friend of Congressman Henry Reuss. We have known him as an extraordinarily able and competent law professor, and as a very fine person, and we are delighted to have you here this morning. Go right ahead.

**TESTIMONY OF CARL A. AUERBACH, PROFESSOR OF LAW,  
UNIVERSITY OF MINNESOTA**

Mr. AUERBACH. Thank you, Mr. Chairman. It is a pleasure to appear before this committee, with you as chairman. I hope that the kind words you have said about me will be repeated after my testimony.

Chairman PROXMIRE. I am sure they will.

Mr. AUERBACH. You have asked me to discuss principally the wage-price policy set forth in the 1967 Economic Report.

Both the President and the Council of Economic Advisers have been criticized in recent weeks for abandoning the wage-price guideposts. But this criticism, in my opinion, is too general and, therefore, unfair.

I think the most significant change in the administration's policy is not that it has refused to specify a single figure as the wage guidepost for 1967—neither President Truman who originated the guidepost policy, nor Presidents Eisenhower and Kennedy, who further elaborate it, ever specified such figures. Rather, the most significant change is that the President has announced that the Government's weapons of intervention in private wage and price decisionmaking would be limited to information and persuasion and efforts to apply "sanctions" to "violators" of the guideposts would be abandoned.

If this is a correct interpretation of administration policy, the change is to be welcomed, not deplored; and particularly if Congress now seizes the opportunity to accomplish the objective which Congressman Reuss has urged upon it in recent years.

I say this because very serious criticism may be directed at the way the guidepost policy has been formulated and administered up to now. To be clear about the problem we face, we must begin with the fact—which Presidents Truman, Eisenhower, Kennedy, and Johnson, their Councils of Economic Advisers and, I think, this committee have accepted—that structural characteristics of the American economy are responsible for the tendency of wages and prices to rise, even before full employment is achieved. Historical experience has led us to accept this fact. Prices increased rapidly in 1937, despite massive unemployment and under utilization of resources. The defense program of 1940 and 1941 produced inflation even though the economy was then operating far below capacity. Events from 1956 to 1958 again showed that we could have inflation in the absence of excess demand and, indeed, even in the face of declining demand. The experience of the last year only adds to the proof.

Experience has also demonstrated that monetary and fiscal policies alone cannot prevent an inflationary price-wage spiral without sacrificing the twin objectives of income growth and full utilization of resources. In other words, we constantly hesitate to use monetary and fiscal policies, to the extent necessary to attain these objectives, for fear of inflation. To eliminate the necessity for such hesitation is the principal purpose of the guidepost policy. Through this policy, it is hoped price and wage restraint will come to be practiced in certain otherwise unregulated sectors of the private economy.

The guidepost policy has been defended as a means of assuring such private restraint principally on the ground that it is not a policy of compulsion but one that calls for voluntary compliance with its re-

quirements. It would seem that the advocates of a policy which depended for its effectiveness upon the voluntary action of labor and management should have tried to enhance its acceptability by affording these groups an opportunity to participate in its formulation. Yet, there is no evidence that representatives of labor and management, or even the President's Advisory Committee on Labor-Management Policy, participated in the formulation of the original guideposts in 1962 or in their subsequent elaboration.

As a consequence, both the AFL-CIO and spokesmen for various industry groups have attacked the guidepost policy. Secretary of Labor Wirtz, before this committee, has said that it seemed to them to constitute stabilization without representation.

The failure to recognize the necessity for participation of the major interests affected by the guidepost policy in its formulation is due in my opinion to the somewhat technocratic attitude of the Kennedy and Johnson administrations toward the policy. President Kennedy most clearly expressed this attitude in his celebrated 1962 commencement address at Yale University when he called for "more basic discussion of the sophisticated and technical questions involved in keeping our mighty economic machine moving steadily ahead." The present Council is fond of speaking about the "arithmetic" of the guideposts. But in truth, the problems of stabilization are not merely "sophisticated" and "technical" and arithmetic alone will not solve them.

The participation of labor and management in the formulation and administration of a wage-price policy may nevertheless be unnecessary, if general agreement existed on what this policy should be and how it should be applied. But I need not tell the members of this committee that there is no such consensus.

Probably all of us agree that full employment, rapid economic growth, and price stability are desirable. We may also agree that uncontrolled inflation of long duration not only will interfere with the process of production itself and jeopardize the possibility of full employment, but also will result in inequities that may threaten to undermine our social and political structure. But there is no agreement about how much price instability at any particular time may be tolerated in the interest of fuller employment or for how long such price instability may be endured without risking uncontrollable inflation.

Paul Samuelson and Robert Solow wrote in 1959, and it remains true today, that the country has a "menu of policy choices" which involve the balancing of different levels of employment and output against varying degrees of price instability. Those of our people who live on fixed or relatively fixed incomes, those with secure jobs, savings depositors, owners of life insurance and mortgagees, would like to see the balance struck in favor of price stability. The unemployed and all who are troubled about the social costs of unemployment would like to see the balance struck in favor of still higher levels of production and employment. A wage-price policy should seek to lessen the degree of disharmony between full employment and price stability. But the disharmony cannot be avoided completely. Equally important, there is no agreement on the ingredients of a desirable wage-price policy. Technical experts, in time, may be able to resolve to everyone's

satisfaction, some of the issues on which conflicting opinions have been expressed before this committee. But any wage-price policy also raises questions as to what is a "fair" wage and a "fair" profit and an "equitable" distribution of the national income on which opinions and interests will remain in sharp conflict.

The conflicts of interest become apparent when we turn to the burning question whether wage rate increases should be limited by the trend rate of productivity growth, even in the face of significant increases in the cost of living. Whether unions whose contracts will be renegotiated in 1967 will be satisfied with only a partial and gradual adjustment for cost of living increases—as in effect the President urges—may well depend upon whether they are persuaded that the stabilization program will be applied equitably to all groups in the population. But obviously, there is no agreement in the country on what the principle of equality of sacrifice requires under present circumstances.

When it erected the original guideposts in 1962, the Council recognized that, if adhered to, they would perpetuate the existing "relative shares of labor and nonlabor incomes in total output." So it emphasized that "there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes." It thought it desirable that labor and management "should bargain explicitly about the distribution of income of particular firms or industries," so long as they did so within the framework of a stable price level. In 1964, the Council further explained that such bargaining should take place in an industry "whose trend productivity is growing more rapidly than the national average" only after prices were reduced "enough to distribute to the industry's customers the labor-cost savings [the industry] would make under the general wage guidepost." But since then the Council has vacillated on the desirability of bargaining about the distribution of income.

This year, for example, the Council warns that "attempts on the part of the unions to redistribute income from profits to wages through excessive wage increases in high-profit industries results primarily in higher prices in those industries," and in the redistribution of "real income from the rest of the community—who are mostly other wage earners—to the workers in question, with very little redistribution from profits to wages."

But of course, this is true only because management in high-profit industries has been unwilling to reduce prices and no means have been found to compel it to do so.

Recognizing that it is unfair to ask workers to restrain their wage demands if their restraint will only result in higher profits, the Council appeals for forbearance on the part of management. It asks producers to "absorb cost increases to the maximum extent feasible, and take advantage of every opportunity to lower prices."

But there is no agreement in the country on any standard of "reasonable" profits that would tell us to what extent producers should absorb cost increases and how much lower profit margins should be. For this reason, we cannot tell whether a wage increase higher than that permitted by the wage guideposts should have the effect of redistributing the industry's income or should justify a price increase or a smaller price decrease than the guideposts call for.

Under these circumstances, very little is to be gained by asking management to adopt a policy of profit minimization, or by scolding it even for trying to maximize profits. Similarly, labor should not be scolded for trying to improve its position.

The point I wish to make is that the issues raised by the guideposts, or any wage-price policy, are the kind that are resolved in our democracy only by an accommodation of conflicting claims which all concerned find tolerable. To reach such an accommodation, labor and management must be given the opportunity to participate in the formulation of a wage-price policy. Furthermore, since any bargain that these groups may strike will affect the life of the ordinary citizen more than much legislation passed by the Congress, Congress must be the final arbiter.

Accordingly, I urge this committee to institute hearings immediately to determine what our wage-price policy should be in the period ahead. Representatives of labor, management, the public and, of course, the administration, should be heard. This committee should then write a report which would enable the appropriate legislative committees of Congress, if they approved it, to draft a bill setting forth the components of an overall wage-price policy.

It has been objected that it is unwise to legislate a wage-price policy, because that will give it "legal status and a flavor of compulsion," and destroy its voluntary character. But if it is agreed that representatives of labor, management, and the public should participate in formulating the wage-price policy, some way must be provided for settling controversies that may arise. Only the President or Congress can do so. I think Congress should do so, but that it should act in a manner that will require it to run the gauntlet of a possible Presidential veto.

Furthermore, I do not see why congressional formulation of a wage-price policy by itself will destroy the voluntary nature of labor-management compliance with the policy. No overall wage-price policy formulated by the President or Congress can be expected to set forth clear guides to action in every case. The more general and more flexible the statement of such a policy, the more difficult it will be to apply it to any particular industry or firm and, therefore, the more difficult it will be to judge whether a particular wage or price decision is in accord with the policy. To tailor the overall wage-price policy adopted by Congress to the circumstances and needs of particular industries and firms is an administrative task. In my opinion, this function should not be assumed by Congress, the Joint Economic Committee, or the Council of Economic Advisers. It should be given to an administrative agency. However, a tripartite committee, representing labor, management, and the consuming public, should be appointed by the President for each industry, to advise the agency in the formulation of a specific wage-price policy for that industry. It is important that such advisory committees be set up as quickly as possible in those industries in which wage agreements will be newly negotiated in 1967.

In addition, the agency should be required to hold public hearings on the wage-price policies proposed for particular industries and to issue written statements justifying the policies adopted for each industry. In time, this agency should have valuable advice to offer to all concerned with the formulation of the overall wage-price policy, which should be under constant review by the Congress.

If there is to be voluntary compliance with the wage-price policies thus formulated for an industry, and if the force of public opinion is to be brought to bear to help secure compliance, then labor, management, and the public must be able to know whether a particular wage or price decision accords with the policies laid down. The administration of the guidepost policy to date has not assured the availability of such knowledge. Indeed, the Council of Economic Advisers admits that when it meets privately with producers about price increase, "it ordinarily does not have the detailed information which would permit a clear judgment as to the appropriateness of the proposed price change on either the basis of the guidepost standards or other relevant considerations."

To determine whether a particular wage or price decision accords with the stabilization policies laid down is a task that must be performed by an impartial, respected public body. It requires a judicious approach which should include a full and fair hearing for the interested parties and for public representatives.

I do not think that the Council of Economic Advisers should be asked to perform this function of hearing and judging. Nor, with all due respect, do I think that this excellent committee is the appropriate body to do the job. This task is likely to be accomplished more expertly and fairly outside the Halls of Congress. I would recommend, therefore, that it be given to the agency charged with formulating the industrywide policies. This agency will thereby gain experience with particular situations which will help it in formulating these policies. In turn, its experience in elaborating these policies will help it to judge specific cases.

Furthermore, because it is always difficult to secure the rescission of action that has been taken, Congress should require labor and management to give this agency advance notice of any proposed wage or price increase. The agency should then be relied upon to institute hearings in those cases in which it thinks that a proposed wage or price increase may threaten national economic stability. After hearing, the agency should be required to publish its findings and recommendations in the case.

It is also very important to authorize the agency to initiate hearing in those cases in which it thinks price decreases are called for by the stabilization policies, and the failure to make the decreases threatens national economic stability. The Government's past interventions to secure compliance with the guideposts have raised serious questions of propriety. Too often they have become public tests of strength between the President of the United States and the executives of a great industry or a great labor union.

"In any such confrontation with the President," Alcoa's President Harper has said, "there can and should be only one outcome." But precisely here is the difficulty. In such a test of strength, the President must not lose. But this necessity itself creates the danger that the outcome may be arbitrary.

Furthermore, whenever, in order to have his way, the President must resort to means other than persuasion—such as selling stockpiled materials, awarding contracts to producers who have not raised their prices, instituting tax or antitrust investigations—he will subject himself, inevitably, to criticism for allegedly abusing his authority.

Equally troublesome, there can be no certainty in this situation that the President will deal even-handedly with all those who are similarly situated. Not only is the fairness of this system of enforcement in question, but the haphazard quality of Presidential intervention also makes it an ineffective way to enforce stabilization policies.

Finally, in time, labor and management will appreciate that even the powers of the President are limited and begin to flout the President's policies with impunity. I am afraid that the President's 1967 Economic Report reflects his estimate that this time has already come.

The suggestions that I have put before this committee may make it possible to carry out the overall wage-price policy adopted by Congress effectively and equitably without the personal intervention of the President. I would hope and expect that these suggestions will maximize the possibility of securing the voluntary cooperation of labor and management, and, if necessary, of mobilizing public opinion to induce such compliance.

For this reason I do not recommend that Congress, at this time, should impose any sanctions for noncompliance with the wage-price policies that will be elaborated under the authority of the legislation I have outlined.

I would not object, however, if Congress should decide to impose such sanctions. I would not object to sanctions because I do not think that the controls which Congress would then be legislating would displace a free market. On the contrary, they would displace the exercise of private power over the market by the exercise of public authority in the interest of economic stability.

It is very important, in my view, Mr. Chairman, that we should not be ruled by a taboo against price and wage controls. They constitute a way of managing the economy which must be compared and evaluated with other ways. We are told by Chairman Ackley that if the actions of labor and management "create an inflationary spiral, the most likely outcome will be restrictive fiscal and monetary policies which will aim to stop further price increases but will in the process also reduce output, cut back profits, and reduce employment." Because of its impact on our balance of payments, Chairman Ackley adds that the inflationary spiral will also have to be fought by "cutting back or eliminating expenditures on foreign economic assistance, by yielding to restrictionist pressures in our trade policy, and by further limitations on the outflow of capital to friendly nations."

Certainly, Mr. Chairman, even direct controls deserve the most serious consideration as an alternative to policies that would have these disastrous consequences. They may permit us once and for all to abandon the idea of managing the economy through unemployment. And they may even eliminate any possible necessity for a tax increase in 1967.

Thank you, Mr. Chairman.

(The prepared statement of Mr. Auerbach follows:)

#### PREPARED STATEMENT OF CARL A. AUERBACH

Mr. Chairman, you have invited me to discuss the wage-price policies set forth in the President's Economic Report and the Annual Report of the Council of Economic Advisers. Both the President and the Council have been criticized

in recent weeks for abandoning the wage-price guideposts. Yet this criticism is too general and, therefore, unfair. This Committee will come to grips with the difficult problems of economic stabilization we face this year only if it is clear about the specific nature of the changes in the Administration's wage-price policy.

#### HAVE THE GUIDEPOSTS BEEN ABANDONED?

The President regards the restoration of price stability as "one of our major tasks,"<sup>1</sup> the accomplishment of which will require "the responsible conduct of those in business and labor who have the power to make price and wage decisions."<sup>2</sup> The President is also quite definite about what conduct of business and labor would be irresponsible. "If unions now attempt to recoup in wages all of the past or anticipated advance in the cost of living—in addition to the productivity trend" and "if businesses now seek to pass along rising costs when it would be possible to absorb them or do not reduce prices when costs fall," then, the President warns, the result will be a wage-price spiral "damaging to business, damaging to labor, and disastrous to the Nation."<sup>3</sup>

Furthermore, the Council of Economic Advisers has attempted to define the affirmative requirements of responsible conduct on the part of labor and business. So far as wage policy is concerned, the Council is still firmly of the opinion that the "only valid and noninflationary standard for wage advances is the productivity principle."<sup>4</sup> Nothing in its Report gives any indication that the Council has abandoned its position that the trend of productivity which should govern wage movements is 3.2 percent a year.<sup>5</sup> "If price stability is eventually to be restored and maintained in a high-employment U.S. economy", the Council insists, "wage settlements must once again conform to that standard."<sup>6</sup>

Those who seek a specific wage guidepost figure in the Council's Report will find that it continues to be 3.2 percent a year. But as a practical matter, the Council—and the President—recognize that the 3.3 percent increase in the cost of living in 1966 and the unusually high profits earned in recent years make "it unlikely that most collective bargaining settlements in 1967 will fully conform to the trend increase of productivity."<sup>7</sup> And the President obviously thinks it would be futile for him to try to see that these settlements do so conform.

Since the Council, even under current conditions, adheres to the productivity principle, it "sees no useful purpose to be served by suggesting some higher standard for wage increases, even on a temporary basis."<sup>8</sup> It calls for "restraint in wage settlements" and defines "restraint" to mean "wage advances which are substantially less than the productivity trend plus the recent rise in consumer prices."<sup>9</sup> It also calls upon producers to "absorb cost increases to the maximum extent feasible, and take advantage of every opportunity to lower prices."<sup>10</sup> In like vein, the President appeals "to business and labor—in their own interest and that of the Nation—for the utmost restraint and responsibility in wage and price decisions."<sup>11</sup>

#### HOW HAS ADMINISTRATION POLICY CHANGED?

In my opinion, the most significant change in the Administration's policy is not that it has refused to specify a single figure as the wage guidepost for 1967. Neither President Truman, who originated the guidepost policy, nor Presidents Eisenhower and Kennedy, who further elaborated it, ever specified such figures. It is more significant that President Johnson has apparently abandoned the policy—which on occasion was also of President Kennedy—of using the influence and prestige of the Presidency to assure that particular wage and price decisions satisfy the requirements of the public interest as viewed by the President.

Gone from the President's 1967 Economic Report are his 1964 and 1965 pledges that he would "not hesitate to draw public attention to major actions by either

<sup>1</sup> 1967 Economic Report of the President, at 11.

<sup>2</sup> *Id.* at 12.

<sup>3</sup> *Ibid.*

<sup>4</sup> 1967 Annual Report of Council of Economic Advisers, at 128.

<sup>5</sup> See *id.* at 123.

<sup>6</sup> *Id.* at 128.

<sup>7</sup> *Ibid.*

<sup>8</sup> *Ibid.*

<sup>9</sup> *Id.* at 129.

<sup>10</sup> *Id.* at 133.

<sup>11</sup> 1967 Economic Report of the President, at 13.

business or labor that flout the public interest in noninflationary price and wage standards";<sup>12</sup> or his 1966 declaration that "it is vitally important" that labor and industry follow the guideposts.<sup>13</sup> Instead, we have the presidential "appeal to business and labor—in their own interest and that of the Nation—for the utmost restraint and responsibility in wage and price decision."<sup>14</sup>

The Council, which has been the President's executive arm for administering and enforcing the guideposts, has stated that it will continue to meet privately with "leaders of business and labor" in order "to underscore the public interest factor in wage and price decisions and to solicit the cooperation of union and corporate leadership in specific situations."<sup>15</sup> But it does not state that it will henceforth, as it has on occasion in the past, issue "formal statements to the public commenting on particular wage or price decisions."<sup>16</sup>

While there is no firm basis for reading into the President's Economic Report an espousal of a policy of non-intervention in private wage- and price-decision-making, it is fair to interpret it as adopting a policy of limiting the Government's weapons of intervention to information and persuasion and renouncing future efforts to apply "sanctions" to "violators" of the guideposts.

If this is a correct interpretation of administration policy, the change is to be welcomed—not deplored—and particularly if Congress now meets its obligations and acts to accomplish the objectives which Congressman Reuss has urged upon it in recent years.

#### DIFFICULTIES WITH GUIDEPOST POLICY AND SUGGESTIONS FOR OVERCOMING THEM

Very serious—and legitimate—criticism may be directed at the way the guidepost policy has been formulated and administered to date. It has tended, in my view, to jeopardize the values which we associate with the rule of law in our democracy.

##### *Need for a wage-price policy*

To be clear about the problem we face, we must begin with the fact—which Presidents Truman, Eisenhower, Kennedy and Johnson, their Councils of Economic Advisers and, I think, this Committee, have accepted—that structural characteristics of the American economy are responsible for the tendency of wages and prices to rise even before full employment is achieved. Historical experience has convinced us of this fact. Prices increased rapidly in 1937 despite massive unemployment and under-utilization of resources. The defense program of 1940 and 1941 produced inflation even though the economy was then operating far below capacity. Events from 1956 to 1958 again showed that we could have inflation in the absence of excess demand, and indeed, even in the face of declining demand. The experience of the last year only adds to the proof. "The critical economic problem to be solved in the year ahead", the Council tells us, "is that of maintaining income growth and full utilization of resources without becoming trapped in an inflationary price-wage spiral."<sup>17</sup>

Experience has also demonstrated that monetary and fiscal policies alone cannot prevent an inflationary price-wage spiral without sacrificing the twin objectives of income growth and full utilization of resources. In order words, we constantly hesitate to use monetary and fiscal policies to the extent necessary to attain these objectives for fear of inflation. To remove this hesitation, it is commonly accepted, price and wage restraint will have to be practiced in certain sectors of the otherwise unregulated private economy. Differences quickly arise when the discussion shifts to the means of assuring that such private restraint, in fact, will be practiced.

##### *Stabilization without representation*

The guidepost policy is defended as a means of assuring such private restraint principally on the ground that it is not a policy of compulsion but one that calls for "voluntary" compliance with its requirements. As Chairman Ackley succinctly put it, having "been exposed to persuasion and willing to risk

<sup>12</sup> 1964 Economic Report of the President, at 11; 1965 Economic Report of the President, at 13.

<sup>13</sup> 1966 Economic Report of the President, at 12.

<sup>14</sup> 1967 Economic Report of the President, at 13.

<sup>15</sup> 1967 Annual Report of Council of Economic Advisers, at 126-127.

<sup>16</sup> *Id.* at 127.

<sup>17</sup> *Id.* at 72.

the censure of public opinion," labor and management are "able in the end to violate the guideposts with impunity."<sup>18</sup>

It would seem that the advocates of a policy which depends for its effectiveness upon the voluntary action of labor and management should have tried to enhance its acceptability by affording these groups an opportunity to participate in its formulation. Yet there is no evidence that representatives of labor and management—or even the President's Advisory Committee on Labor-Management Policy—participated in the formulation of the original guideposts in 1962 or in their subsequent elaboration. It is interesting in this connection that the only reference to the President's Advisory Committee on Labor-Management Policy in the current Economic Report is the Council's statement that its activities in 1967 included meeting formally with a number of advisory groups, one of which was the President's Advisory Committee.<sup>19</sup>

Both the AFL-CIO and spokesmen for various industry groups have attacked the guidepost policy. Secretary of Labor Wirtz thinks that a "good deal of the objection to" the guidepost policy "is that it seemed to constitute 'stabilization without representation'."<sup>20</sup>

#### *Lack of consensus about wage-price policy*

The failure to recognize the necessity for participation of the major interests affected by the guidepost policy in its formulation is due, in my opinion, to the technocratic attitude of the Kennedy and Johnson Administration toward this policy. President Kennedy most clearly expressed this attitude in his celebrated 1962 Commencement Address at Yale University when he called for "more basic discussion of the sophisticated and technical questions involved in keeping our mighty economic machine moving steadily ahead."<sup>21</sup> The present Council is fond of speaking about the "arithmetic" of the guideposts.<sup>22</sup> But, in truth, the problems of stabilization are not merely "sophisticated" and "technical" and "arithmetic" alone will not solve them.

The participation of labor and management in the formulation and administration of a wage-price policy might nevertheless be unnecessary if general agreement existed on what this policy should be and how it should be applied. But I need not tell the members of this Committee that there is no such consensus.

#### *How much unemployment should be tolerated in the interest of price stability?*

There probably is agreement in the country that full employment, rapid economic growth and price stability are all desirable. Probably there is also agreement that uncontrolled inflation of long duration not only will interfere with the process of production itself, thereby jeopardizing the possibility of full employment, but also will result in inequities that will threaten to undermine our social and political structure. But there is no agreement about how much price instability at any particular time may be tolerated in the interest of fuller employment or for how long such price instability may be endured without risking uncontrollable inflation. There is no shared understanding of when employment is "full" or how rapidly our economy should grow.

Paul A. Samuelson and Robert M. Solow wrote in 1959 that the country has a "menu of policy choices" which involve the balancing of different levels of employment and output against varying degrees of price instability.<sup>23</sup> Those of our people who live on fixed or relatively fixed incomes, those with secure jobs, savings depositors, owners of life insurance and mortgagees would like to see the balance struck in favor of price stability. The unemployed—and all who are troubled about the social costs of unemployment—would like to see the balance struck in favor of still higher levels of production and employment. It is the purpose of a wage-price policy to "lessen the degree of disharmony between full employment and price stability."<sup>24</sup> But the disharmony cannot be avoided completely.

<sup>18</sup> Hearings on H.R. 11916 before a subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 67 (1967) (statement of Chairman Ackley).

<sup>19</sup> 1967 Annual Report of Council of Economic Advisers, at 206.

<sup>20</sup> Hearings on H.R. 11916 before a subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 93 (1966) (statement of Secretary Wirtz).

<sup>21</sup> Wall Street Journal, June 12, 1962, p. 20, col. 1.

<sup>22</sup> 1967 Annual Report of Council of Economic Advisers, at 120; Hearings on H.R. 11916 before a subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 82 (statement of Chairman Ackley).

<sup>23</sup> Samuelson and Solow, Our Menu of Policy Choices, in *The Battle Against Unemployment* 74 (Okun ed., 1965).

<sup>24</sup> *Id.*, at 75-76.

*Should wage rate increases be limited by the rate of increase in productivity; if so, how?*

Equally important, there is no agreement on the ingredients of a desirable wage-price policy. This Committee has heard testimony that the wage guideposts should not always tie wage rate increases to the rate of increase in productivity because the increasing productivity of capital may require, for a while, that wage earner gains exceed productivity gains in order to restore economic equilibrium.<sup>25</sup> It has also heard the wage guideposts criticized because, allegedly, they reinforce the myth in the public mind "that everyone is entitled to some average productivity increase in wages annually."<sup>26</sup>

Among those who accept the principle that wage rate increases should be tied to productivity rate increases, there is disagreement as to whether the standard should be the nation-wide trend rate of productivity-increase or the rate of productivity-increase in the particular industry in question.<sup>27</sup> There is also disagreement as to how the trend rate of productivity increase, on the one hand,<sup>28</sup> and employee compensation per man-hour, on the other,<sup>29</sup> should be measured. These may be issues which, eventually, technical experts should be able to resolve to everyone's satisfaction. But the guidepost policy also raises questions as to what is a "fair" wage and a "fair" profit and an "equitable" distribution of the national income on which opinions and interests will remain in sharp conflict.

*Should increases in real, not money, wages be used for guidepost comparisons?*

The conflicts of interest become apparent when we turn to the question whether wage rate increases should be limited by the trend rate of productivity growth even in the face of significant increases in the cost of living. The guideposts assumed that real wages would go up as productivity increased. But this has not happened because price stability has not been maintained. Under these circumstances I agree with Mr. Gerhard Colm that it is not realistic or equitable to expect a "union whose contract is under consideration . . . to pay the penalty for the failure of government, business and other unions to do their part in the stabilization effort."<sup>30</sup> Therefore we should not blame such a union for seeking to improve its position.

Whether particular unions will exercise restraint in this struggle and be satisfied with only a "partial and gradual adjustment" for cost of living increases<sup>31</sup>—as Mr. Colm recommends—may depend upon whether labor is convinced that the stabilization program is being applied "equitably to all groups in the population."<sup>32</sup> But obviously there is no agreement in the country on what the principle of equality of sacrifice now requires because there is no agreement on what is an "equitable" distribution of income.

