

STAGFLATION

HEARINGS
BEFORE THE
SPECIAL STUDY ON ECONOMIC CHANGE
OF THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
NINETY-SIXTH CONGRESS
FIRST SESSION

APRIL 30, AND MAY 7 AND 9, 1979

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STAGFLATION

MONDAY, APRIL 30, 1979

CONGRESS OF THE UNITED STATES,
SPECIAL STUDY ON ECONOMIC CHANGE OF THE
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 6226, Dirksen Senate Office Building, Hon. Richard Bolling (vice chairman of the committee) presiding.

Present: Representative Bolling and Senator Javits.

Committee staff present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director, SSEC; Lloyd C. Atkinson, Kent H. Hughes, and L. Douglas Lee, professional staff members; Mark Borchelt, administrative assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

Special Study on Economic Change staff present: George D. Krumhaar, Jr., counsel; Douglas N. Ross, senior economist; Richard D. Bartel, economist; and Michael J. Lockerby and Carolyn H. Crowley, research assistants.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, VICE CHAIRMAN

Representative BOLLING. The committee will be in order. The chairman, Senator Bentsen, is delayed a little bit. And I will start.

This morning we are opening the second set of public panel discussions of the Joint Economic Committee in connection with our Special Study on Economic Change. I might explain for those not familiar with the Special Study project that it grew out of discussions with the majority and minority members of the Joint Economic Committee and with the leadership in the House and Senate. We prepared a prospectus about 2 years ago which calls for a 3½-year study to identify the nature of major economic changes occurring in the United States and the world that may have rendered ineffective the traditional methods for achieving aims of the Employment Act of 1946. We believe thorough analysis of these profound changes would yield not only a better understanding of long term problems confronting Congress, but would also suggest fresh policy options for our consideration. On the basis of this prospectus, House Concurrent Resolution 248 was introduced in the House and passed overwhelmingly, then was approved by the Senate by unanimous consent on July 18, 1977.

The underlying thesis of the Study is that economic, social, political, international, and technical conditions have changed, and are

still changing markedly. This suggests that conventional wisdom and established economic tools may not be equal to the challenge of making sound policies in the economic sphere. The so-called laws of economics have not been repealed but all guiding principles presuppose certain environmental conditions, customs, and practices. When these change the implementation of new policies and modes of adjustment have to change also.

This comprehensive project now has underway papers and reports on the nature and consequences of economic change in nine major areas: Human resources and demographics; materials and energy resources; research and innovation; stagflation; government regulation; Federal finance; State and local finance; pensions; and the international sector.

Today we turn our attention to the twin problems of inflation and unemployment which our study addresses under the heading "Stagflation." Last Thursday Senator Bentsen said to Mr. Kahn when he testified before the JEC that he thought it premature to talk about a safe landing when inflation is still taking off. It seems to me there is plenty of time to worry about the landing when we started down from what has again become double-digit inflation. We are not here today to talk about the short run aspects of stagflation. What we want to discuss today is where will the typical American family be in the next decade. How long can they go on altering their spending and borrowing habits to protect their purchasing power and standard of living? How long before continuing inflation corrodes the basic institutions of our free society and market economy? Yet the American public and congressional legislators alike recognize that there are no quick or easy solutions to the twin problems of extensive inflation and unemployment.

So serious are these problems in the minds of many congressmen that the Joint Economic Committee for the first time in 20 years issued a unified report endorsed by both the Democratic and Republican members. The JEC report pointed out that in order to correct deeply entrenched inflation and unsatisfactory levels of unemployment requires the Federal Government to put its financial house in order and to meet the major challenges confronting us on the supply side of the economy.

On the supply side we look for higher production, not lower. We take no satisfaction when our index of industrial production rises little or not at all. We look for more efficient production processes, more effective management, higher investment, more skilled labor and higher total productivity. It is our target to achieve price stability in an expanding economy, not a declining one. We cannot make our peace with either rising inflation or rising unemployment.

If we do not solve both of these problems of inflation and unemployment, not one but both, we may encounter in these United States, not far down the road, challenges to both our economic and political institutions of a seriousness we have not recently hitherto contemplated. To avert the tragedy of such destructive challenges is our primary purpose.

Accordingly, the Special Study has invited a number of preeminent economists, business leaders, and labor authorities to join us in a dialog on the longer term outlook and solution to the problems of inflation

and unemployment. As in our hearing last year we have organized today's discussions as a panel. Our experience with panel discussions since the 1950's confirms our belief that the democratic process works in an intellectual sense. The best ideas, the best insights emerge from free exchange from a spirited dialog among a variety of people. Some will draw from their academic experience and intellectual interests, others from their political pursuits and others from their activities in business and labor.

Our panelists today are too well known to need an introduction. Arthur Okun, a senior fellow at Brookings; Otto Eckstein, president of Data Resources, Inc.; Martin Feldstein, president of National Bureau of Economic Research; and Jerome Hardy, president of the Dreyfus Corp. I think I ought to add one more fact you might not know about Mr. Hardy. He is the former publisher of Life magazine.

Mr. Okun, you have as proposition 1 that in the mid-1970's chronic inflation is new in our history. It is a new phenomenon that can't be treated effectively with old prescriptions. I think it would be ideal for you to start our discussions. We are delighted to have you.

**STATEMENT OF ARTHUR M. OKUN, SENIOR FELLOW, THE
BROOKINGS INSTITUTION, WASHINGTON, D.C.**

Mr. OKUN. It is a privilege to address you. I did want to emphasize the chronic problem and the need to think about its implications for revising our theories.

Unlike all previous reported U.S. recessions, the 1970 recession did not stop inflation in its tracks. Even more remarkably, the prolonged 1973-75 recession left us with a basic inflation rate of 6 percent.

The transformation of our inflationary behavior is rooted in a system of pricemaking that, throughout modern times has departed farther and farther from the textbook model. Most of our economy is dominated by cost-oriented prices and equity-oriented wages. Most prices are set by sellers with principal focuses on maintaining customers and market share over the long run. The pricing policies designed to treat customers reasonably relies on some standard measure of costs and a percentage markup that displays very little variation over the business cycle.

Similarly, the key to wage decisions in both nonunion and union areas is a common long-run interest of skilled workers and employers in maintaining their job relationships. Employers make investments in a trained, reliable, and loyal work force. They know that if they curbed wages stringently in a slump, they would pay heavily for that strategy with swollen quit rates by their workers during the next period of prosperity, and so during recession and slack periods, nonunion firms with workers on layoff and queues of eager job applicants find it worthwhile to raise the wages of their workers, in order to protect their longer-term personnel relationships.

In those nonunion areas where workers have rapid turnover and thus employers and employees have little stake in lasting relationships, wages respond more noticeably to the level of unemployment. But, in most areas, personnel policies are sensibly geared to the long run with an emphasis on equitable treatment. And the basic test of equity is that

the pay of workers is raised in line with the wage increases of other workers in similar situations. Such a strategy introduces inertia in the rate of wage increase; it creates a pattern of wages following wages.

The customer and career relationships that desensitize wages and prices from excess supplies and demands in the short run have a genuine social function. They are not creations of evil business monopolies or unduly powerful labor unions, but rather efficient arrangements for a complex interdependent economy in which customers and suppliers, workers and employers benefit greatly from ongoing relationships.

And the resulting influence on prices and wages cuts two ways. When total spending in dollars starts to expand rapidly, most of the increase takes the form of a bonus in output and employment, with little added inflation. In that sense, these institutions make inflation slow starting. But when the dollar value of GNP slows down, most of that takes the form of a loss of production with little relief from inflation. So inflation becomes slow stopping.

As people recognize the persistence of inflation, they change behavior in ways that make inflation more rapid and more tenacious. Prior to the 1970's, the U.S. economy had a basically noninflationary environment—average inflation rates in peacetime rarely exceeded 2 percent for any sustained period.

In that environment, price and wage decisions relied heavily on the dollar as a yardstick, a scorekeeping device, and a basis for planning and budgeting.

During the 1970's, these institutions changed as Americans adjusted to the persistence of inflation. The notion of par-for-the-course on wage increases was revised upward. Escalator clauses spread through the major collective bargaining contracts and thus made wages respond promptly to inflation in the cost of living. Businessmen began to adjust their pricing to reflect the growing gap between high replacement costs and low actual historical costs. They shortened the intervals at which they raised prices, and many stopped taking fixed-price orders. These adaptations to chronic inflation speed up the spiral, transmitting higher wages and other costs into higher prices and higher prices into higher wages even more rapidly.

That takes me to the second point. If left untreated, the syndrome of chronic inflation is likely to become more severe and to impose even greater economic and social costs in the 1980's. This neglect of inflation is malign, not benign.

The adaptations to chronic inflation contributed to the bad news of 1978. Nonunion wages, which had been rising much less rapidly than union wages during the preceding few years, began to catch up.