*Bargaining about distribution of income*

When it erected the original guideposts in 1962, the Council of Economic Advisers recognized that, if adhered to, they would perpetuate the existing "relative

<sup>25</sup> Hearings on 1963 Economic Report of the President Before Joint Economic Committee, 88th Cong., 1st Sess. 727 (1963); Hearings on 1965 Economic Report of the President Before Joint Economic Committee, 89th Cong., 1st Sess., pt. 4, at 27 (testimony of Mr. Leon Keyserling).

<sup>26</sup> Hearings on 1964 Economic Report of the President Before Joint Economic Committee, 88th Cong., 2d Sess. 219 (1964) (testimony of Professor Walter D. Fackler).

<sup>27</sup> See 1950 Annual Economic Review of Council of Economic Advisers, at 101; Hearings on H.R. 11916 Before a Subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 82-83 (statement of Chairman Ackley); Joint Economic Committee, Report on Jan. 1964 Economic Report of the President, S. Rep. No. 931, 88th Cong., 2d Sess. 38 (1964) (minority views); Hearings on 1964 Economic Report of the President Before Joint Economic Committee, 88th Cong., 2d Sess., pt. 2, at 158 (testimony of Mr. W. A. Boyle, President of United Mine Workers); N.Y. Times, Aug. 9, 1966, p. 1, col. 8 (views of Secretary of Commerce John T. Connor).

<sup>28</sup> See for example, Hearings on 1966 Economic Report of the President Before Joint Economic Committee, 89th Cong., 2d Sess. 398 (1966) (testimony of Mr. Walter Reuther); *id.* at 617-618 (testimony of Mr. Leon Keyserling); Joint Economic Committee, Report on Jan. 1964 Economic Report of the President, S. Rep. No. 931, 88th Cong., 2d Sess. 38 (1964) (minority views).

<sup>29</sup> See for example, Hearings on 1965 Economic Report of the President Before Joint Economic Committee, 89th Cong., 1st Sess., pt. 3, at 102 (1965) (testimony of Mr. Leon Keyserling); Hearings on 1966 Economic Report of the President Before Joint Economic Committee, 89th Cong., 2d Sess. 444 (1966) (testimony of Mr. Elisha Gray II).

<sup>30</sup> Hearings on H.R. 11916 Before a Subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 7, 8 (1966) (statement of Mr. Colm).

<sup>31</sup> *Id.* at 8.

<sup>32</sup> See statement of AFL-CIO Executive Council, The American Federationist, Sept. 1966, p. 8.

shares of labor and nonlabor incomes in total output.”<sup>33</sup> So it emphasized that “there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes.”<sup>34</sup> It thought it desirable that labor and management “should bargain explicitly about the distribution of income of particular firms or industries”, so long as they did so within the framework of a stable price level.<sup>35</sup> However, if such bargaining resulted in price increases, the Council pointed out labor and management would not be redistributing income within the industry involved; they would be redistributing income “between that industry and other segments of the economy through the mechanism of inflation.”<sup>36</sup>

The Council affirmed this position in 1964, stressing that price behavior in an industry in which such bargaining was going on must remain consistent with the general price guidepost. This guidepost, as we know, requires that in an industry “whose trend productivity is growing more rapidly than the national average, product prices should be lowered enough to distribute to the industry’s customers the labor-cost savings it would make under the general wage guidepost.”<sup>37</sup> In effect, the Council was saying that bargaining about the distribution of income in such an industry should take place only *after* prices are reduced to the extent indicated. Labor might then receive a larger share of the industry’s income if it won greater wage increases than the productivity standard permitted or a larger share might go to profits if the workers were granted smaller wage increases than the productivity standard permitted.

But the Council has vacillated on the desirability of bargaining about the distribution of income. In 1965 it felt constrained to warn that experience during the 1950’s demonstrated that such bargaining “proved self-defeating”, that neither labor nor capital “gained, and both lost through higher prices, weaker markets, reduced profits, and lower employment.”<sup>38</sup> In 1966, apparently, it felt that it had gone too far in advising labor not to bargain collectively for a change in the distribution of income. So it retreated to the position that “public policy is and should remain neutral with respect to wage and price decisions that attempt to change the distribution of industry’s income between labor and capital”—so long as such decisions do not produce inflationary pressures.<sup>39</sup> This year, however, the Council repeats its warning “that attempts on the part of unions to redistribute income from profits to wages through excessive wage increases in high-profit industries results primarily in higher prices in those industries” and in the redistribution of “real income from the rest of the community—who are mostly other wage earners—to the workers in question, with very little redistribution from profits to wages.”<sup>40</sup>

But of course this is true only because management in high-profit industries has been unwilling to reduce prices and no means have been found to require it to do so. Recognizing that it is unfair to ask workers to restrain their wage demands if their restraint will only result in higher profits, the Council appeals for forbearance on the part of management. It asks producers to “absorb cost increases to the maximum extent feasible, and take advantage of every opportunity to lower prices.”<sup>41</sup> For the first time, too, the Council states that profit margins appropriate for the boom stage of a boom and bust economy—to which it likens 1966 average profit margins of manufacturers which were higher, as a percentage of equity, than in any prior year since the highly inflationary year of 1950—are too high for a steadily expanding economy.<sup>42</sup> Indeed, the Council maintains that lower profit margins may be essential to maintain a steadily expanding economy.<sup>43</sup>

But there is no agreement in the country on any standard of “reasonable” profits that would tell us to what extent producers should absorb cost increases and how much lower profit margins should be. For this reason, we cannot tell whether a wage increase higher than that permitted by the wage guideposts should have the effect of redistributing the industry’s income or should justify a price increase or a smaller price decrease than the guideposts would call for.

<sup>33</sup> 1962 Annual Report of Council of Economic Advisers, at 186.

<sup>34</sup> *Ibid.*

<sup>35</sup> *Id.* at 188.

<sup>36</sup> *Ibid.*

<sup>37</sup> 1964 Annual Report of Council of Economic Advisers, at 119.

<sup>38</sup> 1965 Annual Report of Council of Economic Advisers, at 109.

<sup>39</sup> 1966 Annual Report of Council of Economic Advisers, at 91.

<sup>40</sup> 1967 Annual Report of Council of Economic Advisers, at 132.

<sup>41</sup> *Id.* at 133.

<sup>42</sup> *Ibid.*

<sup>43</sup> *Ibid.*

Under these circumstances little is gained by asking management to adopt a principle of profit minimization or even to blame it for trying to maximize profits.

Yet the fact remains that unless agreement is reached on some standard of "reasonable" profits to guide price policy in the administered-price industries, organized labor cannot reasonably be expected to acquiesce in absorbing any part of the cost of living increases due to the rise in prices in other sectors of the economy—in farm products and services, for example. Nor can it be expected to heed the Council's advice that it pay for the higher minimum wage by accepting lower wage increases than the average permitted by the productivity standard.<sup>44</sup>

*A proposal for congressional formulation of a wage-price policy*

I shall not try to suggest answers to the many questions I have raised. The point I wish to make is that the issues raised by the guideposts—or any wage-price policy—are the kind that are resolved in our democracy only by an accommodation of conflicting claims which all concerned find tolerable. To each such an accommodation, labor and management must be given the opportunity to participate in the formulation of a wage and price policy. Furthermore, since any bargain that these groups may strike will affect the life of the ordinary citizen more than much legislation passed by Congress, Congress must be the final arbiter.

Accordingly, I urge this Committee to institute hearings immediately to determine what our wage-price policy should be in the period ahead. Representatives of labor, management, the public—and of course the Administration—should be heard. This Committee should then write a report which would enable the appropriate legislative committees of Congress, if they approved it, to draft a bill setting forth the components of an overall wage-price policy.

It has been objected that it is unwise to legislate a wage-price policy because that will give it "legal status and a flavour of compulsion" and destroy its voluntary character.<sup>45</sup> But if it is agreed that representatives of labor, management and the public should participate in formulating a wage-price policy, some way must be provided for settling controversies that may arise. Only the President or Congress can do so; I think Congress should do so but that it should act in a manner that will require it to run the gauntlet of a possible Presidential veto.

Furthermore, I do not see why congressional formulation of a wage-price policy, by itself, will destroy the voluntary nature of labor-management compliance with the policy.

*Translating the overall wage-price policy into specific policies for particular industries*

Flexibility was the key to the 1962 formulation of the guideposts. In addition to the factors making for flexibility which I have already mentioned, the 1962 formulation recognized exceptions in the interests of "efficiency and equity."<sup>46</sup> Exceptions from the general wage guidepost were envisaged for an industry which was unable to attract sufficient labor and for one which was unable to provide jobs for its entire labor force; and for industries in which wage rates were either exceptionally low or exceptionally high compared with those earned elsewhere by similar labor.<sup>47</sup> Similarly, exceptions from the general price guidepost were expected in industries in which the level of profits was insufficient to attract the capital required to finance a needed expansion in capacity or in which the relation of productive capacity to full employment demand showed the desirability of an outflow of capital; in industries in which costs other than labor costs had either risen or fallen; and in which excessive market power had resulted in rates of profit substantially higher than these earned elsewhere on investments of comparable risk.<sup>48</sup>

In 1964, for the first time, the Council announced that the general guideposts could "cover the vast majority of the wage and price decisions" and that the exceptions recognized in 1962 were "intended to apply to only a relatively few cases."<sup>49</sup> The Council affirms this position in its 1967 report. While it con-

<sup>44</sup> *Id.* at 130.

<sup>45</sup> Hearings on H.R. 11916 Before a Subcommittee of the House Committee on Government Operations, 89th Cong., 2d Sess. 91 (1966) (statement of Chairman Ackley objecting to the Reuss bill which would not go as far as the suggestion made above).

<sup>46</sup> 1962 Annual Report of Council of Economic Advisers, at 188.

<sup>47</sup> *Id.* at 189.

<sup>48</sup> *Ibid.*

<sup>49</sup> 1964 Annual Report of Council of Economic Advisers, at 119.

tinues to recognize exceptions from the general wage guidepost "that serve an economic function by assisting in the reallocation of labor toward shortage occupations and industries," it points out that "the remaining labor shortages this year will be concentrated in unorganized professional and technical occupations."<sup>50</sup> The Council also seeks to confine the "comparable wages" exception from the general wage guidepost.<sup>51</sup>

But the Council's continuing attempt to prevent the flexibility that must be part of any wage-price policy from becoming the means to defeat the policy itself is negated this year by the practicalities of the situation the Council faces. It does not believe that any firm rules will or can be applied for the movement of either wages or prices in 1967.

In fact, no overall wage-price policy formulated by the President or Congress can be expected to set forth clear guides to action in every case. The more general and more flexible the statement of such a policy, the more difficult it will be to apply it to any particular industry or firm and therefore the more difficult it will be to judge whether a particular wage or price decision is in accord with the policy.

*A proposal for administrative implementation of the overall policy adopted by Congress*

To tailor the overall wage-price policy adopted by Congress to the circumstances and needs of particular industries and firms is an administrative task. In my opinion, this function should not be assumed by Congress, the Joint Economic Committee or the Council of Economic Advisers. It should be given to an administrative agency. However, a tripartite committee—representing labor, management and the consuming public—should be appointed by the President for each industry to advise the agency in the formulation of a specific wage-price policy for that industry. It is important that such advisory committees be set up as quickly as possible in those industries in which wage agreements will be newly negotiated in 1967. In addition, the agency should be required to hold public hearings on the wage-price policies proposed for particular industries and to issue written statements justifying the policies adopted for each industry. In time, this agency should have valuable advice to offer to all concerned with the formulation of the overall wage-price policy, which should be under constant review by the Congress.

*Determining whether a particular price or wage decision accords with the wage-price policies adopted for the industry*

If there is to be voluntary compliance with the wage-price policies thus formulated for an industry—and if the force of public opinion is to be brought to bear to help secure compliance—then labor, management and the public must be able to know whether a particular wage or price decision accords with the policies laid down. The administration of the guidepost policy to date has not assured the availability of such knowledge. Indeed, the Council of Economic Advisers admits that when it meets privately with producers about price increases, "it ordinarily does not have the detailed information which would permit a clear judgment as to the appropriateness of the proposed price change on either the basis of the guide post standards or other relevant considerations."<sup>52</sup> Nor has such detailed information been made available even in those cases in which the Council has issued formal statements to the public commenting on particular wage or price decisions. Yet in many cases, labor and industry spokesmen have challenged the Council's application of the guideposts to their situations. For example, the steel industry in 1962 and 1966, the aluminum industry in 1966 and the machinists in the airline industry in 1966 challenged Council conclusions.

*A proposal for hearings to determine propriety of particular wage or price decisions*

To determine whether a particular wage or price decision accords with the stabilization policies laid down is a task that must be performed by an impartial, respected public body. It requires a judicious approach which should include a full and fair hearing for the interested parties, including public representatives.

<sup>50</sup> 1967 Annual Report of Council of Economic Advisers, at 130.

<sup>51</sup> *Id.* at 130-131.

<sup>52</sup> *Id.* at 126.

I do not think the Council of Economic Advisers should be asked to perform this function of hearing and judging. Nor, with all due respect, do I think that this excellent Committee is the appropriate body to do the job. This task is likely to be accomplished more expertly and fairly outside the halls of Congress. I would recommend, therefore, that it be given to the agency charged with formulating the industry-wide policies. This agency will thereby gain experience with particular situations which will help it in formulating these policies. In turn, its experience in elaborating these policies will help it to judge specific cases.

*Advance notice of proposed wage and price actions*

Furthermore, because it is always difficult to secure the rescission of action that has been taken, Congress should require labor and management to give this agency advance notice of any proposed wage or price increase. This requirement will apply, it should be recalled, only to those industries in which labor and management have a substantial measure of discretion in setting wages or prices. The agency should then be relied upon to institute hearings in those cases in which it thinks that a proposed wage or price increase may threaten national economic stability. After hearing, the agency should be required to publish its findings and recommendations in the case.

The Council of Economic Advisers reports that "the greatest failure of observance of the price guidepost lies in the failure to reduce prices on a considerable number of the product lines of a large number of industries."<sup>53</sup> For this reason, it is important to authorize the agency to initiate hearings in those cases in which it thinks price decreases are called for by the stabilization policies and the failure to make them threatens national economic stability.

*Securing compliance with wage-price policies*

The government's past interventions to secure compliance with the guideposts raise serious questions of propriety. Too often, they have become public tests of strength between the President of the United States and the executives of a great industry or a great labor union. "In any such confrontation with the President," Alcoa's President Harper has said, "there can and should be only one outcome."<sup>54</sup> Precisely here is the difficulty. In such a test of strength, the President must not lose. But this necessity itself creates the danger that the outcome may be arbitrary.

Furthermore, whenever, in order to have his way, the President must resort to means other than persuasion—such as selling stockpiled materials, awarding contracts to producers who have not raised their prices, instituting tax or antitrust investigations—he will subject himself, inevitably, to criticism for allegedly abusing his authority.

Equally troublesome, there can be no certainly in this situation that the President will deal even-handedly with all those who are similarly situated. Not only is the fairness of this system of enforcement in question, but the haphazard quality of president intervention also makes it an ineffective way to enforce stabilization policies. Finally, in time, labor and management will appreciate that even the powers of the President are limited and begin to flout the President's policies with impunity. I am afraid that the President's 1967 Economic Report reflects his estimate that this time has already come.

The suggestions that I have put before this Committee may make it possible to carry out the overall wage-price policy adopted by Congress effectively and equitable without the personal intervention of the President.

At this time, I do not suggest that Congress should impose any sanctions for non-compliance with the wage-price policies that will be elaborated under the authority of the legislation I have outlined. I would hope—and I expect—that Congressional adoption of a wage-price policy, subsequent administrative implementation of the policy on an industry-by-industry basis and public hearings to determine whether particular wage-price decisions accord with the policies formulated—will maximize the possibility of securing the voluntary cooperation of labor and management and, if necessary, of mobilizing public opinion to induce such compliance.

I would not object, however, if Congress decides to impose some sanctions; if, for example, it specifically authorizes and directs the President to manage the

<sup>53</sup> *Id.* at 125.

<sup>54</sup> Harper, *A Businessman's View of Guideposts*, in Committee for Economic Development, *Managing a Full Employment Economy* 39 (1966).

country's stockpiles of materials so as to help effectuate price stabilization objectives or to write into every Government contract and subcontract a requirement that the contractor comply with the wage-price policies formulated for his industry. I would not object if Congress provides that wage increases in excess of those permitted by the applicable wage-stabilization policies should not be recognized as business costs for tax purposes and that net income attributable to price actions in conflict with applicable price-stabilization policies should be subject to a tax of 100%; or even if Congress makes available more traditional civil and criminal penalties. Some sanction may prove to be necessary to assure compliance with the requirement that advance notice be given of certain proposed wage or price actions. And it may prove to be impossible, without some sanction, to bring about the price and profit reductions which the stabilization policies may call for and without which the structure of voluntary compliance may collapse.

I would not object to sanctions because I do not think that the controls which Congress would then be legislating would displace a free market. On the contrary, they would displace the exercise of private power over the market by the exercise of public authority in the interest of economic stability.

It is important that we should not be ruled by a taboo against price and wage controls. They constitute a way of managing the economy which must be compared and evaluated with other ways. We are told by Chairman Ackley that if the actions of labor and management "create an inflationary spiral, the most likely outcome will be restrictive fiscal and monetary policies which will aim to stop further price increases but will in the process also reduce output, cut back profits, and reduce employment."<sup>55</sup> Because of its impact on our balance of payments, Chairman Ackley adds that the inflationary spiral will also have to be fought by "cutting back or eliminating expenditures on foreign economic assistance, by yielding to restrictionist pressures in our trade policy, and by further limitations on the outflow of capital to friendly nations."<sup>56</sup>

Certainly, even direct controls deserve the most serious consideration as an alternative to policies that would have these deleterious consequences. They may permit us once and for all to abandon the idea of managing the economy through unemployment.

Chairman PROXMIRE. Thank you very much, Professor Auerbach. Let me see if I understand your proposal. You would establish boards for the various industries which are characterized by administered price behavior and by large unions. The boards would consist of representatives of unions, management, and the public. They would hold public hearings on labor-management policy within the particular industry.

They would then make recommendations. For the time being, you would not insist on sanctions to carry out those particular recommendations. What have I missed here?

Mr. AUERBACH. The principal board that I envisage would not be a tripartite board. It would be an agency in the executive branch of the Government, preferably answerable to the President—not an independent agency.

The representation of labor, management, and the public would come through committees that would be advisory to this public body which would have the ultimate authority. I do not envisage that the agency that would be entrusted with the authority would itself be a tripartite board.

Chairman PROXMIRE. A tripartite board would be an agency that would be for the purpose of giving representation.

Mr. AUERBACH. Correct.

Chairman PROXMIRE. The kind of thing that Secretary Wirtz said was absent in the present stabilization policy.

<sup>55</sup> 1966 Annual Report of Council of Economic Advisers, at 93.

<sup>56</sup> Ackley, Why Stability of Copper Prices Is So Urgent an Objective of U.S. Policy, No. 14, 1965, p. 3 (unpublished mimeo.).

Mr. AUERBACH. That is right.

Chairman PROXMIRE. And the agency itself would recommend the level of wage increases.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. And also recommend whether prices would be permitted to go up or down in a particular industry.

Mr. AUERBACH. Yes, sir. I think that a reasonable argument could be made that the agency itself should be a tripartite board. But I react against proposals to give tripartite boards governmental authority.

Chairman PROXMIRE. I think it is most important that it be only advisory.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. I think that is very important.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. Because if you have a tripartite group of this kind, it might very well become biased.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. In favor of higher wages, higher prices.

Mr. AUERBACH. I agree.

Chairman PROXMIRE. And accommodation for the industry, and represent the industry, the industry's viewpoint. I have seen that happen sometimes and so have you.

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. So that you could then have a situation in which the educational process, which many say was the principal purpose of the wage-price guideline, would be enhanced by your advisory committees.

Mr. AUERBACH. I think so.

Chairman PROXMIRE. And in addition, you would have a public agency that would make specific recommendations?

Mr. AUERBACH. Yes, sir.

Chairman PROXMIRE. Then you say the sanctions would not be applied at least at first; is that correct?

Mr. AUERBACH. That is correct. I do not envisage that any sanctions would be provided at this time.

Chairman PROXMIRE. What would this do? Take an instant situation: A day or two ago American Motors announced that they were reducing prices on their automobiles, some of them very sharply, and this is a most encouraging development to many of us, not only those of us living in Wisconsin—we hope it means more jobs there—but it also means some initiative in the automobile industry itself to get lower prices.

Wouldn't the kind of process you propose tend to perhaps discourage that sort of initiative, that sort of competition? Wouldn't it tend to freeze a pattern, in which companies would be less inclined to take the initiative?

Mr. AUERBACH. I don't think so. A similar argument has been made against the guideposts themselves, that they would create rigidity by discouraging price decreases for fear that subsequent increases would have to be justified. But I don't believe that price decreases would be so discouraged. The competitive pressures which

induced American Motors to take this action would continue to operate even if my proposals were adopted.

Chairman PROXMIRE. It seems to me you are kind of institutionalizing this more, and making it more formal, and because you establish this kind of pattern, with a natural tendency for management to push for higher prices, and labor to push for higher wages, and the feeling that this is where you get your ultimate wage determination, where you get your ultimate price determination, I would be somewhat concerned about that possibility.

Let me ask you—is there any similarity between your proposal and the experience they have had in Britain, in their attempts to stabilize wages and prices? Do we gain anything from the results of their experience?

Mr. AUERBACH. You mean the current experience?

Chairman PROXMIRE. Yes.

Mr. AUERBACH. Well, the current experience is with a prices and incomes freeze—or standstill, as the British call it.

Chairman PROXMIRE. Yes; but the current experience some critics say has been the product of the failure of the boards that may be somewhat similar at least in objective to what you have recommended here, to achieve stability. What is your reaction to that?

Mr. AUERBACH. I think that it is true that the British National Board for Prices and Incomes may be similar to the stabilization agency that I have proposed. I don't believe, however, that the situations faced by the two countries are essentially the same, because the problems in Britain are longstanding problems of slow economic growth.

Chairman PROXMIRE. I understand that the recent decision by Britain was very probably independent of any wage-price problem. It was dependent on their international payments situation.

Mr. AUERBACH. Principally so, though the wage-price picture is part of the larger problem.

Chairman PROXMIRE. But what I am getting at is whether or not the experience prior to this that the British have had over a period of years would suggest this proposal will or will not work.

Mr. AUERBACH. I think that, on the whole, the prices and incomes policy that the Labor Party began to introduce when it came to power recently was different from the policy followed by its predecessor government. I don't think it can be said, definitively, that experience under this new policy was discouraging.

In fact, Prime Minister Wilson, if he holds to what he has told Parliament, intends to retain this policy after this period of freeze is over. His long-range plan is to return to the National Board for Prices and Incomes and require proponents of wage and price increases to justify their proposals before this Board.

We don't have enough experience, Mr. Chairman, to be confident that such boards are going to work effectively. All Western democratic countries face this problem of reconciling full employment and economic growth with price stability. It would not be accurate or helpful to say that any of them has succeeded in solving this problem, or that my proposals are certain to do the job. The verdict is not yet in.

Chairman PROXMIRE. Professor Auerbach, you have obviously done a lot of thinking about the overall principles involved in price stabilization. How do you resolve something that has come before the committee again and again? Professor Hansen brought it up in a very convincing way the other day, I thought; and both Walter Reuther and Mr. Goldfinger also brought it to our attention.

How do you resolve this real income dilemma? The whole principle as I understand it is that labor should receive an increase in real income comparable to their productivity increase. You indicate here, in discussing what Colm said the other day that you think you have got to compromise with this and give them something half way between their money income and their real income. That is what you would do, is provide for the increase in productivity and make a partial adjustment for the increase in the cost of living.

Now as soon as you do that, don't you erode the worker's benefit? Don't you create a situation in which he is going to get less than his productivity increase in real terms, and why should workers with a strong labor union, and with their principle supported by such eminent economists as Hansen and others, accept that?

Mr. AUERBACH. Well, Professor Hansen poses a dilemma which we haven't resolved and which I would like to comment on briefly.

The suggestion that Professor Hansen made is attractive and just. But surely labor understands that so long as there are no institutional means to control prices, any effort to obtain wage-rate increases equal to the rate of productivity increase plus post cost-of-living increases plus anticipated cost-of-living increases will create the threat of inflation. This is precisely how the wage-price spiral gets started.

Once the spiral gets started, labor as a whole will not benefit. The less tightly organized, the less fortunate segments of labor are going to suffer the most; the more tightly organized, the more fortunate segments of labor, at best, may hold their own.

In other words, I think that the equitable claim that labor makes for increases in real income cannot be denied. But those who are moved by this claim ought to give more attention than they have in the past to the problem of how you prevent the wage-price inflationary spiral from arising. When you begin to concentrate on that problem, you begin to talk about price control and the equitable distribution of income in the United States.

Chairman PROXMIRE. Senator Percy?

Senator PERCY. Good morning, Doctor. I certainly welcome the comment that you made when you said:

The change in the administration's policy is a welcome one, whereby formal statements to the public commenting on particular wage and price decisions might not be made as freely.

It is unusual for politicians to protect steel companies, but a rise in the steel price oftentimes is only a reflection of thousands of price increases and wage increases that the steel companies have already had. They simply have reflected in their price increase the increase in costs that they have been forced to absorb and feel that they can't, in the long-range good of their own industries—research, development, plowback of profits—continue to carry on. And yet they are the ones that are singled out as the whipping boys and in the industry

leadership made to appear as though they are not working in the public interest.

I am less enthusiastic about this concept of a council on prices and wages from the standpoint of advance notice, unless I have failed to understand it. How much advance notice would really be required by you before a price increase goes into effect? Is it a simultaneous public announcement?

Mr. AUERBACH. No, sir.

Senator PERCY. Of advice to the board, or what?

Mr. AUERBACH. No, sir. I am proposing that a requirement be imposed on people who exercise great power in our economy to justify their decisions publicly. This justification must take place before the action is taken. It ought not to be a post hoc rationalization. It ought to be a justification pursuant to a procedure which will make the actors—labor and management—receptive to counterargument. The actors must be able to hear what other people have to say and, in the light of what they have heard, decide whether they want to go through with their proposed actions or abandon or modify them.

In order to establish such a procedure, you obviously have to have a reasonable period of time elapse between the time the proposal is made and the time when the final decision is made.

Senator PERCY. I know that this problem comes up when the Congress gets into a discussion of the removal of or increase of an excise tax. At the moment it is apparent that there may be a reduction or an increase, it does affect buying at the marketplace.

Mr. AUERBACH. Yes, sir.

Senator PERCY. If a notification were given by a powerful industry, such as the automotive industry, or an electronic industry such as television, that a price reduction was going into effect as of a certain date, why would anyone buy the product until such time as that price reduction took effect?

Mr. AUERBACH. I would not contemplate that advance notice of price reductions would have to be given.

Senator PERCY. Only increases.

Mr. AUERBACH. Yes, sir; only increases.

Senator PERCY. I am still not clear as to how much timelag you would feel would be a requirement between the notification to the Government Advisory Board, whatever it may be called, and the time it takes effect in the market.

Mr. AUERBACH. Senator, if you were on such a board, how much time do you think you would need to become acquainted with the issues, to hear or read the evidence, to make up your own mind, and to elaborate the recommendations that you would like to make for the benefit of the public? I would accept whatever you thought was the time you needed for these purposes. I don't know that I can fix it. If I had that kind of responsibility and sat down with my colleagues to discuss the problem, I am sure we would be able to agree on how much advance notice it was reasonable to require.

There have been various periods mentioned in different bills that have been proposed. Isn't there a current bill by Congressman Celler on this point? You may, Senator Percy, know what period of time for advance notice is specified in the current Celler bill. The times

mentioned are usually 60 or 90 days. But I don't think that a precise figure is vital.

We need to accept or reject the principle underlying my proposal. If we don't accept the principle that people who exercise power should be held publicly accountable for the way they exercise that power, and ought to justify their actions before they take them, then we don't want any advance notice of these actions.

But if we accept this principle, then the problem of deciding how much advance notice is required to make it work will not be a problem on which reasonable people will differ very strongly. I think it would then be a minor problem.

Senator PERCY. Could you name the product, product lines or industries that you would feel would be major enough to have this impact?

Mr. AUERBACH. The industries may be defined in a number of ways. They have been defined in some of the bills by reference to the total value of their output. For example, advance notice may be required of any industry in which gross sales total \$200 million or more a year.

Other bills that I recall have tried to identify these industries in terms of the percentage of their total output accounted for by four or five firms in the industry, generally saying that any industry in which four or five firms account for 70 percent or more of the product must give the required advance notice. We are interested in advance notice only from firms in industries in which labor and management have a substantial measure of discretion in setting wages or prices and can take action that pervades the whole economy.

Senator PERCY. Would you say that an industry such as the meat-packing industry, which is a very large industry, would be exempt because of the nature of the product?

Mr. AUERBACH. No, sir. It is not the nature of the product that is crucial. It is crucial whether a few sellers in an industry have such control over the output that they have all of the characteristics of what the economists call oligopoly and can administer prices. In other words, do they exercise power over the market or not?

Senator PERCY. But, Professor, can you conceive that in an industry such as that, where prices change hourly from one bid to the next, that it is possible to give 60 or 90 days' notice on some sort of a price increase? I think this is theoretically and totally unrealistic as related to the marketplace, and I can name hard goods that are exactly the same way. In the radio industry, which is subject to tremendous competition from abroad, transistor radios prices change twice in a week in retail stores, by manufacturers responding to changes in market conditions, and yet that is a gigantic industry. Can you imagine the control for establishing reviews of price increases? It would be utter chaos.

Mr. AUERBACH. There are ways this problem could be handled. It really isn't as difficult as it sounds. For example, Senator, the public agency I propose could simply say that any industry may effectuate whatever changes it wishes in the relative prices of all the commodities it sells, without giving any advance notice, so long as the total effect of its actions is not to increase its gross revenues. After all, we are not really concerned about the relative prices of bacon and hamburger or of the various cuts of meat. We are concerned with overall

price stability—with the total impact of all the prices of all the commodities sold by the meatpackers on their profits and, consequently, on the wage demands which will be presented to them.

Senator PERCY. You have said that management in high-profit industries is unwilling to reduce prices.

Mr. AUERBACH. Yes, sir.

Senator PERCY. The point is often made that the Consumer Price Index really overstates the increase in prices, simply because quality changes that have been introduced have not been fully taken into account. Isn't your point considerably weakened when quality changes are taken into account?

Mr. AUERBACH. I think the criticism of the Consumer Price Index which you mention may well be justified. I don't know to what extent it is justified. But even if it were, I don't think it would affect the point that managements in high-profit industries are unwilling to reduce prices.

This is a serious point because the possibility of success of the guideposts, the arithmetic of the guideposts to which the Council refers, depends upon price reductions in those industries in which productivity-rate increases exceed the trend productivity-rate increase. These reductions have not occurred and it is precisely this fact that will give great impetus this spring to demands for higher wages.

Senator PERCY. Mr. Chairman, Paul McCracken, of the University of Michigan has written a paper which tests the market power theory and concludes that the problem is not, I think, nearly as serious as many people have pointed out. I would like unanimous consent to insert this statement in the record.

Chairman PROXMIRE. Without objection that will be done.

(The statement referred to follows:)

STATEMENT OF DR. PAUL W. MCCrackEN, EDMUND EZRA DAY UNIVERSITY PROFESSOR OF BUSINESS ADMINISTRATION, GRADUATE SCHOOL OF BUSINESS ADMINISTRATION, THE UNIVERSITY OF MICHIGAN \*

#### PRICE-COST BEHAVIOR AND EMPLOYMENT ACT OBJECTIVES

Dr. McCracken. Mr. Chairman, the stern strictures of the chairman here in regard to the time allotted to us has imposed on me, as is true for most of the other participants, the painful task of excising a good many pages of priceless prose. I dare say that when this venture is concluded, Grover, we ought to cite you to the Anti-Vivisection Society.

What is the relevance of the Nation's price-cost performance to the objectives of the Employment Act? This question may not be the most fundamental issue of economic policy before us to day, but it is probably a leading candidate for the most vexatious piece of unfinished business. The price-cost question naturally divides itself into about three questions. How important is a reasonably stable price-cost level to the more fundamental objectives of full employment and rising levels of living widely shared? Is there a market-power dimension to the price-level problem? Third, what are the policy implications of these matters for the objectives of the Employment Act?

#### I

Certainly the case for attaching high priority to a reasonably stable price level seems to be a persuasive one for reasons concerned with both our external and our domestic economic performance. Given the large noncurrent burdens on our

\*Excerpted from "Twentieth Anniversary of the Employment Act of 1946—An Economic Symposium," hearings before the Joint Economic Committee, Feb. 23, 1966, 89th Cong., 2d sess.

balance of payments, the sharp recovery in the balance on current account, after it had dipped into a deficit position in 1959, probably made the difference between an international dollar crisis and an external payments position that has been tolerable even if not comfortable. From 1954 to 1959 the U.S. export price index increased 8 percent compared with 3 percent for other industrial nations as a whole. During the next 5-year period (1959-64), however, our export prices rose only 3 percent, a markedly better record than the 8 percent in the first half of that decade and somewhat better than the average for other industrial countries. The fact that the U.S. price level did perform much better by international standards is undoubtedly relevant to our improved payments performance on current account in recent years.

In the domestic economy a reasonably stable price level is desirable in itself for many obvious reasons. A rising price level does, for example, pose problems of equity. Some incomes are, if not fixed, at least sticky. The real purchasing power of financial assets held by those of moderate means is more adversely affected than those held by the affluent. The empirical evidence about the relationship between price increases and rates of domestic economic expansion is more complex, but it presents no persuasive case that acceptance of a more rapidly rising price level enables a country to achieve a more rapid rate of economic progress. The record of 39 nations for the period 1950 to 1960 and 1960-63 reveals no significant relationship between rates of growth of GNP (total or per capita) and the rate of increase in the price level. In studies (largely of developing nations) by the International Monetary Fund there seems, in fact, to be some evidence of an inverse correlation between rates of economic growth and the rapidity with which the price level was rising.<sup>1</sup> Countries with a relatively stable price level have done somewhat better on the average than those experiencing strong upward pressures on the price level. There are persuasive reasons for expecting that things might work out this way. The pervasive expectation of continuing inflation does disturb economic decisions. The pattern of capital formation is distorted. It encourages an outflow of domestic capital, and it impedes the inflow of capital from the outside. On all of these matters there is supporting empirical evidence.

The relationship between the rate of growth of output and the rise in the price level for more developed nations such as the United States is again indistinct. For 17 of these nations in the 1950's there seems to be no discernible relationship between the rate of rise in the price level and the rate of growth in real per capita GNP. For total output there was a faintly perceptible negative relationship, but too low to be statistically significant. If we limit ourselves, in our quest for a price-level target, to the criterion of growth rates, international experience does not lend support to the view that a moderately rising price level is essential or inimical to vigorous growth in developed nations.<sup>2</sup> The desirability of a strong position on price-level policy must then rest heavily with such considerations as equity or our external economic position.

II

Suppose we turn now to the second question. Is there more to the problem of a stable price level than good monetary and fiscal policy? Is there a market power dimension to the problem? The decision does not automatically go to the affirmative. From 1909 to 1929 (excluding 1914-20) there were 14 years of rising business activity. In eight of these the price level rose, in three there was no change, and in three the price level declined from that of the preceding year. On the average the price level rose 1 percent per year for these 14 years. For

<sup>1</sup> Cf., for example, Graeme Dorrance, "The Effect of Inflation on Economic Development," staff papers, March 1963, pp. 1-47.

<sup>2</sup> Computations were made for 17 developed nations for the period 1950-60. They were: Australia, Austria, Belgium, Canada, Denmark, France, West Germany, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Sweden, Switzerland, United Kingdom, and the United States. The terms were: G—rate of growth in real total GNP; G<sup>1</sup>—rate of growth in real per capita GNP; P—rate of rise in the cost of living. GNP growth rates are from the United Nations Yearbook of National Accounts, 1965, and the rate of increase in the cost of living was computed from data in International Financial Statistics. The results are:

Equations

$$\begin{array}{r} \frac{1950-60}{G=5.5-0.30P} \\ G^1=f(P) \end{array} \qquad \frac{R^2}{0.060}$$

the period 1949-65 there were also 14 years of economic expansion. The average price rise was 2.3 percent for these 14 years, and in only one expansion year (1955) did the price level recede. The average rise in rising years, however, was greater in the 1909-29 period than after 1949. The principal difference between these two periods seems to be the lesser frequency of any price decline at all, during expansion years, in the postwar period. The record does not seem to suggest that the price level now is prone to rise more rapidly during an economic expansion than in our earlier history. If anything it may be less so.

Our experience in the late 1950's was, of course, undeniably disturbing. From mid-1956 to mid-1958 the price-cost level was rising too rapidly, and after mid-1957 it was also a period of subnormal employment. Even that period in retrospect has its extenuating circumstances. Some of the wage adjustments that were pushing our cost level upward were the result of negotiations conducted in the ebullient climate of 1955. Moreover there was a swelling wave of inflation-mindedness. The proportion of people, for example, expecting the price level to continue rising for the long run tripled from 1953 to 1957. Here was a phenomenon of social psychology bearing perhaps some resemblance to the Salem witch hunts or the Communist hunts of the McCarthyism era. In retrospect these ground swells always seem a bit perplexing and inexplicable, but they are real and influential while they last. These expectations of inflation, the inflation-mindedness, considerably overshot the basic facts of economic life, of course, but for a time they were an important force nudging the price-cost level upward. Business response to union demands was in part reflecting these assumptions. Union demands for wage adjustments in turn were responsive to this climate. Each settlement, therefore, was followed by the higher prices that gave another thrust to the rising price level, seemingly confirming the wisdom of making decisions on the assumption that an age of inflation was ahead.

The disinflationary policies of 1957 to 1959 (except for a brief interlude from mid-November 1957 to about July 1958) were probably too severe, but they did perform the desirable function of puncturing this bubble of inflation-mindedness. And the more moderate pace of the price level in recent years dates from mid-1958—not, as all good things in economic policy are sometimes alleged to do, from January 1961.

Even so there probably is an element of the market-power phenomenon in the tendency for our price-cost level to edge higher. Since 1960 the price level has continued to drift upward at the rate of perhaps  $1\frac{1}{4}$  percent per year, and costs per unit of output (in the corporate sector) have shown a comparable rise—even though unemployment averaged 5.8 percent of the labor force. Moreover, the rise in both the price level and costs per unit of output were apparently at a somewhat greater rate in 1965. This is a less impressive performance than, for example, the 1920's (1922 to 1929) when unemployment averaged about 4 percent, and the price level increased at the rate of only 0.2 percent per year.. (The average annual rate of increase in output from 1922 to 1929 of 4.7 percent was also higher than the 4.5 percent average from 1960 to 1965.)

### III

What, then, are some of the elements of a price-cost policy for the Nation? Clearly this has become once more an urgent question. The economy by the latter part of last year had regained reasonably full employment, and the tolerances began to narrow sharply. Once again we are in a zone where strengthening the capability of the economy to resist inflation, always desirable, must be given even higher priority.

Measures to avoid a rise in aggregate demand that outruns the economy's productive capability are now, of course, fundamental. Whatever differences may exist about other dimensions of the price-level problem, there would be a wide measure of agreement that inflationary pressures cannot be contained in an overheated economy. The most fundamental and basic requirements for a reasonably stable price level is, therefore, fiscal and monetary policies that do not crowd demand too hard against the economy's capability to produce. This is hardly controversial, in principle, and issues of fiscal and monetary policy have already been discussed, so we can move on to other matters.

There seems to be some measure of agreement that a modern industrial nation should have a wages or incomes policy. In the 1961 O.E.E.C. study on "The Problem of Rising Prices," the panel of distinguished economists agreed that

negotiated wage increases were "decisive in explaining why some countries have failed to a far greater extent than others to achieve price stability."<sup>3</sup> On the problem of wages their report is quite explicit. "In the view of the majority of the group, the essential element to be stressed, first of all, is that the stabilization authorities must have a wages policy for dealing with the problem of wages—just as they have monetary and fiscal policies for dealing with the problem of demand."<sup>4</sup>

Our own venture into incomes policy has been via the guidelines. It has, on the whole, been a constructive step. It was the logical sequel to extensive academic and professional discussion, antedating the 1962 Economic Report, about the relationship between wages and prices. This ancillary discussion included increasing attention to the problem in successive Economic Reports during the Eisenhower Administration. The articulation of the guidelines has focused public attention and understanding more squarely on the problem, and in their absence it is reasonable to suppose that we might have had a somewhat higher price-cost level today.

We need to recognize, however, that the guideline approach also involves some important risks. For one thing there is danger that preoccupation with inevitably only a few highly visible price or wage settlements will cause inattention to the more fundamental matters of monetary and fiscal policy in the strategy for maintaining a reasonably firm cost-price level. The excessive rate of credit expansion in the closing months of 1965, at a time of a few highly visible price controversies, reminds us that this is not an academic matter. There is, in fact, real danger that an overly expansive policy, as in 1954–55, will force a sharp reversal, as in 1956–57.

Another danger is that the guideline approach, if it becomes *de facto* or *de jure* a program for extensive price control, would impede the mobility and fluidity of the economic system. And the more effective (and, therefore, extensive) the guideline program becomes, the greater is this danger. The trouble fundamentally is that the articulation of the guidelines principles largely ignores the role of changes in demand in our system. Our economy depends for its efficient operation on extremely complex and sensitively adjusting pricing relationships that serve as the communications system for promptly reflecting the ever-changing pattern of demand.<sup>5</sup> There is not much recognition of this in the enunciation of the guidelines. "The general guidepost for prices," says this year's Economic Report, in the strong language of italics, "is that *prices should remain stable in those industries where the increase of productivity equals the national trend; that prices can appropriately rise in those industries where the increase of productivity is smaller than the national trend; and that prices should fall in those industries where the increase of productivity exceeds the national trend.*"<sup>6</sup> On the next page we learn that increases above this may be appropriate to reflect increases in unit material costs, if not otherwise offset, or to correct an inability to raise capital. This latter exception is quite explicitly not considered to be "widely applicable in the present environment."

Now this simply describes a cost-plus economy. It will not do even as a short statement of our pricing system. A rise in prices for industries with a productivity rise below average may be quite inappropriate and inconsistent with economic efficiency if the industry is declining and should be extinguished. Price increases may be a desirable means of signaling for increased production of a product even when the industry has average or above-average gains in productivity if demand has intensified.

These are not academic matters. An economy whose pricing system operates according to the guidelines as enunciated would certainly find its capability for progress weakened.<sup>7</sup> Half of our gains in output have come from uncovering more effective ways of utilizing productive resources of labor and capital, and through open competition diffusing these across the economy generally. A cost-plus

<sup>3</sup> P. 45. The authors of the report were William Fellner, Milton Gilbert, Bent Hansen, Richard Kahn, Friedrich Lutz, and Pieter de Wolff.

<sup>4</sup> P. 56. Cf. also Henry Smith, "Problems of Planning Incomes," *Lloyds Bank Review*, January 1966, pp. 30–40.

<sup>5</sup> My colleague, Prof. Charles N. Davisson, pointed out to me the full significance of this point.

<sup>6</sup> Economic Report, January 1966, p. 90.

<sup>7</sup> Cf. Arthur F. Burns, "Wages and Prices by Formula," *Harvard Business Review*, March–April 1945, pp. 55–64.

economy would tend to prolong the lives of decaying industries, and it would slow responses to areas of increasing demand.

The problem here is fairly clear. It is the danger of attempting to apply an aggregative macroeconomics rule relevant to the general price level to the ever-changing relationships among specific prices in microeconomics. The pricing system that we would get if this cost-plus pricing were fully implemented would, to an observer from the University of Mars, look like a highly primitive and crude version of what we now have.

Problems of equity will also inevitably become more difficult if attempts to apply the guidelines to specific situations become more extensive. Even though the guidelines recognize exceptions, most situations will actually be measured against the average. The steel wage settlement is an example. If it was on the 3.2-percent average, it really exceeded the guidelines because it has been an industry with more than its share of unemployment, wage rates were relatively high already, and profits have been relatively low. These are conditions that, according to the Council's articulation of the guidelines, call for a below-average wage settlement. Yet the settlement was pronounced to be right on target—because it came out on the average.

The procedures for singling out price and wage candidates for attention will inevitably be uneven and capricious. Steel would be apt to get the works even though prices of some other products in the aggregate might be just as important. The price which, according to the guidelines, ought to go down and does not would probably be safer from official wrath than the price that ought to stay put but goes up. And there is the question of equity as among wage settlements. The USW or UAW member is apt to find his income more affected by guidelines than a member of the construction union. And it is almost inevitable that a larger proportion of the wage area will be under surveillance than of prices. An industry that has one major labor contract may have hundreds of prices. This is bound to create political strains that either weaken the guidelines or force the Government in the direction of price control.

Another important dilemma of the guidelines approach (or any variant that is some *de facto* form of direct price or wage control) is that it introduces some upward biases of its own. Because price increases when needed may involve some abrasive moments, there would be considerable incentive to resist any price declines. And there would be strong incentives to take the maximum price rises that could plausibly be attributed to such exogenous factors as wage settlements or higher material costs.

There is also an issue of government here. We have probably gone about as far down the guideline road as is appropriate in the absence of legislative action. A form of price-wage control could ultimately come to have the force of law because of the formidable power that the Federal Government can assemble against any miscreant in pricing or wagemaking. If these programs are to become significant instruments of economic policy, the Congress should debate the issue and, if persuaded of their wisdom, take the necessary legislative steps to authorize administration action. The come-let-us-get-together approach can be a device that builds up a power structure in Government which circumvents the legislative process, and in the private sector which circumvents the normal market disciplines of competition. This is not desirable in our political system or in our economy.

The basic reservation about the guideline approach, however, is the evidence that it is of quite limited practical effectiveness. There has not been much displacement in the relationship between our price-level performance and the pace of the economy. In their paper before the American Economic Association 5 years ago Professors Samuelson and Solow suggested that to achieve a stable level of labor costs per unit of output unemployment might have to be 5 to 6 percent, and to achieve "the nonperfectionist's goal" of 3 percent unemployment the price index might have to rise 4 to 5 percent per year.<sup>8</sup> If we make a simple linear interpolation between these two points of their modified Phillips curve, the 4.6 unemployment rate for 1965 would imply about a 1.7-percent rise in the price index. The Consumer Price Index actually rose 1.7 percent from 1964 to 1965, and the rise would have been somewhat higher except for the effect on the index of reduced excise taxes. The guidelines do not seem to have been holding the rise in the price level to anything markedly different from what would have been expected, given our volume of unemployment. Moreover, international experience also suggests cautious expectations about what guidelines can accom-

<sup>8</sup> Paul A. Samuelson and Robert M. Solow, "Analytical Aspects of Anti-Inflation Policy," *American Economic Review*, Proceedings, May 1960, p. 192.

plish. The trend of wages and prices in European countries does not suggest that the incomes-policy approach is apt to provide strong defense against inflation. The results from the United Kingdom's policy for incomes and prices, launched just over a year ago, are not auspicious, and the next version will apparently be legislation to require advance notice of price change and of wage negotiations.<sup>9</sup>

The articulation of the guidelines, let me repeat, has been useful. It has certainly given the whole subject greater public visibility and understanding, and that has been helpful. Their job is to make a marginal contribution—to field the few wild-ball price and wage situations that might occur—under circumstances where fiscal and monetary policies are the basic defense against inflation. At the same time the hard evidence here or abroad does not suggest that they are a strong or highly effective anti-inflationary weapon. And if they divert attention from more fundamental matters of fiscal and monetary policy, they could give the price level an upward bias while they are also reducing the capability of the economy to sustain vigorous economic progress. At this point they would collide squarely with any reasonable interpretation of the Employment Act's section 2.

It is, however, high time that we move on to other matters. One possible contribution to a more stable price level is squarely within the domain of the Federal Government's operational activities. The fact is that important Government programs and actions give a direct and significant upward thrust to the price-cost level. At a time when rising food prices have been a significant factor in the higher cost of living, which in turn will influence wages, the Government will spend on agriculture an estimated \$4.3 billion this fiscal year and \$3.4 billion in fiscal year 1967. Proposals to increase the minimum wage are inimical to the objectives of the Employment Act if we are concerned about price-cost-level problems, and if we are also trying to draw into regular employment those in the labor force only marginally employable. Secretaries of Labor in their administration of the Bacon and the Walsh-Healey Acts have usually interpreted prevailing "minimum" wages for Government contracts to be synonymous with union rates even in localities where these rates had no real relevance to local situations.<sup>10</sup> Obviously the rationale that these programs reflect "political realities" will no longer do. Political gain is to the political arena what profits and wages are to the economic arena. A Government requesting unions and managements to rise above their self-interest on wage and profit decisions can be asked to lead the way itself in some of these operational programs.

If society decides to channel more of its national income into the public sector, and to do so via sales and excise taxes, it makes no sense to have this affect the Consumer Price Index. In an era where demands in the public sector are going to be heavy, we have arranged things so that the use of a tax with substantial popular support would quite directly push upward our most widely used measure of changes in the price level. During 1965 the Consumer Price Index rose 2 percent, but the rise would have been 2¼ percent except for the reduction of excise taxes. And we are in the odd position of increasing excise taxes in 1966 to counter inflation, though their increase will directly raise the price index—and directly and indirectly have an effect on wage movements.

It would be in the public interest for the Joint Economic Committee to conduct an exhaustive study of all Federal programs that have direct effect on costs and prices. They might be found to be consequential.

Few things are more effective in neutralizing the exercise of power than availability of alternatives. Even our powerful corporations cannot force or cajole consumers into buying what they do not want. They cannot because the consumer has alternatives. If the gas company suffers from delusions of grandeur, it will be brought back to earth by marginal shifts of energy requirements to electricity or oil. If Chevrolet buyers were to feel abused, Ford or Chrysler would be eagerly ready with alternatives. A part of our price-cost policy could usefully be exploration of ways to widen alternatives further. The increasing internationalization of economic life offers a major opportunity. The alternative of imports has already served as a significant restraint on the dour ritual of large increases in wage rates duly succeeded by ample price increases.

<sup>9</sup> Cf. Ray Vicker, "Holding the Guidelines," Wall Street Journal, Feb. 7, 1966, p. 14. Also International Financial News Survey, Jan. 14, 1966, p. 10.

<sup>10</sup> Gordon F. Bloom and Herbert R. Northrup, "Economics of Labor Relations" (Irwin, 1961), pp. 549-550.

In some cases it has had a notably therapeutic effect on more aggressive product development. Further relaxation in constraints on the availability of alternative foreign products and services would make a useful contribution to the Nation's price-cost performance, and it would also make for better jobs and a stronger economy. The administration is to be commended for its insistence on adjustment assistance for hardship cases as trade barriers are relaxed, rather than the route of blocking tariff reductions.

Things which might increase the ease with which capital could be substituted for labor must also be classed in the category of broadening alternatives. It is a grisly thought, but the labor cost per unit of classroom output might be under less severe upward pressure if a teaching machine could more readily be substituted for professors. Capital budgeting came upon the industrial scene belatedly, but it has made great strides. If the capital budgeteers and the capital goods engineers could increase the substitutability of capital for labor, we would come close to getting the best of three worlds—an upgrading of jobs; a more stable cost-price level; and an accelerated rate of economic progress.

#### IV

Suppose that even with appropriate fiscal and monetary policy, supported by as much marginal help from other policies and programs as it is reasonable to expect in this world, the price level is still not quite stable. This is probably a reasonable expectation. The last sustained period of full employment, vigorous economic growth, and a stable price level was the period from about 1922 to 1929. And for the entire period from 1900 to 1929 (excluding the war periods), 80 percent of the expansion years saw some rise in the price level.

The objective of a stable price level is an important one, but it does remain a facilitating and not a fundamental objective. It is important largely to the extent that it is essential for full employment, vigorous economic growth, and high and rising levels of incomes widely and equitably shared. We must not be so obsessed by building the bridge over the Kwai that we lose sight of the larger picture. It would be better to retain the motility and adaptability of our free-market economy, for example, than to contract economic arthritis through extensive direct intervention into the specifics of economic life—out of zeal for a flat price index. It is possible, however, that emergent inflation-mindedness may become a problem. We must in that case contemplate occasional episodes of disinflation. These might briefly reduce the proportion of the labor force employed by perhaps a percentage point. It should, however, be quite possible to achieve results through short periods of moderately reduced growth, still avoiding any significant recedence in the economy. Episodic disappointed inflationary expectations would probably be enough to serve as a reminder that caution is appropriate even if the general trend is up because it is also necessary to survive shorter run contingencies.

It is to be hoped that a stable price-cost level becomes possible with full employment. The fact is that with the existing state of the arts of economic policy severe insistence on price-cost stability is a recommendation for the distortions of suppressed inflation that enervate the economy—and probably for a lower trend rate of growth. Obviously we cannot close down the economy until we know more about achieving a stable price level without retarding the economy's growth. We therefore face the inevitable problem of feeling our way along with a mix of real growth, high employment, and some concession to the price level—with the mix itself changing a bit from time to time—if we are to achieve the maximum rise over a long period of time in widely diffused levels of living.

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Since the act which we honor today was signed, every President has explicitly recognized the importance of a reasonably stable price level to the performance of our economy and to the quality of our Nation's economic life. This clearly continues to be the case, and it is wise. As is true of our objectives for employment, production, and purchasing power, we sometimes fall short of our price-level goal, and we shall probably have our shortfalls in the future. We can, however, say of this goal what Beardsley Ruml said of the Employment Act's objectives two decades ago when he told a Senate committee that "this statement of the goal of our sincere efforts to attain it will make the reality much closer to the ideal than if the ideal had never been expressed."

Chairman PROXMIRE. Congressman Bolling?

Representative BOLLING. Dr. Auerbach, I think perhaps your statement and the discussion that followed is the most stimulating that I have heard or read during this hearing. I say "read" because I haven't been at all of the hearings.

I would take it that your purpose is to attack the problem that all of us have given lipservice to, or recognition of, that of getting the public represented at the bargaining table in some fashion or another, rather than try to develop arguments that would persuade us to do nothing.

I believe that your idea, while not to me an entirely new one, is better worked out and better supported by the discussion than any I have heard, and all I will say further is that I note that we plan to have further hearings of the full committee on this, and I hope that we will pursue this particular point, because I think you have made a very important and timely contribution.

Mr. AUERBACH. Thank you, Congressman Bolling.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

I want to associate myself with what Congressman Bolling has just said. I think you have made a real contribution to the thought processes of this committee.