The American people identify inflation as domestic public enemy number one in opinion surveys. And they did so by an overwhelming margin even during 1976 and 1977, when inflation proceeded at a fairly steady 6 percent rate and was well predicted. They are concerned for good reasons. Only a small minority of Americans have obtained cost-of-living escalators that protect their real incomes effectively from inflation. They do not find opportunities in financial markets to protect their wealth against inflation and still preserve their liquidity.

For the long run, no American can plan effectively in a world where the dollar remains the yardstick, but shrinks in real value at an uncertain rate.

Moreover, the ratcheting-up of inflation has produced a serious credibility gap between the citizenry and its elected officials. Americans have been told again and again that inflation would be curbed. But, in fact, it has kept ratcheting-up right to the present.

Finally, inflation has exacerbated social divisiveness. It is not easy for families to know where they stand in the price-wage race. They feel threatened by it and regard it as unfair. Many undoubtedly feel that they are behind in the race, even when that may not be objectively the case. And so, they feel that they have the short end of the stick and are convinced that somebody else must have the long end. The principal new product of the American economy in the decade of the 1970's has been sticks with two short ends.

Finally, I want to stress that an efficient anti-inflationary program must be diversified. It needs three major elements. First, enough fiscal-monetary discipline to provide a safety margin against excess demand. Second, a coordinated Federal initiative to reduce private costs. And third, constructive measures to obtain price and wage restraint.

We should set our fiscal and monetary policies to accept some downside risks on output and employment in the short run. We didn't accept enough of those risks in 1977 and 1978. It turned out in retrospect that fiscal-monetary policy was too stimulative. We must do better in the future to establish a safety margin against overly strong markets.

On the other hand, we must recognize the ill effects of overdoses of fiscal and monetary restraint. Those effects are clear in the sad experience of 1974-75, when we crusaded against inflation relying solely on tight budgets and tight money.

With that approach, the Nation squanders about \$200 billion of real production and roughly 5 million worker-years of jobs for every point that it reduces the inflation rate. The evidence of recent years suggests that, through its fiscal and monetary policies, the Federal Government can control—within a reasonable margin—the total growth of the GNP measured in dollars. But it cannot control the division of that growth between increases in output and increases in the price level. That is determined by private price and wage decisions.

During recession and slack periods, each dollar trimmed from GNP means a loss of roughly 90 cents of output and the savings of about a dime on the price level. Any anti-inflationary proposal that relies solely on balancing the budget and tightening money is, in reality, a proposal for an encore of that experience. And it should carry a truth-in-packaging label revealing that its probable contents are 90 percent production losses and job losses and only about 10 percent inflation saving.

There is no doubt that there is a pure fiscal monetary cure taken by itself for inflation. Nobody questions that. Nobody should. The questions all lie in the consequences of such a strategy. All the evidence suggests that those consequences for production, employment, capital formation, and for our social fabric would be horrendous. Average

citizens cannot reasonably be expected to recognize those consequences fully, and it is understandable when some of them grasp at the straw of budget balancing in the hope of a rescue from inflation. But our political leaders ought to know better; and if they don't, they ought to be willing to learn better.

Turning to Federal cost-reducing initiatives, I want to stress that Federal policies have pervasive impacts on costs and prices in many sectors of the economy. The Federal Government adds to the price level when it imposes cost-raising taxes, like excises on products or payroll taxes on employers. Its social regulation for safety, health, and environment is a source of higher costs and prices—necessary in part, but unnecessary to some degree.

Its economic regulation of industries with public utility characteristics influences their price and costs. In order to pursue certain equity objectives, the Government sets floors on some prices—as in the dairy and sugar program—and on pay; it works through supply controls on planted acreage, timber cutting, and oil leasing and through tariffs and other restrictions on imports.

In my judgment, the most serious inflationary stimulus in recent years came from a series of such self-inflicted wounds incurred during 1977: A major increase in payroll taxes on employers, a large rise in the minimum wage, reinstated acreage controls in farming, added regulatory burdens on business, and new barriers to imports.

Proposals that would reduce costs have been frequently rejected. Hospital cost containment was not passed by the last Congress; Presidential proposals to cut certain Federal excise taxes were ignored. Indeed, to my amazement, some congressional leaders advocate a new value-added tax, which would surely add to our inflationary woes.

There are enormous potential anti-inflationary benefits in this area. We could cut Federal payroll taxes on employers; we could use grant formulas to encourage States and cities to lower their price-raising and cost-raising taxes. We could reform regulation to reduce its cost burdens.

I have suggested again and again, and I will try once more, as a first step into this area, a procedural reform—the development of a system of inflation scorekeeping. The Congressional Budget Office, or General Accounting Office, should be asked to issue a quarterly report, identifying all actions and pending proposals by the President and by the Congress that serve either to raise or to lower the price level, and that report should show an impact. I think putting it on the table would make an enormous difference in the way Congressmen behave.

Finally, the need for price and wage restraint. During recent years, the price-wage spiral has been the most fundamental source of rapid inflation in the United States. Any efficient cure for inflation must get directly at that source. At the present time, the administration's program of price-wage standards deserves our full support.

Any plea for voluntary cooperation in our society implies a threat of focusing the spotlight of public opinion on flagrant violators. Beyond that, the present program carries that threat of sanctions associated with privileged relationships that many business firms have with the Federal Government. These provisions strengthen the credi-

bility of the program, although they invoke an unlegislated bureaucratic power that is not ideal. That informal structure is about right. It is the best we can do.

I don't think we want to do more and I don't think we can afford to do less. I do not expect the President to seek authority for price and wage controls, and I personally would emphatically oppose any mandatory structure of controls over prices and wages.

Despite a few collective bargaining settlements that exceeded the wage standard, the overall behavior of pay since last October has accorded remarkably well with the standard.

On the other hand, the overall behavior of industrial prices raises strong suspicions of significant violations of the price standard. But the identification of violators is apparently a complex and difficult task. All in all, I expect this program to contribute to the deceleration of inflation, as some wage restraint passes into price restraint, and as businesses are made more conscious of the urgent need for their cooperation.

Informal semivoluntary policies of price and wage restraint have helped significantly over some periods of time. But such programs have been brittle in the face of changes in economic conditions and in business and labor reactions. And so they get phased out and then reshaped and reinstated. Keeping an incomes policy in the anti-inflationary arena is not easy. P. T. Barnum once noted that keeping a lamb in a cage with a lion requires a large reserve supply of lambs. Similarly, society may need a reserve supply of incomes policies, because we will need some program of price-wage restraint for years to come.

Along with a number of economists, I have been advocating the development of a tax-based income policy, either in a reward or penalty form. There is a tremendous social interest in wage and price restraint, and it can be pursued better by providing market-type incentives for such restraint through the tax system than by relying on voluntary appeals or rigid mandatory rules.

I presented a specific proposal last spring. I won't present it here, but I will be glad to answer questions about it. This is getting to be an old story for me, Congressmay Bolling.

I have been advocating a cost-reducing program and tax-based income policy as essential parts of an efficient anti-inflationary strategy—in combination with fiscal-monetary restraint—for the past 5 years. I realize that many of these proposals are untried and unproven, and that many pose administrative problems and meet political opposition from major interest groups. So I remain patient and persistent.

I am more encouraged that the President saw to propose real wage insurance than I am disappointed by its rejection by the Congress.

I do want to stress that my proposals are realistic. The only thing that bothers me is when people call them imaginative. In fact, there are two popular doctrines that require imagination. One predicts inflation will simmer down naturally or become tolerable to the American people. And the other proclaims that fiscal and monetary restraint alone can cure inflation without deep and prolonged recession. Those are the imaginative strategies. They have been tried and proven false.

It is time to face the realities of the new disease of chronic inflation and to focus on the prescriptions that are appropriate for curing it.

Thank you.

Representative BOLLING. Thank you.
 [The prepared statement of Mr. Okun follows:]

PREPARED STATEMENT OF ARTHUR M. OKUN¹

It is a privilege to present to this distinguished committee my views on the crucial issues posed by stagflation. Chronic inflation has been the outstanding feature of the American economy in the seventies, and it is our foremost economic problem as we approach the decade of the eighties. My statement will emphasize three key propositions:

(1) That the chronic inflation of the seventies is unprecedented in our history. It is a new and different phenomenon that cannot be diagnosed correctly with old theories or treated effectively with old prescriptions.

(2) If left untreated, the syndrome of chronic inflation is likely to become more severe and to impose even greater economic and social costs in the eighties. Thus, any neglect of inflation is malign, not benign.

(3) An efficient anti-inflationary program must be diversified. It needs three major elements: (a) enough fiscal-monetary discipline to provide a safety margin against excess demand; (b) a coordinated federal initiative to reduce private costs; (c) constructive measures to obtain price-wage restraint.