You have sketched out a program for the future which would enable this country to live with something like full employment without inflation. However, this committee and the country now confront a situation where it is very important to keep prices stable in 1967 for both domestic and foreign reasons, and yet the Economic Report, unfortunately, I won't say throws up its hands at the problem, but doesn't really, in my judgment, come to grips with it.

I feel that we are a little in the position of the widower who was returning from the funeral of his young and beautiful wife, and somebody seeks to console him and pats him on the back and says, "Joe, don't take it so seriously. You will find another wonderful wife in the next year or two." And Joe looks at his comforter and says, "Yes, but what am I going to do tonight?"

That is the problem of the economy as I see it: What are we going to do in 1967? Would you address yourself to an immediate set of actions, if you can, which would enable us to keep our prices stable?

Mr. AUERBACH. May I tell you honestly, Congressman Reuss, that your story occurred to me as I was writing my statement.

Representative REUSS. It's quite an old story.

Mr. AUERBACH. You pose a very difficult problem. You have been one of the men in Congress who, very properly in my view has been asking the Congress to take greater responsibility in this area. If the guideposts constituted a good program for the President of the United States, they were also good for the Congress and the Congress should have said so in some responsible way. If they did not constitute a good program of stabilization for the Congress, Congress should not have permitted the President to administer them.

Nevertheless, in spite of your urgings over the years, nothing was done to avert the impasse we now confront. It is difficult, in the light of this past history, to answer your question. "All right, what do we do now?" But I acknowledge that you are right in criticizing

my statement for not directing itself to the immediate problem. In fact, what we can do about the immediate problem is limited but, nevertheless, I will venture some suggestions.

It is clear that even if Congress should agree with the proposals I have made, and frankly I don't have any real hope that it will, nothing will happen for quite awhile, at least not before the spring negotiations begin. A wage-price spiral may get underway before any effective action can be taken.

It seems to me that the basic principle that I have tried to emphasize may nevertheless have immediate application; namely, the principle that labor and management should be held to public accountability for decisions they take that affect the public as a whole. Possibly, the public interest may be served if this committee were to turn to the administration and say "Don't give up so soon, we are now willing to participate and to help"; if a public review board were created, composed of administration representatives and representatives of this committee and the public; if their immediate steps were taken to get the representatives of labor and management who will be involved in negotiations in 1967 to appear before this public review board and justify the actions they propose to take.

Representative REUSS. What would you think as a goal for 1967 in terms of a guidepost? We don't have any now really.

Mr. AUERBACH. I think that the goal in 1967 ought to be overall price stability. I would envisage that the public review board would say to representatives of labor and management appearing before it:

What we want for 1967 is price stability. Tell us what can and ought to be done on the assumption that prices are not going to go up, that they are going to stay where they are for the remainder of 1967.

Representative REUSS. In other words, you would invite an industry which is faced with some sort of a wage demand to indicate what kind of a wage demand it thinks it can absorb.

Mr. AUERBACH. Yes, sir.

Representative REUSS. And what kind of a wage demand it asserts it would have to pass on in the form of higher prices.

Mr. AUERBACH. Yes, sir. I would hope that the public review board would call together the representatives of labor and management well in advance of the time the collective bargaining agreements are due to expire and ask them what they contemplate doing, what wage demands are going to be made, what kind of settlement will assure price stability this year, what price reductions will have to be made—so that no wage-price spiral gets underway.

Representative REUSS. In addition to your "hold the line on prices" policy, and the machinery you have suggested for implementing it, would you envisage the executive branch exercising more anti-inflationary effort than it is now doing, particularly on the supply side? Would you think it useful to have someone in the administration, whether it be an Esther Peterson representing the consumer or somebody, really look at all of these areas, including food prices and agricultural policy and services and all the difficult fields, to see what can be done either by increasing supply or holding down cost to keep both the Wholesale Price Index and the Consumers Price Index just as close to stability in this crucial year as possible?

Mr. AUERBACH. I think that is an excellent suggestion, Congressman Reuss. I would like to see Miss Peterson's office move more aggressively into the price area. But this is a difficult area and yet this possibility ought not to be neglected.

Representative REUSS. Thank you. You have certainly given an answer to my "what can we do now" question.

Thank you, Mr. Chairman. That is all.

Chairman PROXMIRE. Thank you very, very much, Professor Auerbach. You have been an excellent witness this morning—most stimulating. You challenged whether I would be saying as nice things about you after you finished as before. I certainly can, and even more so. As Congressman Bolling indicated, you have brought an extremely interesting and constructive suggestion to us.

It is one thing to criticize and it is very helpful, very important. Something else though, it is much harder to make a concrete specific proposal and make it stand up, so I think you have been a very helpful witness, and we are mighty grateful.

Mr. AUERBACH. Thank you, Senator Proxmire.

Chairman PROXMIRE. Our next witness is an old friend of the committee and an extremely competent economist—Dr. Jules Backman, research professor of economics of New York University, who has quite a different view on the subject. It will be a very stimulating morning.

We are very happy to have you, Professor Backman.

#### TESTIMONY OF JULES BACKMAN, PROFESSOR OF ECONOMICS, NEW YORK UNIVERSITY

Mr. BACKMAN. Thank you, Mr. Chairman. It is always a pleasure to appear before the committee. While the temptation is very great to plunge into the discussion that has already taken place, so that I could register my disagreement with the previous witness on many of the points, I will try first to outline my basic position and then hope these questions will be raised later.

The CEA has made a constructive contribution to public understanding by emphasizing that fringes as well as wages must be considered in measuring worker's gains, and that regardless of the name given to a wage increase, whether it be a cost-of-living adjustment or a productivity increase, it represents a labor cost. However, the CEA presentation does a disservice to economic education when it uses erroneous assumption to supply this policy.

The wage-price guideposts were foredoomed to fail to accomplish the objectives of limiting increases in labor costs and stabilizing the price level. As is shown by the attached conclusions of an analysis I made on February 19, 1962, I do not draw this conclusion from the vantage point of 20-20 hindsight.

There are at least five basic assumptions underlying the guideposts which in my judgment are in error.

1. The assumption there is a direct relationship between unit labor costs and prices.

2. The assumption that productivity (output per man-hour) is the major factor in wage determination.

3. The assumption that the reported increases in private output per man-hour indicate what is available for distribution.

4. The assumption that real labor income should or could increase at uniform annual rates.

5. The assumption that unorganized sectors would follow the leader.

Let me say a few words about each of these assumptions.

The assumption that average labor cost increases equal to average gains in output per man-hour would result in general price stability is based on a very crude labor theory of price determination and one that has support neither in economic theory nor in economic history. In the short run, prices are not determined by unit labor costs, by wages, or by total labor costs. And the long run is a composite of short runs. Labor cost is only one factor in the determination of total costs. Thus, when we are told that prices are determined solely or primarily by labor costs, there is omitted from consideration (1) all factors affecting demand; (2) all factors affecting supply, except costs; and (3) all elements of cost, except labor.

Economic theories concerning long-term relationships between costs (note costs, not labor costs alone) and prices are concerned with the pressures influencing the allocation of resources. Thus, if costs are greater than prices, profits disappear, marginal facilities may be abandoned, and some producers may be forced out of the industry. Conversely, if profits are very high, producers may expand capacity and new producers may be attracted into the industry, thus increasing supply and setting the stage for lower prices. Costs and prices must be out of line to set these corrective actions into operation. The economist is describing tendencies in the economy and the effects of cost-price relationships rather than the way in which prices are set by any company.

Demand is important in the short run when prices and costs may be and often are quite far apart. The wide fluctuations in profit margins between good times and bad illustrate the lack of relationship between costs and prices and the importance of volume, a factor recognized by the CEA.

Thus, a fundamental assumption underlying the wage-productivity-price formula has no basis in fact. Prices fluctuate independently of unit labor costs and hence stability in such costs (which would result from the wage-productivity balance) cannot and does not assure stable prices.

The CEA proposal that companies with above average gains in output per man-hour should cut prices in a period of strongly surging demand and capacity operations was completely unrealistic. Thus, it is now forced to conclude that the greatest failure of observance of the price guidepost lies in the failure to reduce prices on a considerable number of the product lines of a large number of industries. The only surprising thing about this situation is the surprise of the CEA.

Prices have a rationing function—to allocate limited supplies among the more urgent users as indicated by their willingness to pay the price, which is particularly important in periods of shortage. If price doesn't allocate supplies, then this must be done on a first-come, first-served basis, or by favoritism, or by Government priorities or ration-

ing. Where shortages prevail, a reduction in price is exactly the wrong prescription and will tend to result in a less efficient use of resources.

Regarding the assumption that productivity (output per man-hour) is the major factor in wage determination. The CEA states "The only valid and noninflationary standard for wage advances is the productivity principle." For some key industries, the rate of change in output per man-hour nationally is one factor considered in collective bargaining.

The guideposts attempt to convert a long-term truism, namely, that the level of living can only increase as the quantity of goods goes up, into a policy which is effective on a year-to-year basis. Productivity is considered by negotiators in some industries, but it is neither the only factor nor the most important one. Other factors include the general state of the economy, the growth rates of specific companies and industries, changes in the Consumer Price Index, rival union leadership, comparative wages and profitability.

In the real world, wage relationships are of critical importance both to the firm that seeks to hire labor and to the union leadership which must produce results for its members. It is true, as the CEA notes, that proper comparisons often are difficult to make. But each party is more skillful at countering the claims of the other than the CEA seems willing to recognize so that neither party can arbitrarily select only comparisons favorable to itself and make them stick.

In discussing prospective settlements, the CEA states that "many wage settlements in 1967 will exceed the trend increase of productivity." In effect, it treats changes to compensate for rising living costs as "an additional margin" beyond the productivity total. The reality of collective bargaining will be just the reverse.

The first factor considered by negotiators during periods of rising living costs is what increase is required to restore real wages to the level prevailing when the previous contract was negotiated. Then, consideration is given to how much more the adjustment should be to compensate either for anticipated further rises in living costs or to increase real earnings.

The Council has said, and I heard it repeated here this morning, that first we get the increase in productivity and then we hope to get back part of the loss of the cost of living. What really happens in collective bargaining is the reverse. First they negotiate whether to restore the living standards which are eroded by a rise in living costs, and after they have agreed or disagreed upon that point, then they negotiate upon how much more should be given in a particular negotiation. In other words, the first test in a period of rising living costs is what has been happening to the Consumer Price Index.

I agree with the Council that, if in 1967 labor should attempt to obtain an increase in wages and other fringe benefits equal to the combined effect of the rise in living costs and the so-called productivity standard, we would have very great pressure on prices. I do not agree that this large increase in unit labor costs, which will aggregate this year at least 4 percent and possibly a little higher, will be translated into any automatic increases in prices. On the contrary, I am convinced that in 1967 these increases in unit labor costs will be ac-

accompanied by a cut in profit margins and by some increase in unemployment.

Incidentally, 1967 provides an excellent illustration of what is wrong with the guideposts. The assumption that we can increase real living standards by some uniform rate from year to year is one from which the Council departs in this year, and properly so. Historically, living costs, comparative wages, and other factors have been important criteria for wage adjustments. It is a fact that, historically, real wages over long periods of time have gone up as much as productivity. But on the short-term basis, this just has not been the situation at all, as I will indicate in a moment.

There is another assumption which was contained in the CEA's figure of 3.2 percent, namely, that the Council can measure changes in productivity, and then that they use the right numbers.

A year ago the Council was in the embarrassing position of abandoning its own arithmetic. You may recall that when the 5-year average didn't work out, the Council sort of walked away from it and said, "Oh, yes, it may be 3.6 percent, but we really don't think that is important, so we will stick with the 3.2"

If the Council had stayed with its goal of economic education, it necessarily would have stated that changes in output per man-hour cannot be pinpointed, and that only a range of changes could be identified. The Council would then have avoided the situation which increased expectations and may have contributed to the larger increases negotiated later in 1966. The Council also would have been spared the questions raised about its own integrity.

Now why do I raise a question about these figures? Students of the productivity trend are fully aware of certain limitations in terms of their usefulness as a standard for wage increases. For example, about one-half a point of this increase is attributable to the rise in output per man-hour in the agricultural sector. There has been a large shift of manpower from agriculture to industry, and when a worker moves from the farm economy to the nonfarm economy, he slots into the wage level which already is prevailing in the non-agricultural economy; in effect, he gets the gain in productivity.

In other words, the numbers show a gain in productivity, but since we have no composite figure for the economy on wages, there is no wage figure which shows that the average level of wages has gone up because we have more people working at \$2.50 an hour and fewer at \$1 an hour. In other words, the mix in wages has moved in the same direction as productivity.

In addition to that, we have had an important change in the non-agricultural sector. A smaller proportion of the labor force is now production workers, and a higher proportion are scientists, professional workers, and others who get higher wages. This mix uses up part of the gain in productivity, and, in fact, it goes even further when production workers require greater skills in today's technology. As they move up the ladder, they get part of the gains. This is one of the reasons why the use of such numbers is a mistake.

The recent abandonment of the announced guidepost of 3.2 percent was a constructive move. The CEA, of course, hasn't really abandoned the guidepost. It has only abandoned this exercise in economic

marksmanship. The CEA reports it is still wedded to the guidepost approach, and although Mr. Auerbach suggested that the President and the Council may have abandoned their policy of intervention, I call your attention to the experience in gasoline in the last few days. In this situation, the Department of the Interior has indicated that, at the suggestion of the Council, it is attempting to roll back the price increase announced for gasoline. There has been an abandonment of a number, but not of the process used to implement the number.

The fourth error, underlying the guideposts is the assumption that real labor income can or should increase at some uniform annual rate. I checked the changes in real hourly earnings over the past 46 years. Now real hourly earnings can increase in one of five ways. The data are contained in my statement.

You can have no change in wages and a decline in living costs. You can have no change in the cost of living and a rise in wages, and this is the combination which the Council has selected. You can have both going down with the cost of living going down more, and you can have both going up with the wages going up more, or you can have wages going up a little and the Consumer Price Index down a little.

In the past 46 years there was only 1 year in which the combination which the Council has chosen was the actual way in which real wages increased in the economy: in 1929, there was no change in the Consumer Price Index, and there was a rise in real hourly earnings because wages went up a little. And, incidentally, even these figures don't tell the whole story, because in 6 years, real wages went down, which means that in other years we must have larger than long-term average increases in order to achieve the average.

Incidentally, under the guidepost policy, real labor income has risen irregularly and has fallen short of the goal of the guideposts. If anyone had gotten 3.2 percent a year in each of the years since 1962, although that figure wasn't in effect for the whole period, he would have found a significant part of this increase eroded by the rise in living costs, which was 1.7 percent in 1965 and 2.9 percent in 1966.

The actual increase in real hourly earnings during this period—and this includes fringes—was approximately 2 percent in manufacturing and 2.5 percent for trade, or short of the guidepost standards.

Much was said about the control which some companies have of our economy. In fact, the CEA has assumed, that if the highly visible industries conform to price guideposts, "the average of prices would also be stable in the other highly competitive industries, including agriculture and most services, where firms had no discretion." This is a naive view of the relationship between prices of agricultural products and services on the one hand, and those for industrial products on the other.

The assumption that prices of farm products and, in turn, food, would maintain a fixed relationship to other prices has not worked out, nor was there any reason to expect that it would, on the basis of the history of these price relationships.

The objective of stabilizing the price index could not be attained because of the inability to control or to prevent a rise in the prices of

many services, such as hospital care, education, personal care, et cetera, which represent essentially labor costs.

Incidentally, the Council has also stated that "businesses and unions can push up prices even when resources are not fully utilized." That was stated here again this morning. However, the record shows that from 1958 to 1964, when the economy operated substantially below capacity, wages and prices were not pushed up generally. Between those years, capacity utilization averaged between 74 and 86 percent in manufacturing. The unemployment rate was between 5 and 6 percent. Wholesale industrial prices recorded no change. The Consumer Price Index rose slightly more than 1 percent a year. And unit labor costs in manufacturing industries remained relatively stable, and for the entire corporate economy rose about 1 percent annually.

The assumption that big business has the market power which can be used to raise prices excessively is not a new one, and in this connection, it is instructive to keep in mind that the largest price rises in the past 2 years have been in farm products, foods and services, rather than in the products of big business.

In the absence of the guidepost policies, it is probable there would have been somewhat larger increases than actually developed in industrial prices. However, there is no evidence that they would have been as large as the rise for services or that they would have had an important impact on the CPI.

The question is not a new one. It was raised by Mr. Kefauver and the Kefauver committee in the middle 1950's. I have introduced two charts into my testimony. One shows the relationship between economic concentration and the rise in metal prices from May 1955 to May 1957. That chart showed there was absolutely no relationship between the extent of economic power as measured by economic concentration and the magnitude of price rises in those days.

I have just completed very extensive studies of the relationship between so-called market power inherent in intensive advertising and price changes, and in my statement I reproduce one of the charts which will be contained in that study scheduled to be published this spring. (See chart 2 p. 976.) Incidentally, that chart shows a line of regression moving downward slightly from left to right. To support the charge of relationship between market power and price increase it would have to move upward sharply from left to right on a somewhat different direction.

My conclusion of that phase of the advertising study was as follows:

The most intensively advertised categories of products have tended to show smaller increases in price than less heavily advertised categories during the post-World War price inflation. The postwar record of changes in wholesale and retail prices for broad groups of products and for selected foods and proprietary drugs reveals that there has been no relationship between the intensity of advertising expenditures and the magnitude of price increases.

These data indicate that heavy advertising expenditures did not create a degree of market power which gave the affected industries the freedom to raise prices substantially during this period of general price inflation.

These studies are cited to illustrate that market power need not necessarily be translated into higher prices.

I would like to say just a few words about the price and wage outlook for 1967, because these tendencies and trends will play an im-

portant role in terms of what should be done and the consequences of what we do. There will be two basic pressures for price rise in 1967. One is the deficit in the Federal budget, and I would like to say at this point that I support the request for an increase in the surtax of 6 percent, because I find it difficult to believe that we will be able to hold price inflation under control with a \$15 billion deficit in the administrative budget, regardless of what the cash or the national income budget shows. They have effects upon economic activity, but this administrative budget has an effect upon inflation.

But secondly, and the most important pressure for price inflation in 1967 will be the very large increase in labor costs which will take place this year.

Throughout the entire postwar years, regardless of what the consequences may have been—and I now go back to the earlier postwar years—there was no time in which unions were willing to settle for, nor management unwilling to give, at least the increase in the cost of living.

Most of the battles in the early postwar period, and I had the opportunity to participate in many of those proceedings, were concerned with how much beyond the cost of living one went. It was almost viewed as a matter of equity that labor should get at least the rise in the cost of living.

And so we start with contracts that have been in many cases 2-year contracts, the one exception is the automobile industry, because auto workers have received both cost-of-living and the productivity increases. In the past 2 years the Consumer Price Index has risen about 4.5 percent. I don't think there is any union of any size that is going to accept less than the 4.5 percent as a start.

In fact, and this is not generally realized, automobile workers received in 1966 a 7-percent increase in wages, which works out to between 5- and 6-percent increase in labor costs. This will be the minimum target for unions in 1967. And since the probability in 1967 is for a rise in productivity or output per man-hour of about 2 or 2.5 percent, we face the large rise in unit labor costs which I described earlier. And, as I indicated, I think this rise will be reflected largely in a cut in profit margins, and in some unemployment, and to a lesser extent, in higher prices.

What about the indications of stability in prices? One of the most important portents of the movement of wholesale prices is what happens to the index of 22 sensitive products. A year ago that index was 115 on a 1957-59 basis. Today it is about 102. The Wholesale Price Index has shown stability since last July. There has been little or no change in the comprehensive Wholesale Price Index for the past 7 or 8 months, and one of the very interesting points about this index is that if we break it down and study what I like to call the anatomy of prices, we find that every component of the index was rising through July 1966, but in the last 7 months, from July 1966 to January 1967, four of the 13 components have actually gone down.

I submit that a period when some components of the index are showing little or no change and others are going down is not the type of price behavior one expects to find in a period of general price inflation.

Second, there are indications that in the absence of a further escalation of Vietnam, the rate of increase in economic activity may slow down or may even come to a halt. The expansion which has lasted 6 years is looking tired, particularly in the civilian sector.

Third, the suspension of the 7-percent investment tax credit and of accelerated depreciation for buildings combined with tight money helped to slow down the boom in the plant and equipment. The narrower profit margins probable for this year will reduce the incentive as well as funds available to finance plant and equipment spending. On balance, a leveling off in plant and equipment spending is probable even if the investment tax credit is restored. Because we have been getting increases in capacity which exceed the growth in the economy, excess capacity is beginning to develop.

I see 1967 as a year in which there will be a slower rate of growth if the Vietnam war continues, and a moderate recession similar to the post-Korean one if the Vietnam war ends.

There is one other factor about 1967 that must be emphasized. Inventories have been accumulating at the rate of in excess of \$15 billion a year. Now what does this mean? It means that if gross national product is \$760 billion and \$15 billion is inventory accumulation, we have only been consuming \$745 billion, and it means that if we stop accumulating inventories, not liquidate them, merely stop the accumulation, we take \$15 billion out of the economy. That represents many jobs and a significant reduction of pressure on prices. And if we should liquidate some of these inventories, we could very easily get a swing which will take \$20 billion out of the gross national product, and will help to reduce, if not eliminate, the pressures for price rise.

As I see the price outlook, inflationary pressures are still present in the economy, particularly from higher labor costs. However, on balance there is a strong probability that we have seen the maximum rate of pressures for price inflation already. Prices should rise at a slower rate in 1967. Assuming no change in Vietnam, the rise in the Consumer Price Index will be 3 percent or less, and that in wholesale prices 2 percent or less. Incidentally, in the last 3 months the Consumer Price Index has risen about two-tenths of a point, and the Wholesale Price Index has shown minor changes.

The actual degree of price inflation will be determined to a large extent by events in Vietnam and by the fiscal and monetary policies adopted. It will not be determined by the wage-price guideposts.

Further escalation of the war would intensify the pressure for higher prices, unless fully offset by higher taxes. On the other hand, a stabilization of the war effort or a cutback would moderate significantly the pressures for price inflation. Since I have no way of determining which of these alternatives will develop, any projection of prospective price change must be qualified.

Let me conclude. I strongly endorse the educational objectives of the guideposts as originally described in 1962. It is useful to emphasize there are general limits to rates of gain in real wages, and in the levels of living that can be realized annually, particularly since public expectations seems to have far outdistanced the possibilities of even our affluent society.

However, the Council's analysis is based on so many erroneous assumptions that the educational value of the guideposts is open to serious question. There is little value to a program which educates the public to believe that unit labor costs determine prices, that only productivity determine wages, that real wages can increase at a uniform annual rate, that the general price level can be stabilized by controlling increases in labor costs, or that levels of living can be raised by 3 percent or more annually.

Moreover, educational goals stated in general terms is a far cry from the establishment of annual objectives expressed in numerical terms. The guideposts as used prior to this year, unfortunately, created expectations of steady, annual increases in real labor income at a 3.2 percent rate, or higher than is realistic and hence higher than actually developed.

Moreover, such a steady increase in real income each year ignores the fact that labor payments perform a rationing function as well as provide a source of purchasing power.

Different rates of change in labor income are appropriate for periods of recession than for periods of marked economic growth. The failure of the guideposts to provide for these cyclical variations is another weakness that usually is ignored.

We would be better off with the termination of this experiment in economic marksmanship. As a device to determine acceptable increases in wages and guideposts and prices, the guideposts leave much to be desired.

The implementation by persuasion has really had no administrative base and appears to be a hit-or-miss affair. If the objective is to overcome the market power of labor and business, the guideposts are a very crude tool, since they seek to contain the exercise of that power in a few instances rather than to attack it at the source.

If we desire to contain market power by business, the main instrumentality is the antitrust laws. Pressures on prices can also be modified by the timing of Government spending programs, lowering barriers to foreign trade and by sales from the stockpile.

It must be recognized that while the latter programs can be helpful in stabilizing the prices of some products, they cannot stabilize the general price level.

The elimination of make-work practices and of restriction of membership in some unions, retraining, training, and mobility programs, and repeal or modification of the Walsh-Healey Act and Bacon-Davis Act could help reduce the pressures on the labor front, but there would still remain the strong market power of the unions in many industries.

One difficulty is that problems may develop through small unions strategically located as well as the giant unions which are the usual targets for antimonopoly proposals.

The most constructive approach would require the mix of fiscal and monetary policies which would restrict excessive expansion in the economy, plus direct attacks on specific abuses of market power.

In the wage-price environment projected for this year, the guideposts can serve no useful purpose. On the contrary, they may

aggravate what already are certain to be excessively large increases in labor costs. By emphasizing long-term gains in output per man-hour and the accompanying rise in living standards, they encourage unions to seek increases large enough to cover both the past rise in the CPI and the so-called normal rise in real wages. This combination would mean labor-cost increases of 7 percent or more, and would result in a substantial rise in unit labor cost as the Council has warned.

The abandonment of a specific numerical value for labor cost increases was unavoidable under these conditions. The quiet burial of the wage-price guideposts would be equally constructive.

That concludes my statement, Mr. Chairman.

(The prepared statement of Mr. Backman follows:)

#### PREPARED STATEMENT OF JULES BACKMAN

##### THE WAGE-PRICE GUIDEPOSTS

The wage-price guideposts are now five years old. At the outset, the CEA emphasized the guideposts were designed to educate the business community, labor unions, and the public that there are limits within which real incomes can be expanded annually and that increases in excess of those amounts will be eroded by price inflation. The guideposts spelled out what the CEA considered to be noninflationary wage and price behavior.

If the wage-price guideposts described only the extent to which labor costs can rise without adding to unit labor costs, they would represent a simple exercise in arithmetic. However, they go further and state that if certain compensating changes in wages and prices take place, average unit labor costs will be unchanged and we could attain price stability. Such price stability, in turn, would convert the indicated rise in money labor income into an identical rise in real income. These latter conclusions are based upon a faulty understanding of the processes of wage and price determination and provide a completely wrong prescription for general price stability.

Under conditions of significant idle capacity (as from 1958 to 1964), the guideposts make no contribution to the stability of the price level. In fact, when there is idle capacity and unemployment, they could have just the opposite effect by encouraging increases in labor costs which are greater than warranted at such times. Such a development could impede the reemployment of idle workers who are priced out of the market.

Similarly, in a period of strong demand fueled by federal budgetary deficits (which still prevail) and an explosive growth in money and credit (which was finally brought to a halt in 1966), wage-price guideposts could not bring about price stability. At best they may have shaved off a small amount from labor settlements in a few highly visible major industries. However, they are ineffective in other negotiations as the experience with many settlements, particularly in the building trades, demonstrated last year.

Although specific situations which have directly experienced the impact of wage-price guideposts can be identified, the magnitude of the effect can not be determined. How much more, if at all, would the labor cost have increased in an industry in which intervention has taken place? How much more did weaker unions obtain because of the guideposts? How much would the prices of steel, aluminum, cigarettes, and other prices have risen if producers had not been aware of the actual or potential scrutiny of the Government? And would such increases have had a significant impact on the CPI?

These questions cannot be answered with any definitiveness. We have no standards to determine the overall impact, if any, of the guideposts on the general level of wages and prices. We have a dynamic economy in which many forces operate simultaneously and usually cannot be disentangled. However, the guideposts appeared to have had no impact on the vast majority of prices throughout the economy and no restraint upon some major segments of the cost of living including foods and services.

Overall price stability is mainly a function of fiscal and monetary policy with wage-price guideposts playing a very subordinate role. Of course, we know

that governments rarely are willing to make fiscal policy and monetary policy restrictive enough to assure an unchanging price level because the attainment of that objective may conflict with the objective of reducing unemployment. Some students have in fact concluded that price stability could only be assured at the cost of high unemployment. In this connection, it will be recalled that the relative stability of the general price level from 1958 to 1964 occurred during a period of unemployment and low levels of capacity utilization and that prices began to move up as we approached fuller utilization of resources. To the extent that there is a basic conflict between the two goals of price stability and reduction of unemployment, public policy might seek to moderate the upward tendencies of prices during periods of high level activity rather than to seek the goal of price stability.

In any event, if the goal of full utilization of resources is to be attained by expansionary fiscal and monetary policies, the wage-price guideposts can not achieve price stability. However, they may act to prevent needed adjustments in some sectors as when prices are held down under conditions of severe shortage (e.g. copper) or to encourage unbalanced increases in wages and prices as when they are held down in some highly visible industries but not in other parts of the economy.

Paradoxically, the guideposts may appear to be effective when there is minimal pressures for price inflation—and hence the guideposts are not needed. However, they cannot prevent increases in the general level of prices when there are strong pressures for price rises and the containing forces have been weakened. Thus, they are an unnecessary appendage when prices are stable and a futile device to prevent rises when there are strong upward pressures. In any event, it seems evident that price stability can not be achieved through the guideposts. Nevertheless, the hope that the guideposts can be effective may slow up the implementation of tighter monetary and fiscal policies.

It is practically a truism that for the *entire* economy the real income of labor (wages plus nonwage benefits deflated by the consumer price index) must increase *over long periods of time* about in line with the increase in output per manhour. In fact, the average level of living can only increase when a larger quantity of goods and services is produced per worker. Mass production requires mass consumption.

In order to sell millions of automobiles, radios, television sets and huge quantities of other products, they must be bought by a broad cross-section of the consuming public representing an overwhelming majority of the population. Such purchases may be made possible, however, either by higher incomes, lower prices, or some combination of both. In the past, each of these alternatives has been important.

Although the general average rise in labor income has been in line with average gains in output per manhour, diversity of change has characterized wages and non-wage benefits among industries. In the dynamic and expanding American economy, diverse changes in labor incomes help to play a role in steering available manpower. Expanding areas and industries tend to have larger than average increases in wages in order to attract the additions to the labor force they require. Conversely, lagging industries should have less than average increases since they face a declining need for labor.

The diversity of wage changes is a response to a myriad of pressures, economic and political, which affect the magnitude and nature of settlements for different industries and often result in different changes for individual companies within an industry. These underlying forces are still operating and will continue to do so in the future.

In its initial analysis, the CEA indicated that exceptions could be made from its general guideposts for the above situations. But in 1964, the CEA stated that such exceptions should apply to "only a relatively few cases." (*Economic Report of the President*, January 1964, p. 119) Thus, an important element of flexibility in the 1962 guideposts was modified since ordinarily the exceptions have been very numerous.

The CEA has made a constructive contribution to public understanding by emphasizing that fringes as well as wages must be considered in measuring labor's gains and by indicating that regardless of the name given to a wage increase, whether it is a cost of living adjustment or a productivity increase, it

represents a labor cost. However, the CEA presentation does a disservice to economic education when it uses erroneous assumptions to support this policy.

#### GUIDEPOSTS WERE BUILT ON ERRONEOUS ASSUMPTIONS

The wage-price guideposts were foredoomed to fail to accomplish the objectives of limiting increases in labor costs and stabilizing the price level. As is shown by the attached conclusions of an analysis I made on February 19, 1962, I do not draw this conclusion from the vantage point of 20-20 hindsight.

There are at least five basic assumptions underlying the guideposts which in my judgment are in error—

1. The assumption there is a direct relationship between unit labor costs and prices.
2. The assumption that productivity (output per manhour) is the major factor in wage determination.
3. The assumption that the reported increases in private output per man-hour indicate what is available for distribution.
4. The assumption that real labor income should or could increase at uniform annual rates.
5. The assumption that unorganized sectors would follow the leader.

1. *The assumption there is a direct relationship between unit labor costs and prices.*—The guidepost policy is bottomed upon a false assumption, namely, that success in stabilizing unit labor costs in major industries would result in a stable CPI. For example, the CEA states that “if wage rates [total labor costs] increase in line with output per man-hour, prices can be stable . . .” (p. 120).

The CEA is imbued with a cost theory of pricing. Thus, it suggests an exception to its price guidepost is permissible if “costs other than labor costs had risen.” (p. 123). It notes that “for cotton textiles, a sharp decline in the cost of raw cotton would have suggested price reductions,” (p. 124) and calls attention to other prices (e.g. copper, sulphur, machine tools and industrial equipment) which have risen more than warranted by costs (pp. 124-25). However, it does recognize that demand was very strong for several of these products. It also notes that “some significant price reductions which the guidepost would have suggested have not occurred” and cites automobile prices as an illustration (p. 124).

The assumption that average labor cost increases equal to average gains in output per manhour would result in general price stability (see p. 131) is based on a labor theory of price determination and one that has support neither in economic theory nor in economic history. In the short run, prices are *not* determined by unit labor costs, by wages, or by total labor costs. And the long run is a composite of short runs. Labor cost is only one factor in the determination of total costs. Thus, when we are told that prices are determined solely or primarily by labor costs, there is omitted from consideration (1) all factors affecting demand; (2) all factors affecting supply, except costs; and (3) all elements of cost, except labor.

Economic theories concerning long term relationships between costs (note costs, not labor costs alone) and prices are concerned with the pressures influencing the allocation of resources. Thus, if costs are greater than prices, profits disappear, marginal facilities may be abandoned, and some producers may be forced out of the industry. Conversely, if profits are very high producers may expand capacity and new producers may be attracted into the industry, thus increasing supply and setting the stage for lower prices. Costs and prices must be out of line to set these corrective actions into operation. The economist is describing tendencies in the economy and the effects of cost-price relationships rather than the way in which prices are set by any company.

Demand is important in the short run when prices and costs may be and often are quite far apart. The wide fluctuations in profit margins between good times and bad illustrate the lack of relationship between costs and prices and the importance of volume, a factor recognized by the CEA. (pp. 128, 132)

Thus, a fundamental assumption underlying the wage-productivity-price formula has no basis in fact. Prices fluctuate independently of unit labor costs and hence stability in such costs (which would result from the wage-productivity balance) cannot and does not assure stable prices.

The CEA proposal that companies with above average gains in output per manhour should cut prices in a period of strongly surging demand and capacity operations was completely unrealistic. Thus, it is now forced to conclude that "the greatest failure of observance of the price guidepost lies in the failure to reduce prices on a considerable number of the product lines of a large number of industries." (p. 125) The only surprising thing about this situation is the surprise of the CEA.

Prices have a rationing function—to allocate limited supplies among the more urgent users as indicated by their willingness to pay the price—which is particularly important in periods of shortage. If price doesn't allocate supplies then this must be done on a first-come, first-served basis, or by favoritism, or by government priorities or rationing. Where shortages prevail a reduction in price is exactly the wrong prescription and will tend to result in a less efficient use of resources.

2. *The assumption that productivity (output per manhour) is the major factor in wage determination.*—The CEA states "The only valid and noninflationary standard for wage advances is the productivity principle." (p. 128) For some key industries, the rate of change in output per manhour nationally is one factor considered in collective bargaining. But it is neither the only factor nor the most important one. Other factors include the general state of the economy, the growth rates of specific companies and industries, changes in the consumer price index, rival union leadership, comparative wages, and profitability.<sup>1</sup>

Apart from periods of rising living costs, the most important factor in the overwhelming number of wage negotiations is the wage comparison criterion. Although the CEA pays lip service to this criterion (p. 130), it emphasizes that "Very often the wage comparisons in collective bargaining are only part of a game of follow-the-leader which, at best, is irrelevant to resource allocation and, at worst, speeds up a wage-price spiral." (p. 131) It also appears to regret that in one settlement the "customary relationship" between different groups of workers in a company was not destroyed. (p. 131)

Certain key industries such as automobiles and steel have helped to establish patterns for general increases in wages and fringes in the postwar years. The CEA has been concerned primarily with such industries although initially it specifically stated that its guideposts do not constitute "a mechanical formula for determining whether a particular price or wage decision is inflationary." (*Economic Report of the President*, 1962, p. 188) However, settlements in other companies and industries do not always match the "key wage bargains".

For smaller companies and industries as well as in local bargaining, the guideposts have been of minor importance since the factors peculiar to the competitive situation, locality, or industry tend to have greater weight in the minds of the negotiators. It is not surprising, therefore that some of the largest departures from the guideposts have taken place in local bargaining. As a result, wage relationships among different sectors of the local economy are bound to be distorted.

In the real world, wage relationships are of critical importance both to the firm that seeks to hire labor and to the union leadership which must produce results for its members. It is true, as the CEA notes, that proper comparisons often are difficult to make. But each party is more skillful at countering the claims of the other than the CEA seems willing to recognize so that neither party can arbitrarily select only comparisons favorable to itself and make them stick.

In discussing prospective settlements the CEA states that "many wage settlements in 1967 will exceed the trend increase of productivity" (p. 128) In effect it treats changes to compensate for rising living costs as "an additional margin" (p. 128) beyond the productivity total. The reality of collective bargaining will be just the reverse.

The first factor considered by negotiators during periods of rising living costs is what increase is required to restore real wages to the level prevailing when the previous contract was negotiated. Then consideration is given to how much more the adjustment should be to compensate either for anticipated further rises in living costs or to increase real earnings.

<sup>1</sup> For a general discussion see Jules Backman, *Wage Determination*, D. Van Nostrand Co., Inc., Princeton, N.J., 1959, *passim*.

The CEA warns that if the labor cost increase in 1967 is large enough to include "a full allowance for productivity" and "to 'compensate' for past increases in living costs, unit labor costs would rise at a rate which would require living costs to continue their rapid rise." (pp. 128-29) I agree that such an increase would probably result in a rise of 4% or more in unit labor costs. But this does not mean a comparable rise in prices. It could be partly met by a cut in profit margins and a reduction in other costs, which means some unemployment. I believe that the 1967 economy will not permit companies to pass on their higher labor costs in full and that large increases in labor costs will result in lower profit margins and some increase in unemployment.

Thus, part of the price of lack of restraint in labor cost increases in 1967 will be unemployment and lower profit margins. The CEA recommends that "producers should absorb cost increases to the maximum extent feasible." (p. 133)

Moreover, 1967 provides an excellent illustration of a year in which real wages should *not* rise as much as output per man-hour because of the large increase required to achieve this objective. The CEA's recommendation for a hold down in total labor costs is a proper objective but it is inconsistent with its basic guidepost approach, namely, that increases "in average hourly earnings and fringes should be steady and smooth, not erratic." (p. 121)

3. *The assumption that reported increases in private output per man-hour indicate what is available for distribution.*—In its establishment of the productivity standard, the CEA utilizes the changes in output per man-hour in the entire private economy. Initially, it referred to long term gains but soon translated long term to mean five years, because it thought such a period "was sufficiently long to induce both the extraordinarily high productivity gains of a year of recovery (1962) and the extraordinarily low productivity gains of a year of recession (1960)." (*Economic Report of the President*, January 1966, p. 92)

In 1966, after five consecutive years of expansion, the CEA abandoned the five year average because it no longer included a recession year and hence reflected "unsustainable productivity gains". Although the CEA didn't identify the years covered, it concluded that "the long term trend, independent of cyclical swings, is slightly over 3 per cent." (*Ibid.*)

The unfortunate use of a five year moving average prior to 1966 placed the CEA in the embarrassing position of being forced to abandon its own arithmetic when it yielded an average of 3.6% for the 1961-65 period instead of 3.2%. (*Ibid.*) If the CEA had stayed with its goal of education, it necessarily would have stated that changes in output per man-hour cannot be pinpointed and that only a range of changes could be identified. The CEA would then have avoided the situation which increased expectations and may have contributed to the larger increases negotiated later in 1966. The CEA also would have been spared the questions raised about its own integrity.

#### *The shift from agriculture*

The changes in output per man-hour for the entire private economy, including agriculture, overstate the average gains that can be attained by workers. Part of the national increase in output per man-hour reflects the shift from agriculture to the non-agricultural economy where the output per man-hour is higher. The shift away from agriculture has been marked. During the period since 1947, agricultural employment has declined by 4 million while non-agricultural employment has increased by some 20 million.

*Employment, 1947, 1961, 1966*

	Total	Nonagri- cultural	Agricultural	Percent
	<i>Thousands</i>	<i>Thousands</i>	<i>Thousands</i>	
1947.....	57,813	49,557	8,256	14.3
1961.....	66,796	61,333	5,463	8.2
1966.....	74,065	69,859	4,206	5.7
Change, 1947-'66.....	16,252	20,302	-4,050	-----

Since the value of output per manhour in the non-agricultural sector is considerably higher (\$4.26 in 1958 dollars in 1965), than in the farm sector (\$2.31), this shift contributed to an increase in the average national gain in output per manhour.

*Real value output per man-hour*

[1958 dollars]

	1947	1965	Percent increase
Nonfarm.....	\$2.59	\$4.26	64.5
Farm.....	.77	2.31	200.0
Total private.....	2.27	4.12	81.5

Source: U.S. Department of Labor, Bureau of Labor Statistics, "Indexes of Output Per Manhour for the Private Economy 1947-65," (mimeo), Washington, D.C., October 1966, table 1A.

From 1947 to 1965 because of the tripling of the real value output per man-hour in the farm sector, the total rise in the entire private sector was 81.5% as compared with only 64.5% in the non-farm sector.

From 1947 to 1966, output per manhour in the non-agricultural sector of the economy increased 2.8% per year as compared with about 3.3% for the entire private economy. The workers who shifted from farming to the non-agricultural sector received the higher wages already prevailing in that area and hence the part of the gain in private output per manhour resulting from the shift in the mix of total employment already has been distributed. Actually, the maximum amount available for distribution is the increase in output per manhour recorded in the non-agricultural sector, not in the entire private sector.

*Upgrading of labor force*

In recent years, there also has been a shift in the composition of the labor force. For example, production workers accounted for 83.7% of total employment in manufacturing in 1947, 75.1% in 1960, and 74.4% in 1966.

The significant expansion in research and development has involved a large increase in the relative importance of personnel devoted to those activities; automation is having a similar effect. To the extent that non-production workers receive higher average salaries than production workers, part of the gains in output per manhour is required to finance the shift in composition of the labor force, and hence is not available for general improvements in wages and non-wage benefits.

Similarly, an increasing proportion of production workers is found in the skilled category. This changing composition of the labor force also results in a built-in increase in labor costs and thus reduces the amount of productivity gain available for distribution through general increases in wages or non-wage benefits, in higher profits, or in lower prices.

The CEA recognized in 1962 that ". . . it must be borne in mind that average hourly labor costs often change through the process of up-or-down grading, shifts between wage and salaried employment and other forces. Such changes may either add to or subtract from the increment which is available for wage increases under the overall productivity guide." (*Economic Report of the President*, 1962, p. 190). It is probable that on balance these changes have subtracted from the increment available for distribution.

In the light of the foregoing factors, it seems clear that neither the 3.3% annual rate of gain in output per manhour for the entire private economy nor the 2.8% gain for the non-farm economy from 1947 to 1966 is available for distribution. This is one important reason why the rise in real earnings has fallen short of such "guideposts" in the postwar period:

Between 1947 and 1965, the latest year for which data for wage supplements are available:

Real average hourly earnings in manufacturing increased at the annual rate of 2.3%.

Real average hourly earnings plus wage supplements increased at the annual rate of 2.7%.

The CEA has been using output per manhour data that are too high and thus building up expectations for annual rates of increase in real labor income which cannot generally be attained continuously over time.

*Effect of announcing numerical goal*

The high number announced by the Council quickly became the minimum acceptable target for unions and the maximum that some managements were

willing to pay. The CEA recognizes this development in its observation that various statements by the Council "have been interpreted as treating the guideposts as firm, though voluntary, rules, and those who fail to adhere to them as "violators." (P. 123.) This was inevitable and should have been recognized in advance particularly since the CEA says the guideposts "were designed to define more precisely to labor and business" the government policy. (P. 125.)

The recent abandonment of the announced guideposts of 3.2% was a constructive move. It was a mistake to have announced any number in the first place. The proposed modifications which were supposed to be a part of the guideposts were largely ignored except to justify above average increases. Some labor settlements above the target figure became subject to public criticism by the Council and the basis for White House intervention. (Illustrations include the airlines and the New York Transit Authority, p. 127). Similar actions attended reported price increases, as was illustrated by steel, copper, aluminum, molybdenum, cigarettes, and gasoline. (P. 127.)

The CEA hasn't abandoned the guideposts; it has only abandoned the numerical yardstick which it had established to indicate when selected collective bargaining settlement or price actions were in the ballpark. The CEA Report indicates that it is still wedded to the guidepost approach. Thus, after discussing its activities in connection with the price guidepost, it specifically states that "this activity will be continued by the Council." (P. 127.) On February 11th, the *New York Times* reported that in line with the guidepost policy, the Interior Department had requested a rollback of a 1 cent a gallon increase in gasoline prices.

4. *The assumption that real labor income should or could increase at uniform annual rates.*—The guidepost approach attempts to substitute relatively uniform annual increases in real wages for the irregular pattern of growth experienced in the past. Real wages have reflected a composite of changes in income and in the consumer price index and necessarily have risen irregularly rather than at a uniform rate over time. Real labor income can rise in any year as a result of five combinations of changes—

- (1) No change in labor income and a decline in the CPI.
- (2) An increase in labor income and little or no change in the CPI.
- (3) A small *rise* in labor income and a small *decline* in the CPI.
- (4) A decline in both with the CPI recording the larger decline.
- (5) A rise in both with labor income recording the larger rise.

Table 1 shows the annual changes in average hourly earnings and in the CPI for the 46 years between 1919 to 1966. The number in the last column is related to the five alternatives noted above. It must be recognized that the exact relationships shown might have been a little different if fringe benefits could have been included in the hourly earnings. Nevertheless, it is instructive to note that:

1. There were no years in which the hourly earnings remained unchanged and the CPI declined (Alternative 1) (Actually 1949 was such a year but this is not shown by the annual data because the unchanging earnings in 1949 averaged higher than in 1948).

2. There was only one year (1929) in which hourly earnings rose and the CPI remained unchanged (Alternative 2).

3. There were six years (1927, 1928, 1938, 1939, 1949, 1955) in which hourly earnings rose and the CPI declined (Alternative 3).

4. There were four years (1921, 1922, 1931, 1933) when the CPI declined more than hourly earnings (Alternative 4).

5. There were 29 years (including every year except two between 1948 and 1966) when hourly earnings rose more than the CPI (Alternative 5).

There is a sixth alternative, namely that real labor income may decline in some years so that the increases obtained under the first five assumptions must average more than the long term average annually in order to achieve such an average over time. There have been six such declines since 1919 (1925, 1926, 1932, 1945, 1946, 1947).

Despite this record, the CEA in its guideposts, relied upon alternative (2), an unchanged CPI and a rise in labor income. Its success would have imposed a fixed mold during good times and bad and during periods of stability and

inflation instead of the flexibility which has characterized our economy in the past.

*Changes in real income, 1962-66*

Real labor income since 1962 has risen irregularly but has fallen short of the goal of the guideposts. In light of the steady rise in the CPI by a little more than 1% annually in 1962, 1963 and 1964, 1.7% in 1965, and 2.9% in 1966, workers who obtained an average increase of 3.2% in money wages and fringe benefits annually during that period necessarily received a smaller rise in real income.

It must be kept in mind, as the CEA has pointed out from the start, that all labor costs including fringe benefits and social security taxes, must be considered in utilizing the guideposts. For example, the social security tax paid by employers increased from 3% of wages (up to \$4,800) in 1961, to 3½% in 1962, 3¾% in 1963 to 1965, and 4.2% (up to \$6,600) in 1966. The increase in the social security tax averaged 0.2% of hourly earnings annually from 1961 to 1966.

The changes in money income and in real income are shown in Table 2. The average rise in hourly earnings plus wage supplements<sup>1</sup> in manufacturing in money terms was 3.3% per year from 1961 to 1965. Somewhat larger annual increases were recorded in other sectors of the economy from 1961 to 1965: construction, 3.1%; wholesale and retail trade, 3.9%. (See Table 3) However, after adjustment for the rise in the consumer price index the increase in real terms averaged only about 2% annually in manufacturing and 2.5% for trade or short of the rise postulated in the guideposts.

In interpreting these data, it must be kept in mind that the increases in costs to employers were somewhat higher because these data do not reflect the cost of fringe benefits involving time off with pay. Nevertheless, it is probable that the increases in real earnings were less than the objectives established by the CEA. And this is really unavoidable because as was indicated earlier, the CEA standard is too high.

5. *The assumption that unorganized sectors would follow the leaders.*—From the outset of the guidepost policy in 1962, the CEA has directed its attention primarily to the "important segments of the economy in which large firms or well-organized groups of employees have same discretionary ability to affect the levels of their prices and wages." (p. 120) These may be described as the highly visible unions and industries.

The CEA assumed that "compensation in unorganized sectors would rise at the same average rate, equal to the gain in over-all productivity." (p. 122) Of course, this unorganized sector includes workers affected by federal minimum wages which have risen much more than the guideposts as the CEA recognizes (p. 129) (From \$1 in August 1961 to \$1.25 in September 1963 and \$1.40 in February 1967) But apart from this development it is of interest to note that the largest increases in consumer prices have been in the service sector which is largely populated by unorganized workers.

The CEA assumed that if the highly visible industries conformed to the price guideposts, "the average of prices would also be stable in the other, highly competitive industries (including agriculture and most services) where firms had no discretion." (p. 123) This is a naive view of relationship between prices of agricultural products and services and those for industrial products.

Prices of agricultural products are significantly influenced by supplies here and abroad and historically have fluctuated much more widely than industrial prices both in the long run and in short periods. For example, from 1940 to 1948, agricultural prices rose 184% as compared with the rise of 75% for industrial prices. In 1958, farm product prices rose 4.4% while industrial prices fell by 2%. In 1959, the trends were reversed. Table 4 shows the diverse annual changes since 1939.

Thus, the assumption that prices of farm products, and in turn food, would maintain a fixed relationship to other prices has not worked out nor was there any reason to expect that it would.

Similarly, the prices of services have risen without interruption in the past quarter of a century while the prices of goods in the CPI have recorded declines

<sup>1</sup> Data reported for wage supplements include legally required social security and unemployment compensation taxes and negotiated pension and welfare benefits.

as well as advances. For example, prices of all commodities in the CPI declined in 1949, 1953, 1954, and 1955 and prices of the durable goods component, an area of great visibility, declined in 1953, 1954, 1955, 1960, 1961 and 1965.

The objective of stabilizing the CPI could not be attained because of the inability to prevent a rise in the prices of many services (such as hospital care, education, personal care, etc.) which represent essentially labor costs. These are sectors of the economy which have relatively small improvements in output per man-hour so that higher labor costs tend to be translated more readily into higher prices. The impossibility of preventing rises in farm and food prices also was important. The CEA recognizes that these are "areas to which the guideposts have no applicability." (p. 128)

The fact is that the guideposts failed to stabilize the CPI from the outset even apart from the increases in foods and services, as the figures in Table 5 show. From 1961 to 1966, the total CPI rose 8.5%. If it had not been for the rise of 13.6% for services and 11.3% for food, the overall advance would have been considerably smaller but there would still have been a rise of about 5% or an average of about 1% annually.

Thus, the effort to contain price inflation by confrontation has not been successful. Criticisms of price increases in aluminum, steel, and other industries have held down prices in those areas and undoubtedly has resulted in a more cautious approach to price increases in other industries. However, the overall effect on the WPI has been minor and there probably has been little effect on the CPI.

In this connection, too, it should be noted that the incomes policy—the parallel approach in such countries as Western Germany and United Kingdom—has not prevented general increases in prices. In England, for example, the cost of living increased almost 5% in 1965 and almost 4% in 1966. The increases in West Germany were about one-half percentage less in both years.

#### *Market power and prices*

The CEA states that "businesses and unions can push prices up even when resources are not fully utilized." (p. 119). However, the record shows that from 1958 to 1964, when the economy operated substantially below capacity, wages and prices were not "pushed up" generally. (See Tables 6 and 7)

Between 1958 and 1964:

For manufacturing industries, capacity utilization averaged between 74% and 86%.

The unemployment rate was between 5.2% and 6.8%.

Wholesale industrial prices recorded no change with the annual indexes ranging between 100.3 and 100.7 (1957-59=100).

The consumer price index rose slightly more than 1% a year.

Unit labor costs in manufacturing industries remained relatively stable and for the entire corporate economy rose about 1% annually.

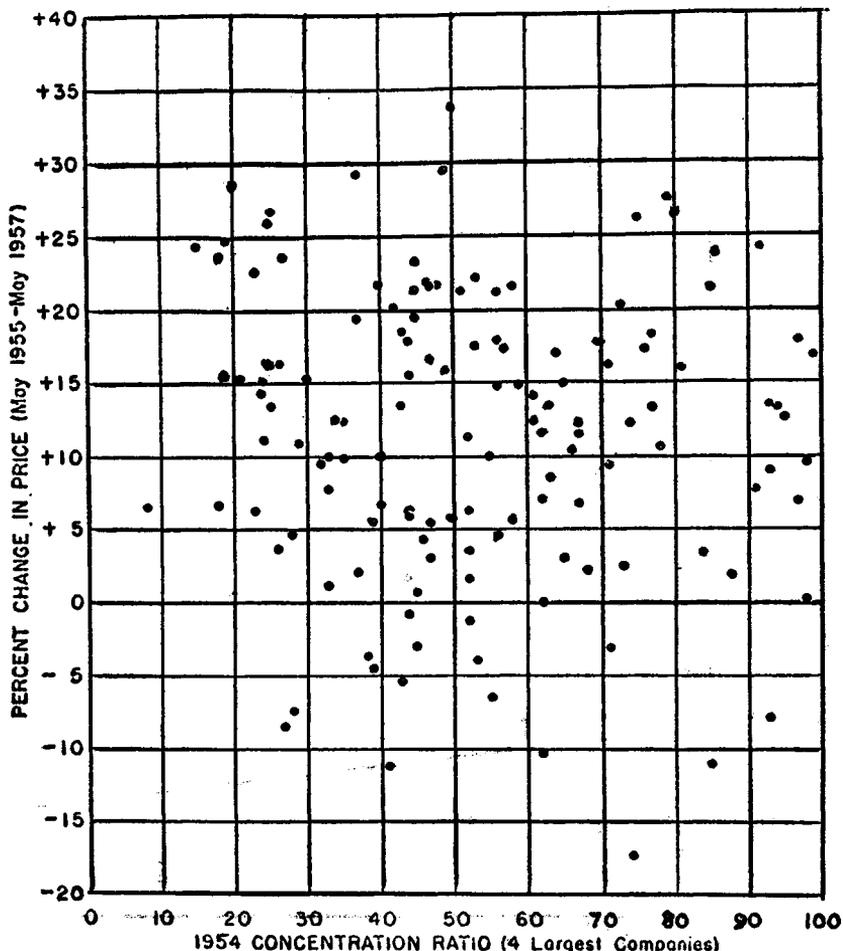
This period of relatively unimportant changes in prices and in unit labor costs includes the 3 years *before* the guideposts were formulated (1958 to 1961) and the first three years of their use (1962 to 1964).