THE DIAGNOSIS OF STAGFLATION

The recent era of inflation began in the mid-sixties with excess demand. That initial episode of inflation fit the traditional definition of too much money chasing too few goods. In 1966-68, the Federal budget was an engine of inflation, and it was not effectively offset by monetary restraint. Employment, production, capital spending, and real incomes soared—but so did prices. Serious mistakes of economic policy were made in the pursuit of guns and butter during the Vietnam period. Yet, it must be remembered that every previous wartime period in U.S. history was marked by more rapid inflation. The big difference this time was that the end of the war did not bring the end of the inflation. On the contrary, it ratcheted up further.

For the years 1968 through 1978, the inflation rate of our GNP averaged 6.1 percent, and at its lowest was 4.1 percent in 1972. In contrast, for the years 1952 through 1967, inflation averaged 2.0 percent and at its worst was 3.4 percent in 1957. Thus, every year since 1968 has had a higher inflation rate than any year between 1952 and 1967. Rapid inflation became a chronic disease for the first time in our history. In 1970, we experienced a recession that, unlike all previous recorded U.S. recessions, did not stop inflation in its tracks. Even more remarkably, the prolonged and severe 1973-75 recession left us with a basic inflation rate of 6 percent, which remained essentially unchanged from late 1975 to the end of 1977.

The transformation of our inflationary behavior is rooted, in my judgment, in a system of price and wage decisionmaking that, throughout modern times, has departed farther and farther from the textbook model in which supply and demand call the tune promptly and reliably. As I will explain, our system of cost-oriented prices and equity-oriented wages actually slows down an inflationary trend initially, but it also makes inflation much more stubborn once it has become entrenched. The resulting inertia of inflation feeds on itself, changing patterns of behavior that were once geared to an essentially noninflationary environment in ways that speed the wage-price spiral.

The realities of the price-wage system.—In a small and shrinking sector of the U.S. economy, products are traded in organized auction markets, and prices vary from day to day to keep supply and demand in balance. Those prices respond promptly and sharply to recession. For example, prices of sensitive industrial raw materials fell by 15 percent between May 1974 and March 1975. That area, which matches the textbook model, offers a striking contrast to the rest of the economy.

Most of our economy is dominated by cost-oriented prices and equity-oriented wages. Most prices are set by sellers whose principal focus is on maintaining customers and market share over the long run. The pricing policies designed

¹ The views expressed are my own and are not necessarily those of the officers, trustees, or other staff members of The Brookings Institution.

to treat customers reasonably and maintain their loyalty in good times and bad times rely on some standard measure of costs. Prices are set to exceed costs by a percentage markup that displays only minor variation over the business cycle.

Similarly, the key to wage decisions in both union and nonunion areas is the common long-run interest of skilled workers and employers in maintaining their job relationships. Employers make investments in a trained, reliable, and loyal work force as well as in plant and equipment. They know that if they curbed wages stringently in a slump, they would pay heavily for that strategy with swollen quit rates by their workers during the next period of prosperity.

Thus, during recession and slack periods, nonunion firms with workers on layoff and queues of eager job applicants find it worthwhile to raise the wages of their workers, in order to protect their longer term personnel relationships.

In those nonunion areas where workers have rapid turnover and thus employers and employees have little stake in lasting relationships, wages respond more noticeably to the level of unemployment. But, in most areas, personnel policies are sensibly geared to the long run with an emphasis on equitable treatment. And the basic test of equity is that the pay of workers is raised in line with the wage increases of other workers in similar situations. Such a strategy introduces inertia in the rate of wage increase; it creates a pattern of wages following wages.

The customer and career relationships that desensitize wages and prices from excess supplies and demands in the short run have a genuine social function. They are not creations of evil business monopolies or unduly powerful labor unions, but rather efficient arrangements for a complex interdependent economy in which customers and suppliers, workers and employers benefit greatly from ongoing relationships. And the resulting influence on prices and wages cuts two ways. When total spending in dollars starts to expand rapidly, most of the increase takes the form of a bonus in output and employment, with little added inflation. In that sense, these institutions make inflation slow starting. But when the dollar value of GNP slows down, most of that takes the form of a loss of production with little relief from inflation. So inflation becomes slow stopping.

Adapting to inflation.—As people recognize the persistence of inflation, they change behavior in ways that make inflation more rapid and more tenacious. Prior to the seventies, the U.S. economy had a basically noninflationary environment—average inflation rates in peacetime rarely exceeded 2 percent for any sustained period. In that environment, price and wage decisions relied heavily on the dollar as a yardstick, a score-keeping device, and a basis for planning and budgeting. Americans adjusted to a reasonable notion of the wage increase that met par-for-the-course. And so labor and management were willing to sign contracts that fixed wage rates over a three-year interval. Firms set their prices on the basis of known actual costs that they had paid for their labor and supplies, rather than on hypothetical calculations of replacement costs. Salesmen accepted orders for the future delivery of products at guaranteed prices. Advertising catalogues carried price lists that were subject to change only infrequently, often at stated intervals. Public utility and other regulatory commissions reviewed rates only occasionally.

During the seventies, these institutions changed as people recognized the persistence of inflation. The notion of par-for-the-course on wage increases was revised upward. Escalator clauses spread through the major collective bargaining contracts and thus made wages respond promptly to inflation in the cost of living. Businessmen began to adjust their pricing to reflect the growing gap between replacement costs and actual historical costs. They shortened the intervals at which they raised prices, and many stopped taking fixed-price orders. These adaptations to chronic inflation speed up the spiral, transmitting higher wages and other costs into higher prices and higher prices into higher wages even more rapidly.

THE PRINCIPLE OF MALIGN NEGLECT

Because reliance on the dollar is so heavily embedded into our economic practices and thinking, these adaptations to inflation have really just begun. If the inflation rate is not reduced, they are bound to spread much further as people keep adjusting to inflation in self-defense. In a sense, some of these adjustments represent ways of learning to live with inflation, and hence they are welcomed by some economists. But while they can reduce the amount of pain per point of inflation, they are bound to increase the number of points of inflation. In my judgment, they are more of a disease than a cure. If these institutional adapta-

tions keep spreading, the inflation rate will keep ratcheting up. Inflation tends to feed on itself rather than to correct itself. And thus neglect of inflation is, in principle, malign rather than benign.

The adaptations to chronic inflation contributed to the bad news of 1978. Nonunion wages, which had been rising much less rapidly than union wages during the preceding few years, began to catch up. Because of the wide gap between historical and replacement costs, businessmen felt a need to raise their markups when the markets for their products strengthened—long before excess demand, in any objective sense, appeared. These developments should not have surprised anyone; they were predictable—indeed, I predicted them in October 1977.

To be sure, food and energy have played a significant role in the acceleration of inflation during the past year. But prices of those products tend to spurt and slow down; indeed, the major inflationary danger they pose over the longer run stems from the way they can get into the wage-price spiral. Over the entire period of 4 years of economic recovery since March 1975, food and fuel have not raised the inflation rate significantly. Since March 1975, the consumer price index has risen at an average annual rate of 7.2 percent; the average for all items except food and energy has been nearly as large—7.0 percent. Thus, we have been experiencing primarily wage-price spiral inflation—not food, fuel, or other special-factor inflation.

The American people identify inflation as domestic public enemy no. 1 in opinion surveys. And they did so by an overwhelming margin even during 1976 and 1977, when inflation proceeded at a fairly steady 6 percent rate and was well-predicted. They are concerned for good reasons. Only a small minority of Americans have obtained cost-of-living escalators that protect their real incomes effectively from inflation. They do not find opportunities in financial markets to protect their wealth against inflation and still preserve their liquidity. The stable interest rates on passbook deposits that once provided them with a predictable, reasonable return on liquid assets now do not even allow their principal to keep up with the price level—not even on a before-tax basis. Common stocks have been miserable failures as inflation hedges, because the era of stagflation brought higher volatility and lower growth of real corporate earnings. The single-family home has been the one good investment for most Americans, but many who have taken advantage of that opportunity have had to sacrifice liquidity and some have plunged over their heads with commitments for cash payments on mortgages. For the long run, no American can plan effectively in a world where the dollar remains the yardstick, but shrinks in real value at an uncertain rate.

Moreover, the ratcheting-up of inflation has produced a serious credibility gap between the citizenry and its elected officials. Americans have been told again that inflation would be curbed. The acceptable rate of inflation in policymaking rose from 1½ percent in the early sixties to 3 percent in the early seventies, and apparently, to 6 percent in the mid-seventies. Anyone familiar with that history must wonder whether the present inflation rate of about 8 percent will be reduced or whether it will be just one more turn of the ratchet.

Finally, inflation has exacerbated social divisiveness. It is not easy for families to know where they stand in the price-wage race. They feel threatened by it and regard it as unfair. Many undoubtedly feel that they are behind in the race, even when that may not be objectively the case. And so, they feel that they have the short end of the stick and are convinced that somebody else must have the long end. The principal new product of the American economy in the decade of the seventies has been sticks with two short ends.