In connection with the assumption that big business has market power which can be used to raise prices excessively, it is instructive to keep in mind that the largest price rises in the past two years have been in farm products, foods, and services rather than in the products of big business. In the absence of the guidepost policy, it is probable that there would have been somewhat larger increases than actually developed in the latter areas. However, there is no evidence that they would have been as large as the rise for services or that they would have had an important impact on the CPI.

Similar charges concerning the effects of market power upon prices were made in connection with the price rises in the mid-1950's. To check the factual basis for such an assumption, I studied the relationship between economic concentration as measured by the share accounted for by the Big Four in 1954, and the changes in wholesale prices from May 1955 to May 1957 for 136 groups of metals and metal products. Chart 1 shows that there was no relationship between the price change and the degree of concentration.<sup>1</sup>

<sup>1</sup> Jules Backman, *Administered Prices, Administered Wages, and Inflation*, Current Business Studies, Society of Business Advisory Professions, New York University, October 16, 1957, pp. 5-24.

CHART 1. METALS AND METAL PRODUCTS CONCENTRATION VERSUS PRICE CHANGE



Source: Jules Backman, "Administered Prices, Administered Wages, and Inflation," *Current Business Studies* No. 28, Society of Business Advisory Professions, Inc., p. 13.

Similarly, it is frequently stated that large-scale advertising expenditures create market power. To determine the extent to which this market power has been exercised I have recently completed studies of the relationship between the intensity of advertising, as measured by the ratio of advertising expenditures to sales, and the changes in prices from 1947 to 1966.<sup>3</sup> Chart 2, which illustrates one of the comparisons made, is reproduced from that study. (See Table 8)

The general conclusion of my study is as follows:

"The most intensively advertised categories of products have tended to show smaller increases in price than less heavily advertised categories during the post-World War price inflation. The postwar record of changes in wholesale and retail prices for broad groups of products and for selected foods and proprietary drugs reveals that there has been no relationship between the intensity of advertising expenditures and the magnitude of price increases.

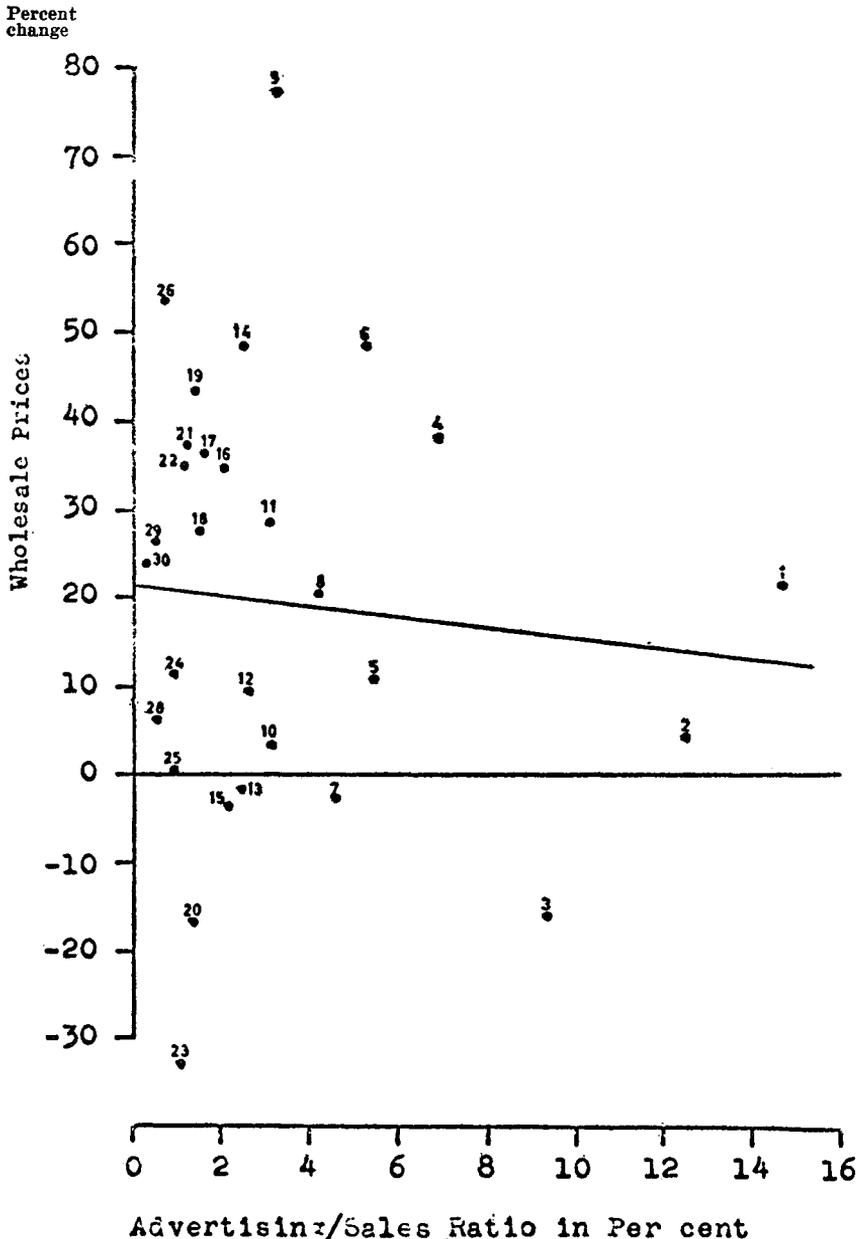
"These data indicate that heavy advertising expenditures did not create a degree of market power which gave the affected industries the freedom to raise prices substantially during this period of general price inflation. It may be asserted that these data merely show that the market power was unexercised but

<sup>3</sup> The detailed findings will be contained in *Advertising and Competition* to be published by New York University Press in the Spring.

remains a threat in the future. However, the earlier discussion indicated that the theory that brands create excessive market power is a myth. The price experience reinforces this conclusion."

These studies are cited to illustrate that market power need not necessarily be translated into higher prices.

CHART 2. ADVERTISING OUTLAYS PER DOLLAR OF SALES, 1962, AND PER CENT CHANGE IN WHOLESALE PRICES, 1947-65, FOR SELECTED COMMODITIES



Source : Jules Backman, *Advertising and Competition*, New York University Press, 1967.

## PRICES AND WAGES IN 1967

I should like to examine now the prospective changes in wages and prices this year. Monetary and fiscal developments have been accompanied by a booming economy and by a higher rate of price inflation. The consumer price index rose about 3% in the past year as compared with an annual rate of slightly more than 1% between 1958 and 1965. Even more important, because there are daily reminders of its impact, food prices increased 3.8% as compared with an annual rate of about 1% in the preceding seven years. And practically all categories of foods have risen in price.

Retail prices have advanced across-the-board with every major category rising 2.0% or more. Increases exceeded 6% for public transportation, footwear, and medical care among the subgroups. (See Table 9).

Industrial wholesale prices increased 2.2% between December 1965, and December 1966. Most of this rise had taken place by July, 1966. Prices of processed foods rose through August and have since recorded a modest decline. (See Table 10).

A significant change has developed since July, 1966. During the nine months ending in July, when the index of industrial wholesale prices rose by 3.2%, each of the 13 groups of prices included in this index advanced. (See Table 11).

In the seven months from July 1966 to January 1967, a markedly different pattern emerged. The industrial price index rose only 0.6% as declines for four groups offset in part the increase recorded by nine groups of prices. This is not the pattern that develops when strong inflationary pressures are operating in the economy. It is apparent that inflationary pressures have subsided since July, 1966. One of the most important clues to the re-emergence of general inflationary pressures will be found in the anatomy of price changes. This is an area, therefore, to be watched carefully in the months ahead.

The more important factors to be considered in evaluating price trends in the year ahead may be summarized as follows:

*Pressures for Price Rise*

1. The federal budget will continue in the red even if the proposals to raise taxes are adopted. Any further escalation in Vietnam would intensify fiscal inflation unless it is offset by a rise in revenues including higher tax rates. Any cutback in our Vietnam commitment would virtually eliminate inflationary pressures from this source.

2. The major pressures for price inflation in 1967 will probably develop from higher unit labor costs. After five years of nominal increases in unit labor costs in the economy and small declines in manufacturing industries, we are now experiencing a rise. The increase in hourly wages and fringes plus higher social security costs added almost 5% to hourly labor costs in 1966. The net result was an increase almost 3% in average unit labor costs in manufacturing for 1966 and a rise of 4% for the corporate economy. This has meant increasing pressure on prices from the cost side. (See Table 6).

The prospect is for an even larger increase in unit labor costs in 1967. Wages and fringe benefits costs probably will rise more rapidly largely due to the increases in the consumer price index and to the relatively low level of unemployment. The increase in automobile hourly wages in 1966 will probably become a target for other unions. Auto workers received an annual improvement factor increase of 2.8% (with a minimum of 7 cents an hour) plus a two cents across-the-board increase plus cost of living increases aggregating 11 cents an hour. This appears to be a wage increase of about 7% in 1966. However, when this wage increase is related to total hourly labor costs including fringes, the rise probably is between 5% and 6%. For all manufacturing industries, hourly earnings rose by 4.1% in the year ending in December. (See Table 12).

In addition, the increase in the minimum wage from \$1.25 to \$1.40 an hour became effective February 1 and social security costs increased from 4.2% to 4.4%. An average increase of more than 5% in hourly costs is probable in 1967.

On the other hand, output per man-hour for the nonfarm economy should increase at a lower rate than in recent years, probably no more than 2%-2½%. The net result will be a rise in unit labor costs of several percent.

It is not going to be easy to pass on very large labor cost increases in higher prices. Moreover, other costs will not be cut rapidly enough to provide an offset to higher labor costs. The result will be a squeeze on corporate profits. It is

already underway. I think we can see this in some industries where mild declines in volume are generating an erosion in profits of significant amounts. So we will have an economy which will have areas of expanding profits and areas of declining profits, but on balance corporate profit should decline.

My feeling is that in 1967, higher unit labor costs will be accompanied by a narrowing of profit margins and by some increase in unemployment. Nevertheless, there will be some pressure for higher prices from labor costs. Higher labor costs could be the most inflationary force in 1967.

#### *Indicators of Lower Prices*

1. One important portent has been the movement of sensitive raw materials prices during the past year. Changes in these prices tend to precede those in the general price level. The raw materials index, which is fairly responsive to underlying pressures, rose about 11% in the year ending February, 1966, at which time it averaged 113.8 (1957-59=100), (the actual daily high was about 115). During the past year, despite the public concern with price inflation, this index has been drifting lower. On February 14, the index was 102.2 or about 10% below the February 1966 level. Every group of raw materials was below the level prevailing a year earlier. (See Table 13)

Wholesale industrial prices have recorded little change since last July. Moreover, as I noted earlier, four out of 13 groups of industrial prices declined between July 1966 and January 1967. Such behavior does not portend a higher rate of increase in consumer prices than we have been experiencing. Rather, it suggests that the increase will be at a lower rate.

2. There are indications that in the absence of further sharp escalation in Vietnam, the rate of increase in economic activity may slow down and may even come to a halt. The expansion which has lasted six years is looking tired, particularly in the civilian sector of the economy. Tighter credit was accompanied by sharp cutbacks in the building industry and this is affecting related lines of activity. There have also been reductions in automobile sales. It is improbable that inventories will continue to rise at the recent rate of more than \$1 billion a month. Any reduction in the rate of accumulations would reduce significantly the pressures for higher prices.

3. The suspension of the 7% Investment Tax Credit and of accelerated depreciation for buildings combined with tight money helped to slow down the boom in plant and equipment spending. Narrower profit margins, which are probable for this year, will reduce the incentive as well as the funds available to finance new plant and equipment. On the other hand, higher labor costs will increase the incentive to substitute machinery for manpower. On balance, a leveling off and then a decline in plant and equipment spending are in prospect. Such a development would contribute to the easing of credit and would act to reduce the pressure for higher prices.

I don't think that the restoration of the 7% tax credit on January 1, 1968, if it takes place, will do very much to arrest such a decline which will reflect fundamental readjustments in our economy.

If the Vietnam war ends, the level of real gross national product should decline from the level prevailing at the end of the war. I think there would be a swing in inventories, which alone would eliminate \$15 to \$20 billion from the national product.

I see 1967 as a year in which there will be a slower rate of growth if the Vietnam war continues, and a moderate recession, similar to the post-Korean one, if the Vietnam war ends.

I do not believe that any recession that develops will be deep and prolonged. The built-in stabilizers and the developments in federal fiscal policy and monetary policy would be such as to contain its magnitude, as it has in each of the postwar recessions.

4. Plant capacity has been expanding at a faster rate than the demand for goods and services so that excess capacity may develop in some industries in 1967. Such a development would make it difficult to raise prices and, in fact, would create pressures for price declines in the affected industries. We have already seen signs of this tendency in the chemical industry, and I think this will spread.

#### *Price outlook*

Inflationary pressures are still present in the economy, particularly from higher labor costs. However, on balance there is a strong probability that we have seen the maximum rate of pressures for price inflation. Prices should

rise at a slower rate in 1967. Assuming no change in Vietnam, the rise in the Consumer Price Index should be 3% or less, and that in industrial wholesale prices 2% or less.

The degree of price inflation will be determined to a large extent by events in Vietnam and by the fiscal and monetary policies adopted. Further escalation of the war would intensify the pressures for higher prices unless fully offset by higher taxes. On the other hand, a stabilization of the war effort or a cutback would moderate significantly the pressures for price inflation. Since I have no way to determine which of these two alternatives will develop, any projection of prospective price changes must be qualified.

#### THE FUTURE OF WAGE-PRICE GUIDEPOSTS

I strongly endorse the educational objectives of the guideposts as originally described in 1962. It is useful to emphasize there are general limits to rates of gain in real wages and in the levels of living that can be realized annually particularly since public expectations seem to have far outdistanced the possibilities of even our affluent society. However, the CEA analysis is based on so many erroneous assumptions that the educational value of the guideposts is open to serious question. There is little value to a program which educates the public to believe that unit labor costs determine prices, that only productivity determines wages, that real wages can increase at an uniform annual rate, that the general price level can be stabilized by controlling increases in labor costs, or that levels of living can be raised by 3% or more annually.

Moreover, an educational goal stated in general terms is a far cry from the establishment of annual objectives expressed in numerical terms. The guideposts as used prior to this year unfortunately created expectations of steady, annual increases in real labor income at a 3.2% rate, or higher than is realistic and hence higher than actually developed. Moreover, such a steady increase in real income each year ignores the fact that labor payments perform a rationing function as well as provide a source of purchasing power. Different rates of change in labor income are appropriate for periods of recession than for periods of marked economic growth. The failure of the guideposts to provide for these cyclical variations is another weakness that usually is ignored.

We will be better off with the termination of this experiment in economic marksmanship. As a device to determine acceptable increases in wages and prices, the guideposts leave much to be desired. The implementation by persuasion has really had no administrative base and appears to have been a hit or miss affair. If the objective is to overcome the market power of labor and business, guideposts are a very crude tool since they seek to contain the exercise of that power in a few instances rather than to attack it at the source.

If we desire to contain market power by business, the main instrumentality is the antitrust laws. Pressures on prices can also be modified by the timing of government spending programs, lowering barriers to foreign trade, and by sales from the stockpile. It must be recognized that while the latter programs can be helpful in stabilizing the prices of some products they cannot stabilize the general price level.

The elimination of make-work practices, and of restrictions on membership in some unions, retraining, training and mobility programs, and repeal or modification of the Walsh-Healey Act and Bacon-Davis Act could help reduce the pressures on the labor front but there would still remain the strong market power of the unions in many industries. One difficulty is that problems may develop through small unions strategically located as well as the giant unions which are the usual targets for anti-monopoly proposals.

The most constructive approach would require the mix of fiscal and monetary policies which would restrict excessive expansion in the economy plus direct attacks on specific abuses of market power.

In the wage-price environment projected for this year the guideposts can serve no useful purpose. On the contrary, they may aggravate what already are certain to be excessively large increases in labor costs. By emphasizing long term gains in output per manhour and the accompanying rise in living standards, they encourage unions to seek increases large enough to cover both the past rise in the CPI and the so-called "normal" rise in real wages. This combination would mean labor cost increases of 7% or more and would result in a substantial rise in unit labor costs as the CEA has warned (p. 129). The abandonment of a specific numerical value for labor cost increases was unavoid-

able under these conditions. The quiet burial of the wage-price guideposts would be equally constructive.

The test of a proper increase in wages and non-wage benefits in any specific negotiation cannot be some "guesstimate" of the average national rise in output per manhour. It is true that the average rise in real labor income for all industries will be close to the average rise in output per manhour for the national economy over a long period of time. But this relationship is neither close nor meaningful on a year to year basis for the entire economy nor for individual companies or industries. The rate of increase for specific industries, companies, or groups of workers will and should vary—often markedly—from the national average. Moreover, increases in money labor costs should not take place annually and if they do they should not be uniform each year. They can be larger in periods of prosperity and smaller or even nothing in periods of recession. They will tend to be greater in periods of inflation and smaller at other times. These variations in the magnitude of changes either annually or periodically are more in accord with the needs of a dynamic economy than any uniform rate of change. It is true that the CEA proposal has an escape hatch which provides for some exceptions to the productivity standard. If the hatch is used, however, the exception will become the rule and the use of the productivity standard the exception. And this is how it should be.

There is no simple wage formula which will yield the right answer for all negotiations in one period or for negotiations of any company or industry over time. The proposal discussed in this paper represents the triumph of the productivity criterion and is based upon the assumption that it will yield a stable price level. However, a proper national wage policy cannot be framed solely with the objective of preventing inflation. It also must consider the demand for labor and hence the impact on the volume of unemployment as well as other factors. If the international balance of payments problem becomes intensified, for example, national policy may have to seek to translate productivity gains into lower prices and an improved competitive position for our products *vis-à-vis* foreign products both here and abroad. Under these circumstances wage increases could be only minimal.

Nor does the proposed policy assure a stable level of prices since price levels are determined by a wide variety of forces of which stability in unit labor costs is far from being the most important. In fact, the whole underlying theory of price determination—namely that prices are determined by unit labor costs—has no basis in fact.

Among the other weaknesses of the proposed guidepost are the following: part of the gains in output per manhour is not available for general increases in wages and non-wage benefits because it is being absorbed by the increase in relative importance of scientific and professional workers and the upgrading in skills of production workers; the stresses created by equal annual rates of increase in labor income when output per manhour changes with great irregularity; the undesirability of freezing labor's share of national income; the varying importance of direct labor costs among different industries with the differing inflationary impact of relatively uniform increases in labor income; and the ineffectiveness of exhortation as the method of implementing the proposal and the undesirability and impossibility of imposing effective wage control.

Finally, it should be emphasized that the proposed guidepost is based on the assumption that gains in output per manhour should be distributed largely in the form of increases in labor income. The needs of an expanding economy, the attainment of high level employment, and our foreign competitive position would be better served if productivity gains were used to a larger extent to reduce prices. Lower prices would increase the real incomes of workers as well as of other groups who contribute directly or indirectly to the increase in output per manhour. Simultaneously, a price reduction would encourage an expanding volume of effective demand for the products directly affected by rising output per manhour. In the absence of a reduction in prices, volume does not expand, fewer workers are required to produce the former volume of output and hence one result is greater unemployment.

By lowering the price it is often possible to assure a prompt use of the released resources. Thus, price reductions help to reduce the threat of technological unemployment at the point of impact by expanding the effective demand

for the products which can be produced more efficiently.<sup>34</sup> Lower prices would be a more effective route to economic growth and expanding employment opportunities than increases in labor income. Therefore, the use of productivity as the guidepost for proper increases in wage and non-wage benefits should be rejected both on grounds of feasibility and economic desirability.

TABLE 1.—Year-to-year changes in average hourly earnings, manufacturing industries and in the Consumer Price Index, 1919-66

[1957=59-100]

Year	Average hourly earnings in manufacturing	Year-to-year percent change	Consumer price index	Year-to-year percent change	Relationship of average hourly earnings to CPI <sup>1</sup>
1919	\$0.472		60.3		
1920	.549	+16.3	60.8	+15.8	5
1921	.509	-7.3	62.3	-10.7	4
1922	.482	-5.3	58.4	-6.3	4
1923	.516	+7.1	59.4	+1.7	5
1924	.541	+4.8	59.6	+0.3	5
1925	.541	0	61.1	+2.5	6
1926	.542	+0.2	61.6	+0.8	6
1927	.544	+0.4	60.5	-1.8	3
1928	.556	+2.2	59.7	-1.3	3
1929	.560	+0.7	59.7	0	2
1930	.546	-2.5	58.2	-2.5	7
1931	.509	-6.8	53.0	-8.9	4
1932	.441	-13.4	47.6	-10.2	6
1933	.437	-0.9	45.1	-5.3	4
1934	.526	+20.4	46.6	+3.3	5
1935	.544	+3.4	47.8	+2.6	5
1936	.550	+1.1	48.3	+1.0	5
1937	.617	+12.2	50.0	+3.5	5
1938	.620	+0.5	49.1	-1.8	5
1939	.627	+1.1	48.4	-1.4	3
1940	.655	+4.5	48.8	+0.8	5
1941	.726	+10.8	51.3	+5.1	5
1942	.851	+17.2	56.8	+10.7	5
1943	.957	+12.5	60.3	+6.2	5
1944	1.011	+5.6	61.3	+1.7	5
1945	1.016	+0.5	62.7	+2.3	6
1946	1.076	+5.8	68.0	+8.5	6
1947	1.217	+13.2	77.8	+14.4	6
1948	1.328	+9.1	83.8	+7.7	5
1949	1.378	+3.8	83.0	-1.0	3
1950	1.440	+4.5	83.8	+1.0	5
1951	1.56	+8.3	90.5	+8.0	5
1952	1.65	+5.8	92.5	+2.8	5
1953	1.74	+5.5	93.2	+0.8	5
1954	1.78	+2.3	93.6	+0.4	5
1955	1.86	+4.5	93.3	-0.3	3
1956	1.95	+4.8	94.7	+1.5	5
1957	2.05	+5.1	98.0	+3.5	5
1958	2.11	+2.9	100.7	+2.8	5
1959	2.19	+3.8	101.5	+0.8	5
1960	2.26	+3.2	103.1	+1.6	5
1961	2.32	+2.7	104.2	+1.1	5
1962	2.39	+3.0	105.4	+1.2	5
1963	2.46	+2.9	106.7	+1.2	5
1964	2.53	+2.8	108.1	+1.3	5
1965	2.61	+3.2	109.9	+1.7	5
1966	2.71	+3.8	113.1	+2.9	5

<sup>1</sup> Notes:

- 2 Average hourly earnings up, CPI unchanged.
- 3 Average hourly earnings up, CPI down.
- 4 Average hourly earnings down, CPI down more.
- 5 Average hourly earnings up more than CPI.
- 6 Real hourly earnings down.
- 7 No change in real hourly earnings.

<sup>34</sup> It is recognized, of course, that the extent to which effective demand will increase in response to lower prices will vary for different products.

TABLE 2.—Hourly earnings, manufacturing industries, year-to-year percent change  
[Percent]

	Money		Real	
	Average hourly earnings	Average hourly earnings plus wage supplemental	Average hourly earnings	Average hourly earnings plus wage supplemental
1962.....	3.0	3.4	1.8	2.0
1963.....	2.9	3.4	1.8	2.4
1964.....	2.8	2.9	1.3	1.5
1965.....	3.2	3.5	1.3	1.9
1966.....	3.8	-----	1.3	-----
1961-1965 total.....	12.5	14.0	6.3	8.1
Per annum.....	3.0	3.3	1.6	2.0

TABLE 3.—Average hourly earnings plus wage supplements in manufacturing, construction, communications, and trade, 1961-65

MANUFACTURING							
	Wages and salaries	Supplements	Percent	Average hourly earnings	Supplements	Total	Year-to-year percent change
	<i>Millions</i>	<i>Millions</i>					
1961.....	\$89,823	\$9,895	11.0	\$2.32	\$0.26	\$2.58	
1962.....	96,662	11,496	11.9	\$2.39	.28	\$2.67	3.4
1963.....	100,606	12,282	12.2	\$2.46	.30	\$2.76	3.4
1964.....	107,166	13,294	12.4	\$2.53	.31	\$2.84	2.9
1965.....	115,509	14,558	12.6	\$2.61	.33	\$2.94	3.5
Percent change, 1961-65.....	-----	-----	-----	12.5	-----	14.0	3.3
CONSTRUCTION							
1961.....	\$15,843	\$1,329	8.4	\$3.20	\$0.27	\$3.47	
1962.....	16,842	1,435	8.5	\$3.31	.28	\$3.59	3.5
1963.....	17,802	1,664	9.3	\$3.41	.32	\$3.73	3.9
1964.....	19,446	1,744	9.0	\$3.55	.32	\$3.87	3.8
1965.....	21,105	1,859	8.8	\$3.69	.32	\$4.01	3.6
Percent change, 1961-65.....	-----	-----	-----	15.3	-----	15.6	3.7
COMMUNICATIONS							
1961.....	\$4,613	\$514	11.1	\$2.37	\$0.26	\$2.63	
1962.....	4,816	554	11.5	\$2.48	.29	\$2.77	5.3
1963.....	5,013	574	11.5	\$2.56	.29	\$2.85	2.9
1964.....	5,405	686	12.7	\$2.62	.33	\$2.95	3.5
1965.....	5,764	747	13.0	\$2.70	.35	\$3.05	3.4
Percent change, 1961-65.....	-----	-----	-----	13.9	-----	16.0	3.8
WHOLESALE AND RETAIL TRADE							
1961.....	\$46,211	\$2,872	6.2	\$1.84	\$0.11	\$1.95	
1962.....	48,740	3,255	6.7	\$1.90	.13	\$2.03	4.1
1963.....	51,416	3,544	6.9	\$1.97	.14	\$2.11	3.9
1964.....	55,132	3,703	6.7	\$2.06	.14	\$2.20	4.3
1965.....	59,166	3,935	6.7	\$2.13	.14	\$2.27	3.2
Percent change, 1961-65.....	-----	-----	-----	15.8	-----	16.4	3.9

TABLE 4.—Year-to-year percent change in wholesale prices: All commodities, farm products, processed foods and industrials, 1940-66

	Year-to-year percent changes			
	All commodities	Farm products	Processed foods	Industrials
1940	+1.9	+3.5	+0.5	+1.7
1941	+11.2	+21.3	+15.6	+7.5
1942	+13.0	+28.9	+17.3	+7.2
1943	+4.6	+15.8	+4.4	+1.5
1944	+0.7	+0.7	-2.2	+1.6
1945	+1.8	+4.0	+0.7	+1.3
1946	+14.2	+15.7	+27.1	+9.6
1947	+22.8	+20.4	+27.1	+22.0
1948	+8.3	+7.3	+8.0	+8.5
1949	-5.0	-13.5	-9.8	-2.1
1950	+4.0	+5.0	+4.3	+3.6
1951	+11.4	+16.4	+11.6	+10.4
1952	-2.8	-5.7	-2.3	-2.3
1953	-1.4	-9.3	-3.9	+0.8
1954	+0.2	-1.4	+0.6	+0.3
1955	+0.3	-6.2	-3.4	+2.2
1956	+3.2	-1.3	0	+4.4
1957	+2.9	+2.7	+3.8	+2.8
1958	+1.4	+4.4	+5.1	+0.3
1959	+0.2	-6.2	-3.6	+1.8
1960	+0.1	-0.3	+0.8	0
1961	-0.4	-0.9	+0.7	-0.5
1962	+0.3	+1.8	+0.5	0
1963	-0.3	-2.0	-0.1	-0.1
1964	+0.2	-1.5	-0.1	+0.5
1965	+2.0	+4.3	+4.1	+1.3
1966	+3.2	+7.3	+6.1	+2.1

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 5.—Consumer prices, 1961-66

[1957-59=100]

	Total CPI	Food	All services except rent	Rent	Commodities less food
1961	104.2	102.6	110.0	104.4	102.0
1962	105.4	103.6	112.1	105.7	102.8
1963	106.7	105.1	114.5	106.8	103.5
1964	108.1	106.4	117.0	107.8	104.4
1965	109.9	108.8	120.0	108.9	105.1
1966	113.1	114.2	125.0	110.4	106.4
Percent increase 1961-66	8.5	11.3	13.6	5.7	4.4

TABLE 6.—Unit labor costs, 1957-66

[1957-59=100]

	Labor cost per unit of output, manufacturing	Labor cost per dollar of real corporate GNP
1957.....	98.6	98.7
1958.....	102.2	100.8
1959.....	99.7	100.7
1960.....	100.6	103.2
1961.....	100.3	103.7
1962.....	100.4	103.3
1963.....	99.7	104.0
1964.....	99.7	104.5
1965.....	99.0	105.1
1966:		
February.....	98.9	104.5
May.....	98.9	105.3
August.....	98.6	105.3
November.....	99.9	105.4
1966:		
February.....	99.9	106.8
May.....	100.3	108.4
August.....	101.0	109.6
November.....	102.5	(1)
December.....	102.7	(1)

<sup>1</sup> Not available.

Source: U.S. Department of Commerce, Bureau of the Census, Business Cycle Developments.

TABLE 7.—Trends of capacity utilization, unemployment, prices, and hourly earnings, 1957-66

	Capacity utilization rate manufacturing (percent)	Unemployment rate (percent)	Consumer price index [1957-59=100]	Wholesale price index [1957-59=100]	Wholesale industrial prices	Average hourly earnings
1957.....	84	4.3	98.0	99.0	99.2	\$2.05
1958.....	74	6.8	100.7	100.4	99.5	2.11
1959.....	82	5.5	101.5	100.6	101.3	2.19
1960.....	81	5.6	103.1	100.7	101.3	2.26
1961.....	79	6.7	104.2	100.3	100.8	2.32
1962.....	82	5.6	105.4	100.6	100.8	2.39
1963.....	84	5.7	106.7	100.3	100.7	2.46
1964.....	86	5.2	108.1	100.5	101.2	2.53
1965.....	89	4.6	109.9	102.5	102.5	2.61
1966.....	91	3.9	113.1	105.8	104.7	2.71

Source: Economic Report of the President, Jan. 1967, pp. 236, 245, 253, 262, 264.

TABLE 8.—Advertising-sales ratio, 1962, and changes in wholesale prices, selected periods, 1947-66

[In percent]

	Advertis- ing out- lays per dollar of sales, 1962	Weights in whole- sale price index December 1962	Changes in wholesale prices			
			1947 to 1965	1957-59 to 1965	1957-59 to Decem- ber 1965	1957-59 to June 1966
1 Toilet preparations .....	14.72	0.355	21.6	4.2	4.8	6.6
2 Soap, detergents .....	12.55	.563	5.7	4.5	4.4	4.2
3 Drugs <sup>1</sup> .....	<sup>2</sup> 9.39	.859	-16.2	-5.6	-5.4	-5.5
4 Beer and malt .....	6.89	.674	38.0	0.9	1.6	1.4
5 Clocks and watches .....	5.45	.126	10.4	-4.2	-4.2	-3.0
6 Tobacco <sup>3</sup> .....	5.28	.752	48.4	5.8	5.6	10.0
7 Wines, brandy .....	4.58	.103	-2.8	11.4	11.6	9.7
8 Confectionery <sup>4</sup> .....	4.22	.099	20.7	-0.7	-6.6	-6.6
9 Cutlery, hand tools, hardware .....	3.28	.593	77.4	5.9	7.0	9.5
10 Grain-mill products <sup>5</sup> .....	3.18	.449	3.1	13.3	15.3	22.8
11 Photographic equipment .....	3.11	.142	28.8	7.3	7.4	6.8
12 Canning <sup>6</sup> .....	2.72	1.023	9.3	2.1	5.1	4.8
13 Appliances .....	2.48	.953	-3.6	-10.8	-11.2	-10.6
14 Bakery <sup>7</sup> .....	2.48	1.397	48.2	7.9	10.4	12.4
15 Distilled liquor .....	2.18	.269	-3.3	-2.8	-2.8	-2.8
16 Tires and tubes .....	2.09	.533	34.7	-10.0	-8.9	-5.6
17 Paints and varnish <sup>8</sup> .....	1.65	.312	36.5	5.4	5.9	6.8
18 Dairy products <sup>9</sup> .....	1.57	2.594	27.5	8.5	11.3	17.0
19 Footwear .....	1.43	.786	43.2	10.7	13.8	19.1
20 Radio and television <sup>10</sup> .....	1.37	.454	-17.0	-14.8	-11.5	-16.5
21 Household furniture .....	1.25	.957	37.5	6.2	6.7	8.9
22 Floor coverings .....	1.18	.228	34.9	-5.6	-6.0	-2.9
23 Knit goods .....	1.07	.082	-32.9	-8.4	-16.5	-20.4
24 Men's, youths' and boys' apparel .....	.97	1.182	11.6	8.7	10.1	11.3
25 Women's, misses and children's cloth- ing .....	.96	1.499	0.4	2.2	2.6	2.7
26 Motor vehicles .....	.74	3.923	53.7	0.7	0.5	0.7
27 Motorcycles and bicycles <sup>11</sup> .....	.67	.072	NA	-4.3	-4.2	-2.9
28 Meats .....	.56	3.579	6.1	0.8	12.1	8.6
29 Petroleum refining <sup>12</sup> .....	.49	4.044	26.5	-4.1	-1.6	0.2
30 Sugar .....	.28	.383	24.0	11.0	12.8	11.0
Total wholesale price index .....			26.2	2.5	4.1	5.7

NOTE.—The price data used are indicated by the following footnotes.

- <sup>1</sup> Drugs and pharmaceuticals.
- <sup>2</sup> 1961.
- <sup>3</sup> Cigarettes, nonfilter tip, regular size.
- <sup>4</sup> Candy bars; solid chocolate.
- <sup>5</sup> Includes flour and flour base cake mix.
- <sup>6</sup> Canned and frozen fruits and vegetables.
- <sup>7</sup> Includes white bread, cookies and crackers.
- <sup>8</sup> Prepared paint.
- <sup>9</sup> Dairy products and ice cream.
- <sup>10</sup> Television, radio receivers, and phonographs.
- <sup>11</sup> Bicycles.
- <sup>12</sup> Petroleum products, refined.

Sources: Advertising outlays per dollar of sales are from the Internal Revenue Service and published in Advertising Age, July 6, 1964, p. 59 and June 7, 1965, pp. 101-2 and U.S. Department of Labor, Bureau of Labor Statistics, Jules Backman, "Advertising and Competition", New York University Press, 1967.

TABLE 9.—Changes in consumer price index, December 1965–December 1966  
(1957–1959=100)

	December 1965	December 1966	Percent increase
All items.....	111.0	114.7	3.3
Food.....	110.6	114.8	3.8
Food at home.....	108.9	112.6	3.4
Food away from home.....	119.9	126.3	5.3
Housing.....	109.4	113.0	3.3
Shelter.....	111.8	116.4	4.1
Rent.....	109.5	111.3	1.6
Fuel and utilities.....	108.1	108.4	.3
Household furnishings and operation.....	103.6	106.7	3.0
Apparel and upkeep.....	108.1	112.3	3.9
Men's and boys'.....	109.3	112.6	3.0
Women's and girls'.....	104.3	108.1	3.6
Footwear.....	115.6	122.9	6.3
Transportation.....	111.6	113.8	2.0
Private.....	110.1	111.7	1.5
Public.....	122.0	129.8	6.4
Health and recreation.....	116.6	121.0	3.8
Medical care.....	123.7	131.9	6.6
Personal care.....	110.0	113.7	3.4
Reading and recreation.....	115.4	118.4	2.6
Other goods and services.....	113.4	115.9	2.2

Source: Bureau of Labor Statistics.

TABLE 10.—Wholesale price indexes, by months, October 1965–January 1967  
(1957–1959=100)

	All com- modities	Farm products	Processed foods	Commodi- ties other than farm products and foods
<i>1965</i>				
October.....	103.1	99.4	106.9	102.8
November.....	103.5	100.3	107.6	103.2
December.....	104.1	103.0	109.4	103.2
<i>1966</i>				
January.....	104.6	104.5	110.3	103.5
February.....	105.4	107.4	111.8	103.8
March.....	105.4	106.8	111.5	104.0
April.....	105.5	106.4	110.6	104.3
May.....	105.6	104.5	110.5	104.7
June.....	105.7	104.2	110.6	104.9
July.....	106.4	107.8	111.7	106.2
August.....	106.8	108.1	113.8	105.2
September.....	106.8	108.7	113.8	106.2
October.....	106.2	104.4	112.4	105.3
November.....	105.9	102.5	110.7	105.5
December.....	105.9	101.8	110.6	105.5
<i>1967</i>				
January.....	106.2	102.8	110.7	105.8

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 11.—Wholesale Price Index, October 1964, October 1965, July 1966 and January 1967 (1957-59=100)

	October 1964	October 1965	Percent change, October 1964-October 1965	July 1966	Percent change, October 1965-July 1966	January 1967	Percent change, July 1966-January 1967
All commodities.....	100.8	103.1	+2.3	106.4	+3.2	106.2	-0.2
Farm products.....	93.8	99.4	+6.0	107.8	+8.5	102.8	-4.6
Processed foods.....	101.7	106.9	+5.1	111.7	+4.5	110.7	-0.9
All commodities other than farm products and foods.....	101.5	102.8	+1.3	105.2	+2.3	105.8	+0.6
Textile products and apparel.....	101.4	102.0	+0.6	102.4	+0.4	102.0	-0.4
Hides, skins, leather and leather products.....	105.9	113.3	+7.0	122.7	+8.3	117.6	-4.2
Fuels and related products and power.....	96.6	99.4	+2.9	101.4	+2.0	102.2	+0.8
Chemicals and allied products.....	96.9	97.0	+0.7	97.9	+0.3	98.4	+0.5
Rubber and rubber products.....	92.1	93.4	+1.4	95.1	+1.8	95.5	+0.4
Lumber and wood products.....	100.3	101.6	+1.3	106.6	+4.9	102.3	-4.0
Pulp, paper and allied products.....	99.1	100.5	+1.4	103.2	+2.7	103.1	-0.1
Metals and metal products.....	103.8	106.3	+2.4	108.8	+2.4	109.4	+0.6
Machinery and motive products.....	103.0	103.9	+0.9	106.0	+2.0	108.3	+2.2
Furniture and other household durables.....	98.6	97.8	-0.8	99.0	+1.2	100.5	+1.5
Nonmetallic mineral products.....	101.8	101.6	-0.2	102.7	+1.1	103.7	+1.0
Tobacco products and bottled beverages.....	107.6	107.7	+0.1	110.0	+2.1	110.3	+0.3
Miscellaneous products.....	100.0	111.2	+11.2	120.5	+8.4	121.2	+0.6

Source: U.S. Department of Labor, Bureau of Labor Statistics.

TABLE 12.—Average hourly and weekly earnings, manufacturing industries, 1955-66

	Average hourly earnings			Average weekly earnings		
	Dollars	Year-to-year change		Dollars	Year-to-year change	
		Cents	Percent		Dollars	Percent
1955.....	\$1.86	-----	-----	\$75.70	-----	-----
1956.....	1.95	9	4.8	78.78	\$3.08	4.1
1957.....	2.05	10	5.1	81.59	2.81	3.6
1958.....	2.11	6	2.9	82.71	1.12	1.4
1959.....	2.19	8	3.8	88.26	5.55	6.7
1960.....	2.26	7	3.2	89.72	1.46	1.7
1961.....	2.32	6	2.7	92.34	2.62	2.9
1962.....	2.39	7	3.0	96.56	4.22	4.6
1963.....	2.46	7	2.9	99.63	3.07	3.2
1964.....	2.53	7	2.8	102.97	3.34	3.4
1965.....	2.61	8	3.2	107.53	4.56	4.4
1966.....	2.71	10	3.8	112.19	4.66	4.3
December.....	2.77	11	4.1	114.68	3.76	3.4

Source: U.S. Bureau of Labor Statistics.

TABLE 13.—Spot market prices, 1966-67

[1957-59=100]

	February 1966	October 1966	December 1966	Feb. 14, 1967
All items.....	113.8	103.7	102.8	102.2
Foodstuffs.....	101.9	100.1	98.6	97.6
Raw industrials.....	122.9	106.3	105.8	105.6
Livestock and products.....	120.7	97.4	94.9	94.4
Metals.....	147.3	128.4	125.3	124.2
Textiles and fibers.....	113.0	100.7	100.6	101.0
Fats and oils.....	109.5	102.5	96.4	92.6

Source: U.S. Bureau of Labor Statistics.

Chairman PROXMIRE. Thank you, Dr. Backman, for a very provocative and stimulating paper, and one that finds me in disagreement on many scores, although I must say you have made a very powerful case for your position.

There are a number of contradictions that appear here and I am sure that you can straighten many of them out. You make a strong case for a "tired" economy, and I think I can document that case in a couple of minutes here even more, not only a tired economy, but the kind of economy that seems to be close to a degree of price stabilization in the last few months.

I would point out to you, for example, that as you say, wholesale prices have been stable since October at 106.2 percent of the 1957-59 average. The Consumer Price Index went up from 114.5 in October to 114.6 in November to 114.7 in December, and then remained stable at 114.7 in January, so that that is most encouraging.

We had a dropoff in new orders for durable goods from \$25.3 to \$22.7 billion at an annual rate, in the most recent figure in January. We have had an increase at the same time, as you said, but a very, very sharp increase in manufacturers' inventories at exactly the same time when we have this dropoff in new orders.

We have a continued deterioration in new construction. It was \$72 billion in September; it is now down to \$69 billion. We have a dropoff in steel production though it has stabilized somewhat in the last couple of weeks, but it has stabilized at a substantially lower level than it was which is not encouraging for a dynamic, growing economy such as ours.

We have a sharp dropoff in the hours of work from 45.1 hours in September to 40.9 hours in January. We have a stabilization of unemployment that some people think is a satisfactory rate though I don't, and I think many other people don't regard 3.7 percent, 3 million people out of work, as satisfying, especially with all the emphasis we are trying to put on manpower training.

We have a very much slowed down rate of increase in manufacturer's investment in plant and equipment, which I think you point to. And we have a decrease in corporate profits, which I think is one that should concern us very much.

You put all these things together, and you find that there are almost no indicators that are pointing the other way, and you come in and tell us what we need is a tax increase, and restraint in fiscal and monetary policy as the solution for what you say is likely to be a cost-push situation in wages. I am puzzled as to this kind of conclusion.

Mr. BACKMAN. The question is not unexpected. Let me see if I can clarify my position. We have gone through a period now of about 30 years in which "compensatory fiscal policy" has been emphasized. I must confess that for many years I have been defining "compensatory fiscal policy" as a policy under which you spend more than you take in in bad times but in good times you spend more than you take in.

I think we have to look at the general level of the economy. We are talking about an economy in 1967 which the Council in my judgment mistakenly expects to average \$787 billion. Even if we reduce this estimate by \$10 billion, it is still a rather significant increase over last year. It is not an economy that has moved or is moving downward.

We are talking about an economy that was moving forward at a very frenetic pace through last summer. I think your summary of those figures is an excellent one. I agree with it. But the economy is still up in that stratosphere despite these weaknesses.

Now it would seem to me that at this level of economic activity, one could talk about a balanced budget. But I wasn't even talking about that. I am concerned about a \$15 billion deficit, because when we hear about the \$9 billion deficit, it is after the effects of the tax increase. And may I go a step further and point out that the deficit prior to the sale of participation certificates is even larger.

Now we are going to have to get that \$15 billion someplace, and what bothers me basically is this: It isn't a question of the surtax or nothing; it's a question of the surtax or something else. If we don't get part of this \$15 billion deficit through the tax route, how do we get it? Do we get it by a price rise? If we have a 1-percent rise in prices, that is \$7.5 billion. The economic costs of that kind of price rise, I think, are worse than the economic consequences of the so-called surtax.

By concentrating only upon the effect of a tax increase upon economic activity generally, and ignoring its effect upon the role of monetary policy and the other pressures in the economy toward price inflation, means that we only look at part of the picture. In fact, I think I have been one of the few outside of Government who has been calling attention to this leveling off and have been concerned about it. Nevertheless, I still believe that at this level of economic activity, with a war being fought, it should be paid for. We must pay the price somehow. I am prepared to pay it in the form of a tax increase.

Chairman PROXMIRE. Yes, but are you paying for it in the form of a tax increase, if many of us feel the tax increase may be counterproductive in terms of revenue alone. If you have a tax increase of \$5 billion at this time the psychological impact plus the very real impact of taking this much out of the economy could very well result in a lower, not a higher, amount of revenue.

Dr. BACKMAN, don't you feel that we should pay attention to the trend of the economy?

Mr. BACKMAN. Yes; as one factor.

Chairman PROXMIRE. I was one of those who voted against the tax cut in 1964, because I felt with an expanding economy, with unemployment dropping, with conditions improving, it was a mistake at that time for us to, what I thought would be overstimulate the economy. But, similarly, at this time when we are standing still and it seems to me moving down in many indicators, it would seem to be the worst time to increase taxes.

In other words, the important thing it would seem to me for this committee as an economic committee to pay attention to and for the Congress as a group of sensible men would be not whether the budget would be in balance necessarily, but whether the impact of fiscal policy and monetary policy in the economy would be appropriate in view of what we anticipate the state of the economy.

If you say the economy is sick, if you say you are worried about the economy, if you say you are one of those who called attention to

the difficulties in the economy, I don't see how at the same time you can say we should adopt policies that are going to make it a little sicker.

Mr. BACKMAN. Let me make this clear, Mr. Chairman. I don't think the economy is sick.

Chairman PROXMIRE. Maybe that is too strong a word, I would agree, but if you say that the economy is one which is tired—

Mr. BACKMAN. Yes, it is tired, it is advancing a little more slowly, and I think it should move along a little more slowly than it has. I am not concerned about the adverse impact of a tax rise on the economy to the same degree that you suggest you are concerned. I am concerned about that as only one factor, but I am also concerned about creating tinder boxes of inflation for which we must pay tomorrow.

Chairman PROXMIRE. Yes, but have we inflationary tinder boxes, or are we creating under present circumstances, when the pressure on prices seems to have abated from the overall demand situation, and when you have a real tinder box of a different kind? You have very heavy unemployment right now among minority groups. You have a situation in our cities where Negro teenagers, for example, are looking for work in large numbers.

You have a situation that has been documented again and again by the Secretary of Labor and by many other economists, showing that where you have pressure to hire people, because the economy is growing and developing and moving ahead, that under these circumstances, business is going to find ways of finding jobs for these minority groups, these people who are out of work.

Mr. BACKMAN. This is both true and false.

Chairman PROXMIRE. It is true in the sense that it has worked in the past, isn't that right, and it is also true in the sense that if the economy is not growing and unemployment is increasing, you are going to have a situation in our cities that this summer it could be really explosive.

Mr. BACKMAN. In the first half of 1966, despite an economy rising at a rate that could not be sustained, we still had 7 or 8 percent unemployment among these minority groups because it was impossible to absorb all of the unemployed merely by expanding the economy. At the same time there were major shortages of skilled workers. This is the area where retraining and education are so important.

Chairman PROXMIRE. Yes, but the area of retraining and education is something that the Government does maybe 5 or 10 percent of and private industry does maybe 90 to 95 percent of and private industry isn't going to do it unless they have a market to do it.

Mr. BACKMAN. But if we follow through completely on that suggestion, Senator Proxmire, last year, instead of having the great pressures we had, we would have probably blown the roof off of the economy in an effort to really pull the unemployment figure down much further.

Chairman PROXMIRE. It depends upon what time last year you are talking about.

Mr. BACKMAN. Let's talk about the early part.

Chairman PROXMIRE. I think you are right; if you are talking about the latter half of the year I don't think you are right. In talking

about the prospects for 1967, it seems to me that I take a different position.

Mr. BACKMAN. In the early part of the year we still had large unemployment among these groups, despite the high rate at which the economy was operating. I merely call attention to that to indicate that there are limits beyond which you can't solve this unemployment problem by stepping up the rate of economic activity.

Chairman PROXMIRE. Now let me get into something here with regard to the wage-price guideposts, because I have been a strong believer in this. I have argued many times on the floor of the Senate and around the country that the wage-price guideposts have been a great contribution, and you admit in the course of your testimony that they did hold down prices, although you seem to think there is some price that we pay in having had them.

Mr. BACKMAN. Pardon me, I think my testimony will show that I said that in the 3 years before we enunciated the truism involved in the wage-price guideposts, there was stability of prices, and in the first 3 years afterward, there was stability, but these were also periods of idle capacity and unemployment.

Chairman PROXMIRE. What I understood you to say was this. In the absence of guideposts, we would have had bigger increases in prices in these particular areas, but you didn't think they would have contributed very greatly.

Mr. BACKMAN. That is right, there would have been somewhat larger increases for some products.

Chairman PROXMIRE. I think that is an element, an admission, particularly in view of the fact that we were having something of a demand-pull inflation at that time.

In your summary you say "There is little value to a program which educates the public to believe that unit labor costs determine prices." I am certain that Gardner Ackley and Duesenberry and Okun would all disagree that unit labor cost determines price, only productivity determines wages, real wages can increase at a uniform annual rate, the general price level can be stabilized by controlling increase in labor costs. They don't make statements of that kind. This is a strawman.

I ask you to show me any place in here where they don't qualify greatly their references to wage-price guideposts saying this is only one part of stabilization policy. It is a limited part. It is an important part.

Mr. BACKMAN. Senator, I give the citations throughout my prepared statement. In every one of the Council's reports, the essence of the guideposts has been that if you can stabilize unit labor costs, you won't have a price rise. This is what they mean when they say "If you have an increase in wages and labor costs equal to productivity, you will have no change in unit labor costs, hence price stability."

This is what they mean when they say "If you get above average increases in some places, you must get offsetting below average increases in others." This is the essence of what they have been talking about for 4 or 5 years.

Chairman PROXMIRE. I want to call your attention to the qualifications later, but my time is up. Senator Percy?

Senator PERCY. If you want to carry on, you go right ahead.

Chairman PROXMIER. No, thank you, Senator Percy; you may go ahead.

Senator PERCY. Dr. Backman, I would like to preside over "burial" of wage-price guidelines with you and just simply say "amen," because as I recall my economics some years back at the University of Chicago, the term I always heard my professors use was "other things remaining equal," and then they go on to some theoretical dissertation. I never found in the economy things did stay equal, and the price guidelines assumed a uniform condition in every part of the country, uniform demand for labor without any change. In a dynamic economy you have the forces and pressures of that marketplace which constantly have to respond, and in a totally and entirely different way. I, many times, would like to have just had a simple slide rule solution to wages. It is easy to figure 3.2. You wouldn't need management. You wouldn't need labor leadership. You would just need a clerk who could compute out what these increases should be each year. And I think the totally unrealistic concept we had there was that 3.2 was the magic formula that applied to everything.

It constantly pushed wages up to that level that didn't belong up there, and tended to hold down others that should have gone well above that, because of changing conditions.

I would like, however, to get your view on the previous testimony as to how you would stand on the establishment of a price-wage review board established by industries with a prior notification by any basic industry or any major industry or an industry that had a major impact on the economy, of 60 to 90 days before they could raise any prices, and what effect this would have on the economy.

Mr. BACKMAN. I think this is a highly unrealistic proposal. Your earlier illustration of meat is a good one. If we were to require prenotification of 60 to 90 days or any other period, even if it's 2 weeks, the first effect on the part of customers would be to rush in and buy, so they could get the benefit of the lower price still prevailing.

The distortion such buying patterns could create are rather apparent.

Is this an area on which prior approval or prior notification is one that is desirable? I don't think it is. I think that the market power has been tremendously overexaggerated and I will tell you why.

Much of this reasoning and many of the conclusions are based upon our earlier postwar experience which was significantly affected and confused by the effects of inflation. Let me illustrate in an area about which I testified recently before another committee, the question of price leadership.

Up through about 1959, whenever any big company raised the price, they were followed by other companies and this was viewed as an indication, of what has been called tacit collusion. However, between 1959 and 1964, time and again large companies raised prices, and when other companies didn't follow, they were forced to rescind the increases. Now why were the leaders followed in the earlier periods? Because of market power? No. The main reason was a period of inflation.

During a period of inflation, everyone is anxious to raise prices because of increases in costs and other pressures to which they are subject and because demand is strong enough to make it possible to raise prices. However, most companies are waiting until Mr. Big does it, because they are afraid there may be adverse effects in terms of loss of market to other companies if they have any idle capacity.

And so the minute the leaders in an industry raise prices, other companies which were anxious to raise prices follow. In fact, there is ample testimony of this experience before many congressional committees. The Celler committee, for example, in 1949 heard the testimony from Jones & Laughlin officials that they were severely critical of the delay in raising steel prices, and when they were asked—I think it was \$6 or \$8 a ton at that time—was that adequate, they said “No, we would have raised it \$14 but we couldn’t.”

In other words, I think we must separate the effects of an inflation from the exercise of market power before we can really have a firm conclusion that it is market power that explains price leadership-followership.

Senator PERCY. Could I ask you this question? If you were a businessman, and you were establishing a price on a new product line, say bringing out colored television for the first time, and you knew that you could reduce your prices any time, but you knew under this system that you would have to give advance notice and justify any increase in price, then wouldn’t you tend to establish your price as high as possible, so that you wouldn’t get stuck, rather than as low as possible, which might be the tendency of a businessman trying to broaden his market for a new product?

Mr. BACKMAN. I think there would be that tendency, but it is subject to one extremely important qualification, and that is that he doesn’t have all of the freedom you suggest in setting his price. In other words, if he establishes the price too high under those circumstances, he is going to pay a penalty in loss of sales.

It seems to me there is inherent in the question the assumption he can set the price any place he wants. He can’t. He is forced by the pressures of the marketplace, not in the sense of classical economics in a perfectly competitive market, which has never existed except in textbooks, but in terms of the real pressures of the marketplace, including substitute products, the alternatives available, the competitors available, and today the other large companies, who would love to come into his industry if they found that a big profit was possible at this high price. In other words, the businessman doesn’t have the power to do what you have suggested he might do.

Senator PERCY. That has been my experience also, but I would like your verification of the faith in the pricing system of the marketplace.

Mr. BACKMAN. Senator Percy, I have participated in the pricing of many products and I can tell you I still have to find the situation where people sat around the table and in effect were able to set prices without regard to market forces. The usual questions are “What can we get, will customers pay these prices, what volume can we anticipate, what will our competitors do, what substitute products will be important, what imports will come in,” and so on and so on.