A DIVERSIFIED ATTACK ON INFLATION

Inflation must be reduced substantially over the years ahead. That can only be accomplished gradually; and it can only be accomplished efficiently through a concerted use of a variety of anti-inflationary policies—including fiscal-monetary restraint, federal cost-reducing initiatives, and price and wage restraint.

Fiscal-monetary restraint.—In battling against inflation, we must accept some downside risks on output and employment in the short run, in order to clear the way for sustained growth in the long run. In retrospect, we did not balance these risks prudently enough in setting fiscal-monetary policy during 1977–78. We must do better in the future to establish a safety margin against overly strong markets.

On the other hand, we must recognize the ill effects of overdoses of fiscal and monetary restraint. Those effects are clear in the sad experience of 1974-75, when we crusaded against inflation relying solely on tight budgets and tight money. During fiscal year 1974, the federal budget was nearly balanced in the face of a recession; during calendar year 1974, the growth of money (currency and demand deposits) was held to 4½ percent. The beneficial impact on inflation was disappointingly small, while the unfavorable impact on employment, production, and capital formation was enormous.

With that approach, the nation squanders about \$200 billion of real production and roughly 5 million worker-years of jobs for every point that it reduces the inflation rate. The evidence of recent years suggests that, through its fiscal and monetary policies, the Federal Government can control—within a reasonable margin—the total growth of the GNP measured in dollars. But it cannot control the division of that growth between increases in output and increases in the price level. When the government pushed the economy into deep recession and prolonged slack, each dollar trimmed from GNP meant a loss of roughly 90 cents of output and a saving of about 10 cents on the price level. Any anti-inflationary proposal that relies solely on balancing the budget and tightening money is, in reality, a proposal for an encore of that experience. And it should carry a truth-in-packaging label revealing that its probable contents are 90 percent production losses and job losses and only about 10 percent inflation saving.

Undoubtedly, inflation could be eliminated by fiscal-monetary restraint alone, but the consequences of such a strategy for production, employment, capital formation, and our social fabric would be horrendous. Average citizens cannot reasonably be expected to recognize those consequences fully, and it is understandable when some of them grasp at the straw of budget balancing in the hope of a rescue from inflation. But our political leaders ought to know better, or to learn better.

Federal cost-reducing initiatives.—Federal policies have pervasive impacts on costs and prices in many sectors of the economy. The federal government adds to the price level when it imposes cost-raising taxes, like excises on products or payroll taxes on employers. Its social regulation for safety, health, and environment is a source of higher costs and prices—necessary in part, but unnecessary to some degree. Its economic regulation of industries with public utility characteristics influences their price and costs. In order to pursue certain equity objectives, the government sets floors on some prices (as in the dairy and sugar program) and on pay (as in the minimum wage). It affects the supply of various private industries through such provisions as acreage controls, timber cutting, and oil leasing. It also influences price and costs through tariffs and other restrictions on imports.

Because most individual government actions and policy changes in these areas have relatively small effects, they often go unnoticed. And yet they add up to a great deal. In my judgment, the most serious inflationary stimulus in recent years came from a series of such self-inflicted wounds incurred during 1977: a major increase in payroll taxes on employers, a large rise in the minimum wage, reinstated acreage controls in farming, added regulatory burdens on business, and new barriers to imports.

Proposals that would reduce costs have been frequently rejected. Hospital cost containment was not passed by the last Congress; presidential proposals to cut certain Federal excise taxes were ignored. Indeed, to my amazement, some congressional leaders advocate a new value-added tax, which would surely add to our inflationary woes.

There are enormous potential anti-inflationary benefits in this area. We could cut federal payroll taxes on employers; we could use grant formulas to encourage states and cities to lower their price-raising and cost-raising taxes. We could reform regulation to reduce its cost burdens. This is the most efficient strategy for curbing the price level. It does not put people out of work, and it does not have to constrain private price and wage decisions.

I have suggested again and again, as a first step into this area, a procedural reform—the development of a system of inflation scorekeeping. The Congressional Budget Office (or General Accounting Office) should be asked to issue a quarterly report, identifying all actions and pending proposals by the President and by the Congress that serve either to raise or to lower the price level and estimating their dollar impact. Nobody has yet told me why this idea is defective, but nobody has acted to implement it.

Price-wage restraint.—During recent years, the price-wage spiral has been the most fundamental source of rapid inflation in the United States. Any efficient cure for inflation must get directly at that source. At the present time, the administration's program of price-wage standards deserves our full support.

Any plea for voluntary cooperation in our society implies a threat of focusing the spotlight of public opinion on flagrant violators. Beyond that, the present program carries that threat of sanctions associated with privileged relationships that many business firms have with the Federal Government. These provisions strengthen the credibility of the program, although they invoke an unlegislated bureaucratic power that is not ideal. All in all, I can accept them. I would also consider it useful for the President to have clearly legislated authority to delay major price or wage decisions that could pose a threat to the viability of the entire program. But the very discussion of such legislation would intensify the widespread fears of business that we are on the road to controls. In fact, I do not expect the President to seek control authority, and I personally would emphatically oppose any mandatory structure to controls over prices and wages.

As proposed by the President, the overall program was reasonably equitable as between business firms and workers. But that fairness depended heavily on the real wage insurance provision. Without that provision, the standards impose on workers a heavier burden of restraint and much more potential risk than they do on businessmen. America's workers are being asked to ante up for the deal. And thus far most are doing so. Despite a few collective bargaining settlements that exceeded the wage standard, the overall behavior of pay since last October has accorded remarkably well with the standard. On the other hand, the overall behavior of industrial prices raises strong suspicions of significant violations of the price standard. But the identification of violators is apparently a complex and difficult task. All in all, I expect this program to contribute to the deceleration of inflation, as some wage restraint passes into price restraint, and as businesses are made more conscious of the urgent need for their cooperation.

Our historical experience, as well as that of many other countries, suggests that informal, "semivoluntary" policies of wage and price restraint can help significantly over some periods of time. But such programs have been brittle in the face of changes in economic conditions and in business and labor reactions. And so they get phased out and then reshaped and reinstituted. Keeping an incomes policy in the anti-inflationary arena is not easy. P. T. Barnum once noted that keeping a lamb in a cage with a lion requires a large reserve supply of lambs. Similarly, society may need a reserve supply of incomes policies. We will need some program of price-wage restraint for years to come.

Along with a number of other economists, I have been advocating the development of a tax-based incomes policy, either in a reward or penalty form. There is a social interest in wage and price restraint, and it can be pursued better by providing market-type incentives for such restraint through the tax system than by relying on voluntary appeals or rigid mandatory rules. The tax approach allows people to make choices in light of the rewards or penalties provided. The tax seeks to make it worthwhile for most firms and workers to practice the restraint that benefits the entire society. Undoubtedly, such a program adds to the burdens on the tax system, but so do the rules on capital gains, the residential energy credit, and the targeted jobs credit. I presented specific proposals for a wage reward form of tax-based incomes policy to the Senate Banking Committee last spring. I would be delighted to discuss these issues further in response to your questions.

CONCLUSION

I have been advocating a cost-reducing program and tax-based incomes policy as essential parts of an efficient anti-inflationary strategy (in combination with fiscal-monetary restraint) for the past 5 years. I realize that many of these proposals are untried and unproven, and that many pose administrative problems and meet political opposition from major interests groups. So I remain patient and persistent. I am more encouraged that the President saw fit to propose a real wage insurance than I am disappointed by its rejection by the Congress. I am convinced that my proposals are realistic—not "imaginative," as some have labeled them. In fact, there are two popular doctrines that require a lot of imagination. One keeps predicting that inflation will either simmer down naturally or become tolerable to the American people. And the other proclaims that fiscal and

monetary restraint can cure inflation without a deep and prolonged recession. Those "imaginative" strategies have been tried, and they have been proven false. It is time to face the realities of the new disease of chronic inflation and to focus on the prescriptions that are appropriate for curing it.

Representative BOLLING. Next, Mr. Feldstein is president of the National Bureau of Economic Research, and a professor of economics at Harvard University.

Mr. Feldstein.

STATEMENT OF MARTIN FELDSTEIN, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH, AND PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, CAMBRIDGE, MASS.

Mr. FELDSTEIN. Thank you.

I am pleased to have this opportunity to participate in these hearings on stagflation. Although we have a single word for it, stagflation is not one problem but three separate problems: High unemployment, high inflation, and low growth of productivity.

But trying to understand stagflation is like trying to understand a club sandwich. It is important to understand not only the individual parts but also the interactions among them. As I will explain this morning, I believe that our high unemployment rate has contributed to our high rate of inflation and that our high rate of inflation has reduced the rate of productivity growth.

UNEMPLOYMENT

Let me begin with unemployment. For more than a decade now, the unemployment rate has been widely regarded as unsatisfactorily high. I agree with this view. I think that our high unemployment rate represents a substantial waste of productive capacity and, especially for young people, is symptomatic of much more serious problems.¹

There is no economic reason why we in the United States cannot achieve the much lower unemployment rates that have traditionally been enjoyed by other industrial countries.

It is crucial, however, to recognize that our high unemployment rate represents structural and incentive problems and is not an indication of inadequate aggregate demand.

Despite the seemingly high overall unemployment rate, labor markets are actually very tight. The unemployment rate among married men is now at 2.6 percent and has only been lower for 1 year—1973—since 1969.

The latest figures on manufacturing layoffs show as low a layoff rate—0.8 percent—as we have had in the past two decades. The number of employees on payrolls grew more than 4 percent last year. And average hourly earnings rose 8.8 percent, up from 7.7 percent the year earlier despite the substantial growth of new entrants.

A permanent reduction in the unemployment rate cannot be achieved by expansionary macroeconomic policies. Dealing with the unemployment aspect of stagflation will require microeconomic policies that

¹ See M. Feldstein, "The Private and Social Costs of Unemployment," *American Economic Review*, Proceedings, 1978.

focus on specific labor market problems, including the high unemployment rates of young people and the unemployment created by our current unemployment insurance rules.¹

INFLATION

Unfortunately, the high measured rate of unemployment has misled us and has encouraged monetary and fiscal policies that are overly expansionary. The increasing inflation rate over the past decade has been largely the result of the excess demand generated by misguided monetary and fiscal policies.

It is in this sense that our high measured rates of unemployment have contributed directly to our high rates of inflation.

Most economists are now predicting that there will be some slowdown of the economy in 1979 or 1980. There is also a widespread agreement among economists that this slowdown is likely to be both small and short lived, and that it is then likely to be followed by a vigorous expansion of demand.

A very short slowdown of this type will temporarily reduce employment and output while having relatively little effect on inflation. To bring the inflation rate down permanently, we need a more sustained period of economic slack.

The 1973-75 gains in fighting inflation were quickly lost by reflation too soon and too much.

The expectations developed because of the experience of 1973 to 1975 will mean that the inflation response to the current slowdown will be even smaller.

I think it's important not to understate the magnitude of the response then. After all, the inflation rate, the CPI rate in general, was going up at slightly more than 12 percent in 1974, and dropped to less than 5 percent 2 years later.

And for finished goods, the drop was even more dramatic, from more than 18 percent to just slightly more than 3 percent.

So slack in the economy clearly can bring down our rate of inflation. But if we sustain market slack for a few years—enough slack to keep the unemployment rate about 1 percent above the level at which wage and price inflation starts accelerating—we will succeed, I think, in gradually bringing down the rate of inflation.

As the policy is seen to be working, expectations will shift and the inflation rate will come down more rapidly.

This, in turn, will be reinforced by a strengthening dollar which will reduce the cost of imports and the dollar value of potential exports.

It is important to bear in mind that a sustained but temporary period of slack demand will achieve a permanent reduction in inflation.² Failure to accept greater slack in the next few years merely postpones the problem or leaves us committed to a permanently higher rate of inflation.

¹ For specific ways to reduce unemployment, see my earlier study for this committee ("Lowering the Permanent Rate of Unemployment," Joint Economic Committee, 1973) or the summary that appeared as M. Feldstein, "Economics of the New Unemployment," *Public Interest*, 1973.

² Martin Feldstein, "The Welfare Cost of Permanent Inflation and Optimal Short-Run Economic Policy," NBER Working Paper No. 201, forthcoming in the *Journal of Political Economy*.

Moreover, if we do not eliminate the current inflation, every new shock will be regarded as the beginning of further inflation and will merely add to the existing rate of inflation.

The knowledge that we can achieve a permanent reduction in inflation by accepting a temporary period of slack should reinforce the widespread public sentiment that reducing inflation is the No. 1 priority for macroeconomic policy.

Despite this, maintaining slack for a long enough period will require significant political courage.

Fortunately, our unemployment compensation system will eliminate much of the personal hardship that would otherwise accompany cyclical increases in layoffs.

Moreover, as I emphasized a few moments ago, it is possible to proceed with labor market policies that reduce the unemployment rates of young people and other high-unemployment groups at the same time that macroeconomic policies maintain slack in the demand for experienced skilled workers.

LOW PRODUCTIVITY GROWTH

This brings me to the third and final aspect of stagflation: The low rate of productivity growth. This year's Economic Report of the President identified several reasons for the recent slowdown in the growth of productivity. I will limit my remarks on this problem to the way in which our high inflation rate and existing tax rules have combined to reduce productivity.

With our existing tax rules, inflation automatically raises the effective tax rate on corporate income. These high effective tax rates discourage investment and risktaking.

Let me be more specific. In a recent study at the National Bureau of Economic Research,¹ we found that the mismeasurement of depreciation and inventories raised the 1977 tax burden on the income of non-financial corporations by more than \$32 billion. This represents a 50-percent increase in the total tax paid on corporate source income by corporations, their shareholders, and their creditors.

Inflation raised the 1977 effective tax rate on the total real capital income of the nonfinancial corporate sector to 66 percent. Thus, taxes now take two-thirds of the total real income on corporate capital.

This represents a return to the tax level of the mid-1950's before accelerated depreciation and the investment tax credit began reducing the total tax burden.

I really doubt that you or other Members of Congress intended to wipe out those two decades of tax reductions, but that is exactly what inflation has done, because our tax rules are not geared to dealing with an inflationary situation.

Now some lawyers and economists have previously argued that inflation does not increase the effective tax rate on real corporate income because firms deduct nominal interest payments—rather than real interest payments—in calculating taxable profits, or to put that a different way, corporations are not taxed on the fall in the real value of their debts that results from inflation.

¹ Martin Feldstein and Lawrence Summers, "Inflation and the Taxation of Capital Inc. in the Corporate Sector," NBER Working Paper No. 312, 1979.

That argument, I think, is misleading because it focuses specifically on the corporations rather than the total return on capital income in the corporate sector.

I think it's important to go beyond the corporations to their owners, the shareholders, and creditors, those who own their bonds and other debts.

Our calculations show that the extra tax paid by the creditors on the inflated interest payments is as large as the tax savings by corporations and their owners.

In other words, debt is a wash, and can be ignored in evaluating the net impact of inflation on the total tax burden on corporate capital.

The 66-percent tax burden that I mentioned before is the total burden on both debt and equity capital, on total capital, in the corporate sector.

The implication of a 66-percent effective rate of tax on corporate income, I think, is clear. Since the real rate of return on corporate capital before Federal taxes is approximately 12 percent, the net rate of return after tax is only one-third of this or 4 percent.

A net return of 4 percent is just not enough of an incentive to sustain the desirable level of saving and risktaking.

If there were more time, I could continue to discuss the ways in which inflation distorts the taxation of the income of both financial and nonfinancial businesses. The same general conclusion would emerge from all of these analyses: Inflation causes a substantial increase in the rate on the real income from savings. These higher tax burdens discourage both saving and real investment.

The most important direction for tax reform is to eliminate the distorting effects of inflation on the taxation of capital gains and corporate profits. Although we all want to see the inflation rate reduced permanently to the near zero level that our country enjoyed in the early 1960's, I believe that it would be risky and unwise to leave the tax laws unchanged in the hope that such a reduction in the inflation will occur in the near future.

Even if inflation is eventually eliminated or substantially reduced, a tax system based on indexed depreciation would be useful in limiting investors' fears of the adverse effect of potential future inflation.

In short, I believe that eliminating the inflation bias in our tax rules deserves the highest priority in tax reform if we are to reestablish proper incentives for saving and investment.

CONCLUSION

This brings me back to my original statement that stagflation is really three separate problems that require three types of policies. First, specific labor market policies are required to lower the employment rate.

Second, tighter monetary and fiscal policies are required to lower the inflation rate.

And, third, changes in our tax laws to prevent the distorting effects of inflation and to encourage savings and investment are required to reverse the slowdown in the growth of productivity.

Thank you.

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

Next, we welcome Mr. Otto Eckstein, president, Data Resources, Inc.

**STATEMENT OF OTTO ECKSTEIN, PRESIDENT, DATA
RESOURCES, INC., LEXINGTON, MASS.**

Mr. ECKSTEIN. Thank you, Congressman Bolling.

I was delighted to see the Joint Economic Committee has returned to the study of the longrun economic problems of this country. When you and I were engaged in these works 20 years ago we thought we had made some progress, but here we are again. I also note on the list of the committee there are only three members who go back to that earlier study. I think most usefully I could summarize my lengthy prepared statement for you by focusing on the tables and charts that are in it. My basic proposition here is that today's stagflation is not some deep mystery but can readily be explained by theories that have long been at our hand, and that what is new is not so much the fact that there is a fundamental change in structure but rather that we are sitting here at the end of a 15-year process in which we have gradually, inexorably, day by day made the core inflation rate risk worse.