Senator PERCY. Do you know of any European countries where price-wage boards have actually worked and proved to be a constructive force in the economy?

Mr. BACKMAN. In every European country where they have had an income policy the price increases have been greater than in this country. This is true in England, West Germany and in other countries where they have attempted this. I have a couple of citations in my testimony.

Senator PERCY. I think it is also interesting to note that in recent years the index of durable goods, the price index has actually declined slightly. Now, these are certainly durable goods industries that have power and impact on the economy, and we have had a very strong economy, and yet their prices have actually declined. Doesn't this then in your judgment conflict with the thought that market power is the main reason why wages and prices rise before we have full employment?

Mr. BACKMAN. This is a very important observation, because the centers of so-called market power are largely in the heavy goods industries, and it is true that at the retail level the prices of appliances and other durable goods have not gone up as much as other prices, and in some years have gone down. There are at least a half a dozen years (1953, 1954, 1955, 1960, 1961, 1965) in the postwar period when durable goods prices actually went down. In 1965 and 1966, despite the rise of almost 5 percent in the Consumer Price Index, durable goods prices recorded practically no change.

Senator PERCY. Mr. Chairman, even though I may disagree with you occasionally, I would like to commend the Chair once again for bringing two very provocative witnesses, and for balancing out these meetings, so that we have a chance, in the same meeting, to hear opposing points of view, which I think is the essence of seeking the truth in these complex matters.

Chairman PROXMIRE. Thank you very much, Senator Percy, and I would certainly agree that Dr. Backman has done a fine job. I have some other questions for you.

You seem to refer, and Senator Percy did, too, to the so-called 3.2 percent guideline. I would agree that that was very badly misstated. It was grossly unjust. It was unfair. It couldn't be sustained, and I certainly wouldn't favor that at the present time.

On the other hand, you say in your prepared statement that:

By emphasizing long-term gains in output per manhour, and the accompanying rise in living standards, they encourage unions to seek increases large enough to equal the past rise in CPI and the rise in real wages. This combination means increase in labor costs of 7 percent or more and would result in a substantial rise in unit labor costs.

I would agree with your inveighing against a 7 percent guideline. I don't know anybody, though, who has ridden on that tired dead horse and said we ought to have a 7 percent increase, or made proposals that would result in that. Walter Reuther didn't, Goldfinger didn't, and certainly Alvin Hansen didn't. His position was that we ought to forget about the past, that if you try to catch up, you are in trouble, and that seemed to be the position supported by the labor people who are here.

Mr. BACKMAN. I suspect, though, Senator, that—

Chairman PROXMIRE. As far as the Hansen suggestion or guidepost might work out. His suggestion was that you would take the productivity increase, let's say that is 2.8, add on to that the cost of living that we expected this year, we don't know what it would work out to if you made it on an escalator basis, but assume it is 2½, that may be wrong, that would be a 5.3 percent guidepost.

Now you say the minimum labor is going to hit at with these militant unions this year is about 5½, and it is going to be higher. Well, on the basis of that analysis, I submit that a 5.3 guidepost would be a very moderating influence in a cost-push situation, it would be very helpful and particularly because you could document that on labor's own terms.

You could point out that it includes labor productivity increase and the rise in the cost of living. It is at a moderate level. It seems to me it could have a very salutary effect in holding down this kind of pressure that would otherwise push up prices and enable us to have fiscal and monetary policies that might keep the economy growing better.

Mr. BACKMAN. Senator Proxmire, I must say that in all my experience in wage negotiations, which has included most of the major industries in this country, I have never heard of a settlement based on prospective increases in the Consumer Price Index, and ignoring past increases. I can tell you what will happen at the bargaining table.

"We made an agreement in June of 1965," Mr. Labor Leader will say, "and since then there has been an increase in consumer prices of let us say 5 percent. Now, the first demand is that we want to be made whole, that is we want a wage increase to compensate for the rise in the CPI since the last agreement."

Mr. Reuther isn't a good illustration because Mr. Reuther's workers have had no deterioration in real wages during this period. He has an automatic improvement factor plus a cost of living clause. Under this contract auto workers last year received an increase of 7 percent in wages alone, 7 percent. So they didn't experience any deterioration in levels of living. And if he comes into collective bargaining this year, and I have no way of knowing what is in Mr. Reuther's mind, of course, but if he comes in and says, "I want my 2.9 percent again plus cost of living," all he is doing in effect is saying, "I am going to get the 5 percent that Mr. Hansen or Senator Proxmire outline on top of the gains we have had under the old contract."

But you take all the unions which don't have cost of living clauses, and incidentally, very few do. They come in and the first thing they want to do is be made whole, and I will go a step further—

Chairman PROXMIRE. This is exactly the purpose of the guideline. In the absence of the guideline, you bet that is what they are going to do, and it is going to have considerable effect. It is going to be hard to resist. If you have the guideline, then you can say what we are trying to do is productivity plus the cost of living this year, and you don't have to do it prospectively on the basis of an estimate. You can do it through an escalator.

It is true that few of the contracts have the escalator now. They have had it many times in the past. It depends upon the particular economic situation. The escalator technique could be encouraged or discouraged. The policy of the executive branch now is to discourage it emphatically. I am not so sure that is right.

Mr. BACKMAN. I happen to agree it is a good idea to discourage labor cost increases of that magnitude. However, I will merely say what will happen in terms of the realities of collective bargaining, not theory.

There isn't an arbitration board, nor a fact finding board that won't start with a consideration of the deterioration in living levels resulting from the rise in the Consumer Price Index. They haven't ignored this factor in the last 20 years. And they won't start now.

We can improvise, we can issue numbers in Washington. The pressure on the union leaders from their membership, the desire on the part of industry to do what industrialists think may be right will all start with what is required to make their workers whole, and that is the expression that is used. What is required to restore the position to where they were.

I just participated in the hearings before the fact finding board in New York involving New York City and the policemen and firemen, and this was a critical factor. They want increases much beyond that amount. But the first point was "Look how much we have lost." And this is exactly what will be stated in negotiations throughout the country.

Chairman PROXMIRE. That is what you want to turn around. That is what I have been trying to get away from.

Mr. BACKMAN. But you can't turn it around.

Chairman PROXMIRE. You indicated that the Council of Economic Advisers have put all their emphasis on wage-price guideposts and have ignored these other factors. I quote to you a statement on page 119 when they say:

When demand outruns the growth of productive resources, prices and wages will rise, even in the most highly competitive markets. Indeed they may rise faster and farther than where large firms and long-term labor contracts give some degree of stability. That kind of demand-pull inflation can be held in check by fiscal and monetary policies which keep demand in line with productive capabilities. If labor markets are efficient, control of demand-pull inflation will not require restraints in demand that will lead to a high unemployment rate.

They always say monetary and fiscal are the most important elements of stabilization policy, but they do put emphasis on these relatively few industries but extremely important industries. What I would like to call your attention to are two things.

No. 1. What happened in this very period that you cite, the most important and interesting period, when you say that from 1959 to 1964 or 1965, when one company, the big company, would increase prices, the little boy didn't always follow and the big boy would rescind prices. Well, from 1962, 1963, and 1964, which is the period that I remember this taking place, it was because the Government followed a vigorous policy—

Mr. BACKMAN. Oh, no.

Chairman PROXMIRE (continuing). Of going after the big boy when he couldn't justify his price increase. The most spectacular example was in 1962 when Mr. Blough came to the White House and told the President he was going to increase steel by \$6 a ton, and the President used all the power he had to discourage him and won out.

I submit that that historic action by President Kennedy had a very profound effect on the relative price stability we had between 1961 and

1965, and we did have, and I think you would have to concede prices rose much less during that period than they had in an earlier period, although during that period there was some strain on resources.

We were moving ahead. We were expanding. We were growing. But because steel didn't have the push in prices, and because this affected, and the President followed up on many other prices and President Kennedy and President Johnson also worked hard to keep down prices of primary metals, they had some muscle there, I submit that this is part of the reason why prices didn't go up as they had in the past with more demand pushing.

Mr. BACKMAN. Senator Proxmire, early in my statement I call attention to the fact that "in a period of strong demand \* \* \* wage-price guideposts could not bring about price stability," and point out this is one reason why you can't expect uniform increases annually as the Council postulates.

Chairman PROXMIRE. That is in your statement?

Mr. BACKMAN. No. 2. I did not include basic steel or automobiles among the almost 50 different illustrations I cited to the Hart committee of prices that were rolled back.<sup>1</sup>

I took areas where the Government was not intervening, and also showed that during that period there were many illustrations of price cutting from list price in other industries where the Government was doing nothing, paper, office equipment, chemicals.<sup>2</sup>

I could run down the line. The few cases you have cited I don't consider roll-backs because of competition. I consider them roll-backs because the Government intervened. I agree they had an impact.

Chairman PROXMIRE. But that had an impact on the cost of living and an impact on prices.

Mr. BACKMAN. It didn't really have much of an impact on the Consumer Price Index.

Chairman PROXMIRE. Not only a technical impact on prices, but a strong psychological impact on the country and on labor union performance and on labor recognition.

Unions are very sensitive, especially with the Democratic administration, though they would be with any sympathetic administration, a Percy or Johnson or Romney administration, they are sympathetic to what the President of the United States calls for and asks for, especially when he can justify it on some kind of principle.

So to say, "Well, this happened and it was a mistake because there were some prices that had to be paid," I would say you would have to look at this. You would have to say that prices did not go up as you have said, and as I have documented in these areas, and have had some effect on the Consumer Price Index. Now, you will have to show to me what price we had to pay for this. Why did this hurt the economy? What was wrong with it?

Mr. BACKMAN. Senator Proxmire, let me make sure that we have the proper perspective.

First, I did not say that the Consumer Price Index would have gone up. A few years ago I made a study in connection with the

<sup>1</sup> See "Economic Concentration," hearings before the Subcommittee on Antitrust and Monopoly, pt. 2, March 1965, pp. 568-591, 590-595.

<sup>2</sup> *Ibid.*, pp. 571-572, 596-598.

steel price increase in 1957 of \$6 a ton. I reached the conclusion that that had less effect upon the Consumer Price Index than either a 1-cent increase in the price of bread or a 1-cent increase in a package of cigarettes or a 1-cent increase in a gallon of gasoline or a 1-cent increase in a quart of milk.

At the same time, the Commissioner of Labor Statistics, after analyzing the same increase, announced that its impact upon the Consumer Price Index was, and I use his word "negligible," which, of course, was accurate. I think we have to recognize the nature of this Consumer Price Index.

The overall areas where steel or other products can have an effect are rather small. I agree with you that there may be some psychological effects. I wouldn't argue whether the overall Wholesale Price Index might have been up another point or so in the absence of the guideposts. I don't think it would have gone up much beyond that amount. But I do not agree that there would have been any perceptible effect upon the Consumer Price Index. I am not so sure about the restraint to which you refer in connection with the labor unions.

It seems to me that the 5-percent figure that emerged in the latter part of 1966 emerged despite the guideposts, and may I call attention to what is a fact; namely, that the largest departures from the guideposts took place not among the big unions, but by the relatively smaller unions. The building trades were a conspicuous illustration, despite various remonstrations from Washington and elsewhere. It continued to be an exception. And this I think is always the case.

There is an assumption inherent in the guidepost that if you hold Mr. Big either on the union line or on the price line, this automatically holds others. This is highly unrealistic.

Chairman PROXMIRE. I would certainly agree that it has only a partial effect, a limited effect. The effect on the Consumer Price Index you can show technically that that immediate increase in steel would not have been significant.

Mr. BACKMAN. That is right.

Chairman PROXMIRE. But on the other hand you can certainly also argue that this effect has a rippling effect, that when steel prices go up, appliance prices go up, automobile prices go up, and ultimately and eventually if you follow it through far enough, even if you disregard psychological and pattern price increases throughout the economy, disregarding that, it would seem to me logical that you could expect some significant increase in the cost of living.

Mr. BACKMAN. But let's take a look at that. The steel industry, to use that illustration, accounts for about 2 percent of the economy. Let's say we have a 5-percent increase in steel prices. I haven't heard an increase of that amount proposed, but let's assume it is. A 5-percent increase is equal to one-tenth of 1 percent of the economy. Now, what do you want to do, double, triple, or quadruple its effects?

Chairman PROXMIRE. No, I think it would increase many, many times more than that before the effect is ultimately felt throughout, when you consider the add-ons and the percentage. My own experience in business was that we always determined our prices on the basis of cost.

Mr. BACKMAN. So what do you do, double the increase?

Chairman PROXMIRE. The increase grows many times.

Mr. BACKMAN. Do you double the increase? Do you want to take it five times? We are talking about extremely small numbers, even if you take multiples which in my judgment aren't realistic.

Chairman PROXMIRE. And also I would say that the actual increase the steelworkers get and the auto workers get has an influence, maybe not immediately.

Mr. BACKMAN. I agree with that.

Chairman PROXMIRE. It has a significant influence in either the wages that are set or the compensation that is paid in other industries.

Mr. BACKMAN. I agree with that.

Chairman PROXMIRE. So I think from that standpoint there is an element of instability in excessive settlements that can be favorably influenced by Government policy to indicate what guideline will be fair and equitable throughout the economy.

Mr. BACKMAN. I agree that they have an effect, and therefore what are we going to say when other unions find that last year the auto-workers received an aggregate increase of at least 20 cents an hour, which happened to be roughly 7 percent of their wage rate, as I said earlier, or between 5 and 6 percent of their total labor cost. That is the actual increase in wages, wage rates in the automobile industry last year.

Chairman PROXMIRE. Let me say this: That when Reuther came before us, he had some interesting counterargument on that. It is very difficult when we have a highly productive industry like automobiles, where you have a basis for paying high wages, and yet achieving better profits, especially if it is expanding as it was last year.

Mr. Reuther said that he tried hard to negotiate in a situation, in which the productivity increase would be shared directly by a price reduction and a profit sharing with the workers, and a distribution to capital on a one-third, one-third, one-third basis. He wasn't successful in getting that adopted.

Mr. BACKMAN. But he didn't offer to forego the 2.8 percent productivity increase for that cut in prices.

Chairman PROXMIRE. You select the toughest kind of a case when you take the automobile industry, because it is hard to roll back prices. It is hard to get prices reduced. I hope that the action by American Motors is precedent setting.

Are you through, Senator Percy?

Senator PERCY. Have you one more minute?

Chairman PROXMIRE. Oh, sure.

Senator PERCY. This is a subject of great interest to me, Mr. Chairman. I have been concerned, Doctor, about the proposed tax increase as a depressant, on a potentially soft economy. But I was quite interested in a comment made by Ralph Lazarus, a member of the Business Council. He is the chairman of their domestic economy section, and as one of our largest retailers in the country knows a great deal about consumer buying habits.

He maintains that the tax increase will take dollars out of people's pockets, and therefore cause them to cut back their purchases, which would almost appear to be a axiomatic and automatic. He maintains

this: That in his judgment retail sales are based more on credit than on present dollars, and credit is based on confidence, and that confidence can be destroyed by a number of psychological factors. He feels that if the people of this country, who are some of the best informed people in the world, see that there is a huge deficit, a big war to pay for, and the Government fails to do what it should, particularly now that the President has said do it, that it could be that there would be only one conclusion they could come to as to why the Government wouldn't do it.

They would be fearful of the future, fearful of the economy, and therefore this destruction of public confidence and of the credibility of its own Government for doing something that it knows it should do, might be more of a depressant on retail sales than it would be if you just went ahead and did what you should do and raised taxes.

Now, this caused me to go back once again and let me take another look at this whole tax increase picture and I have asked Mr. Lazarus to write me in greater detail so that I can discuss it with the chairman, whom I know is earnestly seeking a right answer on this, also.

Would you care to comment?

Mr. BACKMAN. I think that is an interesting reaction in terms of alternatives. Despite the fact that it would support my position, I don't think I can go along with it completely. The history of retail sales is one of close relationship to consumer disposable income with temporary aberrations, for whatever the psychological forces may be, and when I say temporary, it might be 3 to 6 months. The reason why economists are concerned about any rise in taxes is that disposable income after taxes would be a little less and therefore the amount that could be bought presumably would be a little less.

On the other hand, if this reduces the pressures on the money markets because that \$5 billion must be obtained in some way—it is not the \$5 billion or nothing, it is the \$5 billion or something. If the government must come into the money market to borrow another \$5 billion and create pressure on interest rates, the peak of which I think already has been seen, then this also costs the consumer something. So I think one must look at the whole picture.

I am inclined to feel that a continuation over time of large deficits without doing something about it in a period even like 1967, can undermine confidence. You have to say to yourself, if the Government can't come closer to paying for the things it must buy, when we have a gross national product of \$770, \$780 billion, when are we going to do it? And I think the answer under those circumstances almost becomes it looks like never, and if it is never, then you can have a serious impact on confidence.

Chairman PROXMIER. May I just ask you, Mr. Backman, if it isn't true, under the circumstances, if the economy is tired and there is slack in the economy, resources available, people looking for work, what you simply do is to finance that \$5 billion by open market operations by the Federal Reserve Board. In other words, to put it bluntly, the Federal Reserve Board buys \$5 billion worth of securities. I would agree that that would be the worst possible kind of—

Mr. BACKMAN. That is the most inflationary approach.

Chairman PROXMIRE. In a tight economy it is inflationary, but in a slack economy it is not inflationary, and it doesn't increase interest rates, and it is something that can be done, and I am not sure that this wouldn't be the prescription, depending on the status of the economy.

Furthermore, if you talk about inflation, what is going to happen to these taxes? No. 1, the increase in the corporation income tax is going to be pushed onto the consumer to some extent. Certainly the increase in the corporate income tax in the regulated industry is going to be completely pushed onto the consumer, which is going to increase his cost of living and in other industries to a lesser extent but to some extent. It increases the cost of living of the stockholder, too, incidentally.

In the second place, unless we want to go to jail, we have to pay our taxes, and that is part of the price of living, to pay our taxes, so our cost goes up. I submit, I think you probably agree, the most desirable thing, if we can do it, is to cut spending.

Mr. BACKMAN. That I would agree with completely. I would say that a cut in spending is the No. 1 approach. I can't identify where it can be cut, but out of \$135 billion, there must be some things we can defer, whether it be in a highway construction program, the farm area, or be in any of the other areas where many billions go out.

This would be my first choice.

But let me note, Mr. Chairman, that the effect of a cut in spending is almost exactly the same as the tax increase in terms of narrowing the spread of how much the Government is contributing to the economy.

Chairman PROXMIRE. That is right.

Mr. BACKMAN. So I am happy to see you agree that if we do something in this area we can do it despite the prospect of a leveling off in the economy. I don't like the word "slack," because it implies a whole lot more than what you and I are talking about. I think slack to most people means large amounts of idle resources. What we are talking about is a small margin below the top, a relatively small margin.

We are in a war. We have costs in connection with this war. We must pay for it in some manner and it seems to me that the American people are willing to pay for it.

Do I like a tax increase? Not personally. But I am afraid that this isn't the test. The test is how long can the Federal Government go along in the red at \$10 billion, \$15 billion, or \$20 billion a year even at this level of economic activity?

I think we have become over-preoccupied with whether the production index is going to go down several points. I am afraid I am stuck with the recommendation of a tax increase, unless we can work out a large cut in expenditures or unless a significant downturn takes place.

Chairman PROXMIRE. Thank you very, very much for a most stimulating presentation. You certainly have fielded these questions beautifully.

I would like to ask unanimous consent that a letter by Seymour Harris in the Washington Post pertaining to our hearings, and our monetary policy especially, be included in the record at this point. (The letter referred to follows:)

A Communication <sup>1</sup>

*(The author of the following letter is Chairman of the Department of Economics of the University of California at San Diego, and a former adviser to President Kennedy.)*

IN CALENDAR YEAR 1966 the Government did not introduce a general tax increase. But it was concerned over the large military outlays and inflationary pressures. Hence early in the year the government acknowledged that the stimulation of the economy as required in 1961-65 was no longer necessary. By removing \$9 billion from the economy in early 1966 through new taxes and acceleration of collection of some taxes; and in addition through the later suspension of the Investment Credit, the Government showed it was aware of the need of restraint.

In the first quarter of 1966 a number of outstanding economists urged the Government to introduce a general income tax rise as an anti-inflationary move. In January, Walter Heller suggested a temporary tax increase. At a Chamber of Commerce meeting of February 9, Paul Samuelson proposed a tax increase as well as other anti-inflationary measures. In conversations with the press afterwards he still seemed hesitant, however. Arthur Burns also expressed disapproval of anti-inflationary policies; but did not at this time suggest a general tax increase. In February the Chase Manhattan Bank and the New York Reserve Bank, though critical of anti-inflationary policy, did not propose an anti-inflationary tax increase. The emphasis of the more conservative elements was a reduction of spending or a more restrictive monetary policy rather than a rise of taxes.

IN A LATE FEBRUARY 1966 column, Hobart Rowen of The Washington Post welcomed Samuelson into the tax-rise camp, but complained of the silence of the others of the New Economics school. Soon after the New York Reserve Bank jumped aboard the tax rise caravan. By March the Executive Director of the American Bankers Association joined the tax brigade. By March 9, 1966, Murray Rossant of the New York Times welcomed as supporters of additional taxes, Heller, Samuelson, and Tobin, three of the top economists in the country and as knowledgeable in this area as any economist. But the orthodox business economists still tended to favor spending cuts rather than tax rises. Burns was now ready to accept a tax increase as well as push for reduced spending.

In March Rowen questioned 30 economists. Twenty-two urged a general tax rise. The New York Times also joined in the clamor for a tax rise. In May, 40 percent of the economists questioned approved a general tax rise; by late November only 12 out of 52 (23%) were for a tax increase.

Apparently March was the peak month of acceptance to tax policy as an anti-inflationary weapon. Now Heller would only get ready for a tax increase if needed; and Samuelson was worried that a very strong deflationary policy would be a mistake. Burns, Cary Brown, Buchanan and R. A. Gordon, however, still supported tax increases. Business Week still favored a tax rise as the best of three alternatives. And on March 22, Senator Jacob Javits would raise taxes modestly.

IN APRIL, the bankers who spoke out still seemed to be for tax increases and Samuelson in late April still adhered to the tax-anti-inflation view.

But defections were beginning at this time. Leading indicators increasingly began to point downwards. The Times reported on April 27 that the economists were turning against tax policy as an anti-inflationary weapon. The Administration had waited too long. Samuelson still supported a tax rise in late May but seemed to be wavering. Rowen now (April 27) reported that only some liberal economists were for tax increases, whereas labor, business and politicians were now opposed. It is of some interest that none of the Treasury's panel of 25 outstanding economists at their June meeting with the Secretary urged a rise of taxes. Apparently the signs of economic deterioration and the political

<sup>1</sup> Reprinted from Washington Post, Feb. 19, 1967.

difficulties of getting a tax bill through expeditiously resulted in a loss of enthusiasm.

It was clear that the adherents of tax increases were deserting in the second quarter of 1966. The President's Business Council in May seemed to be 3-1 or 2-1 against a rise of taxes.

**RANKS OF THOSE** favoring tax rises would have been depleted much more had not the Fed introduced a dear money policy which began to bite in May 1966, and its extent not anticipated nor even wanted by the Fed. The bankers now largely joined the tax increase group. They much preferred a tax increase which would allocate the burdens on the whole population to a severely restrictive monetary policy, which especially threatened them.

At various times the Republican leadership expressed views on anti-inflationary policy. As a rule they urged restrictive monetary policy and reduced federal spending. Congressman Melvin Laird speaking for the Republican Conference, in mid-April espoused a cut in spending; but not a rise of taxes. Senator Javits in May still was for the tax increase as was Dirksen in July, though reluctantly. A poll of Congressmen late in 1966 revealed 80 percent against a tax increase.

It was not easy to get the proper mix of monetary and fiscal policy. With monetary policy highly and dangerously restrictive, the Treasury was most hesitant in pushing through large tax increases in the last 8 months of 1965. The movement of leading indicators pushed the Treasury in the same direction.

**ONCE MONETARY** policy had eased greatly the Treasury could recommend to the President a tax increase though one that might be postponed or withdrawn if the economy faltered in the first half of 1967 or even later.

The Treasury was up against a mass of uncertainties as was almost everyone else. How much would Vietnam expenditures rise? How much would prices rise in response to wage escalation, reduced increases in productivity, and general reduction of excess capacity? How to weigh the decline suggested by the leading indicators against the uncertain rise of military outlays?

Government pronouncements reflected these uncertainties. Late in 1965 there were rumors from Paris that Secretary Fowler favored a rise of taxes. In February Fowler was considering all alternatives but emphasizing tax policy. But at the Joint Economic Committee hearings he would not press down on the brakes vigorously. He hoped that the Congress would be ready for a tax increase if needed. By March, Fowler announced that a modest tax rise may be necessary. The President apprised of the direction of the Leading Indicators in the latter part of March, was not convinced of a need of a tax increase. Much would depend on the spending of the Government. Fowler also wanted more data. A few days later the President would accept a rise of taxes if more restraint was needed. He might even ask for a tax increase in April if adequate economies were not to be achieved. In May Mr. Ackley agreed that a temporary tax rise may be necessary; but he would wait. And to Fowler the situation was not clear. Should the deficits rise greatly and prices and demand continue to rise, Arthur Okun of the Council feared that a rise in taxes would be triggered. The economic prospects still seemed uncertain to the President and the Secretary of the Treasury in June. But August the Treasury seemed more receptive to a tax increase as a means of achieving a better mix of monetary and fiscal policy. Ackley in August would reduce interest rates and increase taxes.

**A VIEW HELD** in some quarters was that had the Government introduced a general anti-inflationary tax policy in early 1966 many of our 1967 problems would have been solved. But there were serious obstacles. Not only the Congress but the public also were heavily against a general tax increase. The Congress favored a cut in spending at home which was not to be achieved. In this same period the financial groups stressed monetary rather than fiscal policy. Had the Government put a tax program into the works in late March (say) then assuming acceptance by the Congress by June-July—a bold assumption indeed—then a tax increase on top of the dangerous monetary situation might well have greatly damaged the economy. The only safe thing to do was to introduce a tax bill once the Fed had shown an inclination to end its costly restrictive monetary policy and also to ask for a tax increase—as it did in early 1967—that would be recalled should the economy falter.

In the light of the great advances in 1961-1966 in GNP, stability, employment, unemployment, standards of living, growth of assets both for business and the family—the disequilibria in 1967 which Senator Javits and others emphasize seem

rather unimportant. The great mistake of 1966 was the costly monetary policy, a setback for which the Independent Fed, not the Government, will have to assume responsibility.

The error was to introduce a dear money policy in December, 1965 without the cooperation of the Government. Had the Government, without a guarantee of monetary ease—which they could not get—have introduced a general income tax rise 1966, then the health of the economy would have been jeopardized. It would take time, even if the Fed cooperated, for an easing to have its impact. In the meanwhile two potent weapons would have helped deflate the economy. The lag in effects of monetary changes is evident in a decline of 15 out of 23 Leading Indicators in October and 15 out of 19 in November, 1966.

SEYMOUR E. HARRIS, San Diego, Calif.

February 16, 1967.

Chairman PROXMIRE. This concludes the hearings this committee will hold on the President's Economic Report. We will have a number of other hearings this year, but this ends our formal public review.

The Joint Economic Committee stands adjourned.

(Whereupon, at 12 :25 p.m., the committee adjourned.)