Today the core inflation rate is about 7½ percent, defining the core inflation rate to be that element of the inflation which is the fundamental cost thrust on labor and capital. If you turn to table 1 of my prepared statement, you will see that indeed the United States has lost its membership in the low inflation club. We used to be along with Switzerland and West Germany, a country with 2-percent inflation or less. In the last 3 years our inflation rate has placed us in the middle inflation position, indeed in the last 8 to 10 years.

We have now joined countries such as the Netherlands, Belgium, and Canada as those unable to sustain that low inflation performance. Let me turn to the short run. In my judgment we are not suffering from stagflation today. We are currently in a state of excess demand. The U.S. economy has expanded very rapidly in the last 3 years at an annual average rate of 4.8 percent. Employment is up by 10 million in those 3 years, far above sustainable increases. Unemployment for the prime working groups is at rock bottom levels. The utilization rate of industries is at 89 percent. Vendor performance has deteriorated sharply. Our monitor, which takes a dozen of these measures of excess demand, stands at 62 in March. In industry today there is every evidence of a certain amount of hoarding and of inventory building because of the fear of shortages and also because of the fear of inflation.

As a result of that current condition, it is my belief that nothing stands a chance in reducing our inflation, including the micromeasures which we all know we should undertake, until the excess demand is wiped out of the economy. Indeed, to launch incomes policies, to launch the President's anti-inflation pay and price standards or even to adopt real wage policies in terms of any of these measures, while the total demand is too high, dooms these policies to failure and discredits them. The place to begin is to bring aggregate demand down to a level that the economy can sustain. Now, of course, forecasts say that demand will weaken; that high interest rates and excessive consumer debt burden will bring the economy down in our forecast with a mild recession. The administration forecasts a little softer landing.

But that is absolutely critical. There is a possibility here that demand will just keep on advancing as businesses and households try

to beat the inflation by strong purchases. If that occurs then these micromatters will become even less important because the economy will simply head for a boom-bust path.

Turning now to stagflation, I think we have suffered it three times in the postwar years. We invented it in 1956 to 1958, particularly in 1958 when we had a severe recession and prices kept on rising. At that time there were random events that created that situation. There was a frost in Florida and food prices rose as a result. Also we had some bad luck in timing with the wage settlements of 1956. As a result of that when unemployment went to 7 percent there was no immediate reward in terms of reduced inflation for the recession. Actually that recession did its job. After that recession, we entered 6 years of stable prices. Stagflation disappeared. The word remained. But once aggregate demand retreated to a level the economy could manage, whatever microsins we committed, and I imagine the Congress at that time also raised minimum wages, raised payroll taxes and did all the things it usually does, I'm sure the administration proposed things that made matters worse, despite that there was no inflation. So the matter must lie in something other than new microsins that we have developed later.

The second bout was in 1969-70. At that time we again had a certain amount of bad luck. Recession came. Not much happened. You had already a building up of price expectations. You had a catchup of public employees which drove public sector prices up sharply. You had a catchup of union and nonunion workers. Of course, productivity also happened to go sour at that time, though at that time we didn't recognize how important a phenomenon that was. We got impatient and as a result we put on wage and price controls of August 1971, even though at that time also a little less demand might well have done more for us.

If we now try to convert all the random events that somehow all seem to work out badly for us into some kind of theory and take the mystery out of this process, and I think it is important to take the mystery out because what we are really doing here by doing nothing but wringing our hands about the situation and crying for new paradigms and new solutions, we are really saying to the American people that we don't understand it. That something fundamental has gone wrong with the capitalist system. I don't believe there is a shred of evidence that that is the case. I think as you will now see and I hope I carry along on this analysis, that there is no mystery to it.

I think to make sense of it you first have to divide the stagflation or overall economic inflation into three elements. If you turn to chart 2 and subsequent charts in my prepared statement you will see that. The first is the core rate of inflation. In the core rate of inflation, it principally grows out of the longrun trend in unit labor costs. Those represent two-thirds of all costs in the economy. Of course, unit labor costs are themselves principally the result of fundamental wage movements and the extent to which productivity offsets them. We learn from our econometrics, here I think the proof is pretty strong, that wage claims are based on a long previous experience with inflation. Wages do not respond to current inflation. We see that even now.

After all, even the Teamsters with all the economic clout they possess, with all the flexibility the Government musters on its pay standards, the Teamsters did not sign for a real wage increase. If you believe a current rate of inflation was permanent, the Teamsters were taken and signed for a small real wage cut because they got less than the current inflation rate. Of course, others would be taking even larger cuts. So wage claims do not reflect current inflation but rather look backwards. Productivity if you turn to chart 1, you see it has slowed down. Of course we all know the reasons for that, including diminished capital formation and diversion of some capital to pollution controls and also a change in the mix of economic and various other factors.

In any event, the hard core inflation rate based on wages and productivity shows a steady acceleration since 1966. We did gain some relief in the period of slack demand. The core inflation rate which was built up in the mid-1950's, the inflation rate we studied back then which got up to 2½ percent went away to zero before this whole new set of events unloosed demand inflation, shock inflation, all interacting to gradually build up the core.

When we turn to the shock rate, and here for our formal analysis all we have done is analyzed food and energy and those more immediately measurable Government components including social security taxes, minimum wages, when we look at the composite shock rate, we see it added a half percentage point until 1972. Then it got much worse over the food runup and energy runup of OPEC. It then again faded away. We are now in a second round which is not fully reflected on the chart because it stops at the end of 1978.

Of course on chart 4 you see just the energy and food price shock rate, and you see that, first food made things much worse in 1972-73 over the Russian wheat deal, and world crops, then, of course, you had OPEC a year later.

When we turn to the demand component of inflation, what we see is, let me first explain how we did that. We asked ourselves, what happens after you take out the core rate and shock rate and erratic factor? What's left to explain? Then we ran a statistical correlation between remaining inflation and measures of aggregate demand, in this case the vendor performance, and the GNP gap of the old-fashioned type.

We then derive an equation. You will be able to convert and evaluate that equation with the inputs, as shown in chart 5 of my prepared statement. What you see there is that we have got a lot of demand inflation in 1966 to 1970 during the Vietnam war when unemployment was down to less than 3½ percent. It didn't become visible because there are lags on demand inflation and because it gradually only works its way into the core rate. Ultimately it winds up in the core rate. That is one major reason why we have the trouble of the 1970's.

Now, we had another bout of demand inflation in 1973 when it was completely miserable because of price controls. But demand again got too strong and added to the core rate. We then had the drastic recession which did reduce the core rate somewhat. If you go back to the plot of the core rate, you see a period of drop of the core rate. It did improve for a year or two. Of course, the weak demand and of course the fact that food prices did fall in 1976 helped to bring the core down a bit.

Now we are in another round of demand inflation. Demand is too high. It is not yet visible on chart 5 because the effect is mainly ahead of us. This chart stops at the end of 1978. We are going to add about half a point a year to the inflation rate of 1979-80 because of the excess demand inflation into which we have stumbled through overreaction to the last recession, and that is just adding to the situation.

Well, what is the prospect on the inflation if you take this composition of inflation into its three main pieces? Core, demand, and shock. On the core rate, because it moves so slowly, it cannot get much better and it cannot get much worse. The maximum change you can see in it is about 1 percent a year. I don't think we are going to see the maximum in either direction. The chances are the core rate will get a little worse before it gets better so you may get maybe half a point out of that.

The demand inflation is going to add at least half a point to the inflation for the next couple of years.

The shock element, here I'm speaking mainly of energy, is going to add at least a percentage point to the inflation rate. The deregulation of oil and gas, which I believe was desperately necessary as a matter of restoring our national independence vis-a-vis OPEC, as well as the OPEC increases themselves, are simply going to add a point to the inflation rate. In addition, we are going to pay a little price for the runup of food prices which is now, I believe, mainly behind us.

So, when you get all through with it you look at an inflation prospect of around 9 percent. Let me turn to the real focus of the hearing which is, can the core inflation rate be improved?

Again let me reemphasize, no way on Earth can it be improved until the economy is moved out of the excess demand territory. If the administration is very lucky and very skillful, it will be a soft landing. But one way or another the real growth rate of this economy must be kept below 3 percent for the next 3 years. If it were held below 2½ percent we would be a little safer. Now, that is on the demand side.

On the shocks, obviously if the Congress and administration stop making things worse that would be a blessing. If OPEC behaved itself, that would be a blessing. But those matters, I believe, we economists have very little ability to influence. So we then of course quickly turn to the easy part of improving the core rate. That is to boost productivity. It's easier because that usually winds up with a conclusion. What we have to do is cut business taxes and I think that is a good idea. Although, I would hope we would find a program a little more balanced than that. The main issue on the productivity side—there really are several. First, can we boost the rate of capital formation? The rate of capital formation used to be around 4 percent. Last year it was 2½ percent. We ought to get it back to a higher rate. The rate of R. & D. advance measured by a stock of research and development used to be 4 to 5 percent a year. Now it's down to 1½ percent.

One way or another we will have to accelerate the rate of development of R. & D. Let me emphasize, none of these measures stand a ghost of a chance until we bring aggregate demand back to a level that will work to reduce the core rate of inflation rather than to make it worse.

Thank you.

Representative BOLLING. Thank you, Mr. Eckstein.
[The prepared statement of Mr. Eckstein follows:]

PREPARED STATEMENT OF OTTO ECKSTEIN

*What Is Stagflation Really?*¹

SUMMARY

(1) The core inflation rate has worsened to 7½ percent. To understand the inflation in the modern economy, it is necessary to disentangle the core rate, the shock rate and the demand rate;

(2) The core rate is the product of past demand levels and shocks, which have created the price expectations that underlie the trends of unit costs of labor and capital;

(3) The shock rate is the contribution of inflation created by exogenous events like world oil and food prices, changes in tax rates and government regulatory and other policies;

(4) The demand rate is the contribution to inflation from the level of aggregate demand;

(5) Stagflation, the combination of high inflation and weak demand, occurs whenever the core rate plus the shock rate exceed the demand rate;

(6) Stagflation has occurred at least three times in the postwar period;

(7) The U.S. economy is not suffering just from stagflation at this time: Growth has been very rapid for three years and there is demand inflation along with the shocks and the high core rate;

(8) The immediate goal of policy should be to slow down the economy with only a limited business cycle disturbance;

(9) The solution to the stagflation problem is (1) more cautious demand management policies to get rid of the demand inflation; (2) increased capital formation and R&D to restore productivity performance and slow the core rate; (3) an energy policy to limit OPEC's power to create oil shocks; (4) greater care in the design of government policies to limit inflationary repercussions; (5) measures to make the economy more competitive.

Stagflation has become a rallying cry for dissatisfaction with the performance of the American economy and of its economists. People wish to believe that there is some deep mystery about double-digit inflation. I do not believe that stagflation escapes our understanding. The ability to combine high employment and stable prices is rare for any society. The few who have attained it have done so by combining the national determination to avoid inflation with strong government policies to promote industrial development and success in export markets. For the rest of us, the middling and high-inflation countries, strong economic policies have been impossible for reasons of political structure, the pursuit of other national purposes or weakness of leadership. We will suffer from stagflation until we put stronger economic policies at the top of our priority lists, and even then it will take years to overcome the underlying problems.

TABLE 1.—INFLATION IN MAJOR INDUSTRIALIZED COUNTRIES
[Consumer Price Index, compound annual percent change]

	1950-60	1960-70	1970-75	1975-78
High inflation:¹				
United Kingdom.....	4.0	4.1	13.0	13.5
Italy.....	3.0	3.9	11.3	15.7
Japan.....	4.1	5.8	11.5	7.0
France.....	5.8	4.0	8.8	9.5
Intermediate:				
Belgium.....		3.0	8.4	6.9
Netherlands.....		4.0	8.6	6.4
Canada.....	2.2	2.7	7.3	8.1
United States.....	2.1	2.8	6.8	6.6
Low inflation:				
Switzerland.....	1.4	3.3	7.7	1.3
West Germany.....	1.9	2.6	6.1	3.7

¹ Countries ranked by 1970-78 inflation.

¹ This paper was coauthored by Paul M. Warburg, professor of economics, Harvard University.

I congratulate this committee for undertaking this study and continuing the JEC tradition for balancing its short-run focus on current conditions and policies with a surging examination of the underlying causes of our economic problems.

SHORT-RUN MATTERS

Today, we are suffering not just from stagflation. That would imply that our resources are not fully utilized and that our growth is slow. But in the last 3 years, the U.S. economy has expanded at an annual rate of 4.8 percent. Employment is up by 10 million, or 3.7 percent a year, far above sustainable long-term increases. Of course, these were years of recovery from the worst of the post-war recessions. But during the last nine months, the economy has clearly entered the area of overfull resource utilization. Unemployment for the prime working groups is at figures usually found in times of high prosperity. The utilization rate of the primary processing industries has been 89 percent, a figure always associated with demand inflation. Vendor performance, an important sensitive measure of delivery conditions in industrial markets, has deteriorated sharply. The DRI Boom Monitor stands at 62 in March, close to a boom reading. The opening months of this year have seen a scramble for inventories and increasing shortages and bottlenecks. The price performance that has been created by these boom conditions shows an acceleration of industrial prices, excluding energy, from 6 percent 3 years ago to 9.3 percent over the last 9 months. And this despite the introduction of the President's anti-inflation program.

One new element of stagflation is the slowdown of productivity. As Chart 1 shows, the 5-year productivity trend is now at its low point, up at a mere 0.8 percent rate, 1973-78. Whatever the underlying reasons for this productivity slowdown, it serves to explain the extraordinary employment gains and raises some of the deepest questions about current economic performance.

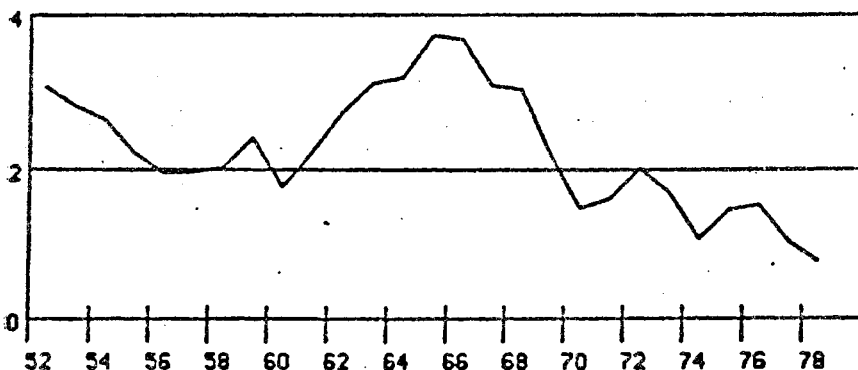


CHART 1.—The 5-Year Productivity Trend (5-Year Average Percent Change)

No anti-inflation policy stands a chance of success until the level of aggregate demand is brought down to sustainable levels. The Federal government affects aggregate demand through monetary and fiscal policies. Elsewhere,^{1a} I have argued that a balanced budget for 1981 would be a sound strategy under the present circumstance. This budget balance should be attained if the economy is operating in the neighborhood of 6 percent unemployment, and assuming a rate of inflation in the consumer price index of 8 percent a year between the first quarter of 1979 and the third quarter of 1981. If unemployment should prove higher because of recession, revenues will clearly fall short and the budget will go into automatic deficit. If the inflation should prove worse, the budget will go into automatic surplus because of the workings of the personal income tax. To achieve budget balance, the Congress will have to forego significant tax reduc-

^{1a} "Can We Break the Inflation Spiral?" Otto Eckstein, testimony presented to the Subcommittee on Economic Stabilization of the Senate Banking Committee, Mar. 23, 1979.

tions for 1980 and 1981, unless it can find new ways to dramatically lower spending. The increase of interest rates made by the Federal Reserve this month will also be helpful in puncturing the current bubble.

Once the economy has retreated from its current excess demand, sensitive material and finished goods prices will fall and will give some temporary relief from double-digit inflation. The telescoping of OPEC increases into the period of Iranian shortfalls also distorts the price outlook by creating the prospect of lesser increases later on. Consequently, an improvement in the inflation rate in the summer is a realistic prospect. But no one expects a brief and mild recession to solve the inflation problem. The "core" inflation rate, which deteriorated from about 6 percent 4 years ago to 7½ percent today, goes up a lot more easily than it comes down. It therefore is appropriate to examine the stagflation phenomenon in a broader context in order to assess how we might make more progress in the longer run.

STAGFLATION: A HISTORIC OVERVIEW

Since World War II, the U.S. economy has experienced three bouts of stagflation. Perhaps something can be learned from a sketchy historical review.

Stagflation first became an intellectual concern in 1956-58. Inflation, which had briefly disappeared during the period of falling world raw material prices after Korea reached 3.4 percent in 1957, and stubbornly refused to disappear during the severe 1958 recession. I believe the term "stagflation" was coined at that time, and the fear of inflation led to the overly restrictive fiscal policies of 1960 which brought about the briefest and also the only incomplete business cycle recovery of the postwar era.

The stagflation of that period can easily be explained by the peculiar circumstance of that cycle. The automobile boom of 1955 was quickly followed by a capital goods boom, to create a sectoral demand inflation. After early 1956, the economy showed very little growth of markets. As a result, productivity stagnated. Unfortunately, the automobile and steel industries signed very costly 3-year wage agreements based on the temporary cyclical profits of 1955-56, which then had some secondary effects on the wage structure generally and produced an unfortunate unit labor cost trend which continued to convert itself into higher industrial prices even while the economy was weakening.

The discovery of "stagflation" however, owes itself to an even flukier development. While the economy was collapsing in 1958, frosts hurt the fruit and vegetable supply, producing a surge in the consumer price index. Thus, in the first half of 1958, price performance, particularly as measured by the CPI, continued at what was then considered inflationary levels raising the question whether we had lost the ability to manage our affairs in a noninflationary way. Once the weather improved and food prices fell, the inflation disappeared. In the years 1958 to 1964, the consumer price index rose by 1.2 percent per year, an increase which can easily be accounted for by changes in product quality. The wholesale price index did not rise at all for 6 years after the "stagflation" of 1956 to 1958.

The next bout of "stagflation" occurred in 1969-71. This time, the inflation developed because of the Vietnam War and the inadequate fiscal and monetary policies. Unemployment below 4 percent from 1966 to 1969 created a classic demand inflation, which was held down only by good price expectations created by the previous history of stable prices, and by President Johnson's active guide-post policies. The stagflation began with the 1969-70 recession which failed to bring the expected relief from the inflation. Having tried a gradualism-cum-recession policy without success, the government turned to mandatory price and wage controls in August 1971.

The stagflation of that period also had institutional and historical shocks in it which disengaged the timing of price behavior from the business cycle to produce the perturbing combination of rising unemployment and rising prices. At that time, the trouble lay in a bulge in the implicit price index for the public sector which was driven up by catch-up pay increases for government workers, a bulge in food prices mainly related to the weather, a surge in homeownership prices caused by high interest rates and low housing production, and weak productivity performance. With the economy flattening out, output per manhour showed virtually no change in 1969 and 1970, converting 6.6 percent increases in total compensation per man-hour into unit labor cost increases of the same magnitude. Wages did not slow down because inflation expectations were deteriorating.

While the higher unemployment of 1970 surely had some moderating effect on wages in the unorganized sector, the worsening inflation experience outweighed this effect and kept wage increases unchanged.

The third bout of stagflation is the period during and immediately after the 1975 recession. Inflation never disappeared despite unemployment approaching 9 percent and industrial utilization rates in the low 1970's. As the economy grew rapidly for four years to close the gap of unutilized resources, inflation went from 5 percent to the current double digits. The oil shock was still working its way through the system and old contracts and poor price expectations kept wages advancing at inflationary rates.

A GENERAL MECHANISM FOR STAGFLATION?

Is it possible to identify a general theory of stagflation? The historical account makes clear that each episode contained various "chancy" elements. Sometimes an inflationary shock struck just after the cyclical productivity upswing was complete, so that food or energy prices combined with rising unit labor costs to produce inflation in a weakening economy. In another case, the stagflation of 1975-77, the previous history of inflation which had created poor expectations was the explanation; the energy price increases in those years were offset by exceptionally favorable behavior of food and other material prices. Thus, in a sense, the theory of stagflation cannot stand alone, but is simply the application of a general view of the economy as it operates in some particular circumstances which happen to produce the stagflation result. The question is not so much why there is stagflation, but why the economy has a permanent inflationary bias.

A broad range of economists would agree on the list of factors which imparts the inflation pressure into our economic performance, though they would surely disagree on the relative emphasis. First, in the short-run, the inflation rate does respond to the level of aggregate demand, and does so in a quite nonlinear fashion. In particular, when excess demand develops, even if it is only for some sectors of the economy, inflation gets much worse. But even the pure demand effects take as much as a year before the demand pressure is fully converted into price pressure.

Second, it is impossible to run the economy in the excess demand territory in the long-run. The public's inflation expectations gradually adjust to the correct levels. It therefore takes accelerating inflation to maintain a constant level of real activity. Since neither the financial system nor the public can live with accelerating prices, a recession is the inevitable outcome. I think this is the true and correct meaning of the common assertion that there is no Phillips curve in the long-run, that the unemployment-inflation tradeoffs are temporary.

Third, inflation expectations are formed rather gradually. The public partially discounts a temporary extreme condition in its consumer buying actions or in its willingness to buy fixed-income securities. But over a period of several years, inflation expectations are adjusted fully to reflect the true reality.

As a result, expectations are a major component of the core inflation rate. If expectations can be changed only very slowly, then wage and unit labor cost trends can change only very slowly, largely limiting the effects of recession to sensitive prices and wages, the improvement of efficiency, with only a small benefit to the core rate.

Fourth, shocks vary the inflation rate in the short-run, and are, in part, converted into long-term inflation as well. Whether a disturbance originates in a run-up of food prices which may be reversed later on, in higher minimum wages and payroll taxes, or in OPEC prices, long-term inflation expectations are affected, and a portion of the temporary inflation enter into wages, unit labor costs, capital costs and therefore the "core" inflation rate.

Fifth, the government is a major source of inflation shocks. There is a bias in a pluralistic democracy toward inflation-creating actions. The political process finds it very difficult to limit cost increases, as can be seen in the current troubles over the hospital containment program and truck deregulation, but finds it very easy to extend additional protection to various producer groups both on the business and labor sides. Special pleas are always very reasonable, and the lobbyists know their profession.

Sixth, there are major elements of monopoly in both product and labor markets which slow down the conversion of demand weakness into lower prices. Business prefers price discipline and the resultant shared quantity variations to competitive price cutting which would let recession produce a higher anti-inflation benefit.

Seventh, in a world which contains OPEC and the strong industrial economies of West Germany and Japan, any domestic inflationary bias is ultimately converted into a weakening exchange rate which fans the domestic inflation further. If the authorities delay the drop in the exchange rate through market intervention, they hold back excess demand a bit by inviting a flood of imports, but they do so at the expense of the productivity performance of domestic manufacturing industries and of a more dramatic exchange rate movement later on.

These general ideas can be converted into a theory of stagflation. The actual inflation rate in any period has three components: (1) the core inflation rate based on unit labor and capital cost trends, (2) the shock inflation rate based on nonsystematic actions of the government and the outside world, (3) and the demand inflation rate, based on the aggregate level and composition of demand. It is possible to identify these three components of inflation from standard economic variables included in the Data Resources Model of the U.S. Economy. Chart 3 plots the results of a preliminary analysis of the three components. DRI will extend this work in the coming months.

It can be seen that the core inflation rate gradually became worse from the mid-1960s until the period of price controls in 1971, and then showed some small improvement. As the price controls dissolved and the enormous OPEC increase struck, the core inflation rate embodied a considerable fraction of these "temporary" increases, worsening the core rate to 6 percent by 1975. The recession and the sharp decline of food prices in 1976 brought a pause in the rise of the core rate. However, the strong real growth of the recovery, and ultimately the excess demand of 1978-1979, gradually were converted into an acceleration of the core rate which today is estimated near 7.5 percent.

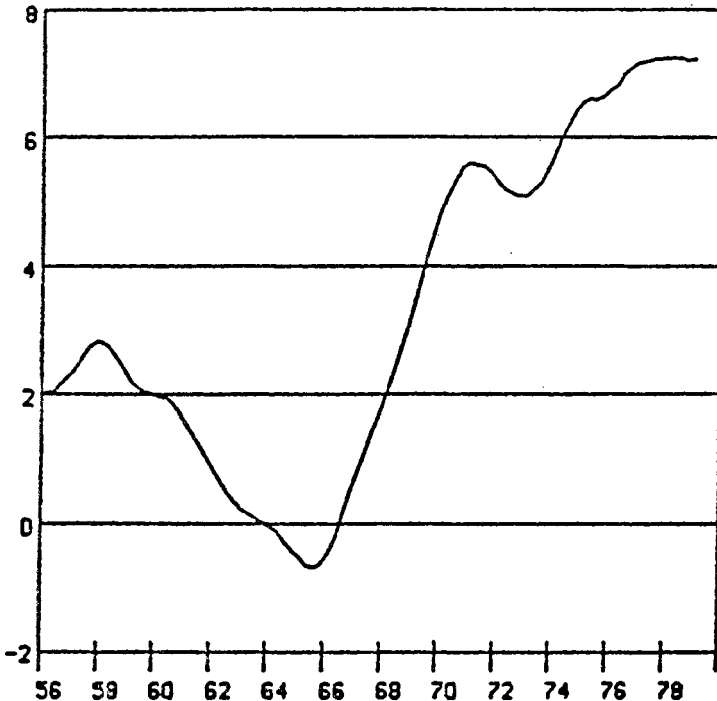


CHART 2.—The Core Rate of Inflation (Percent)

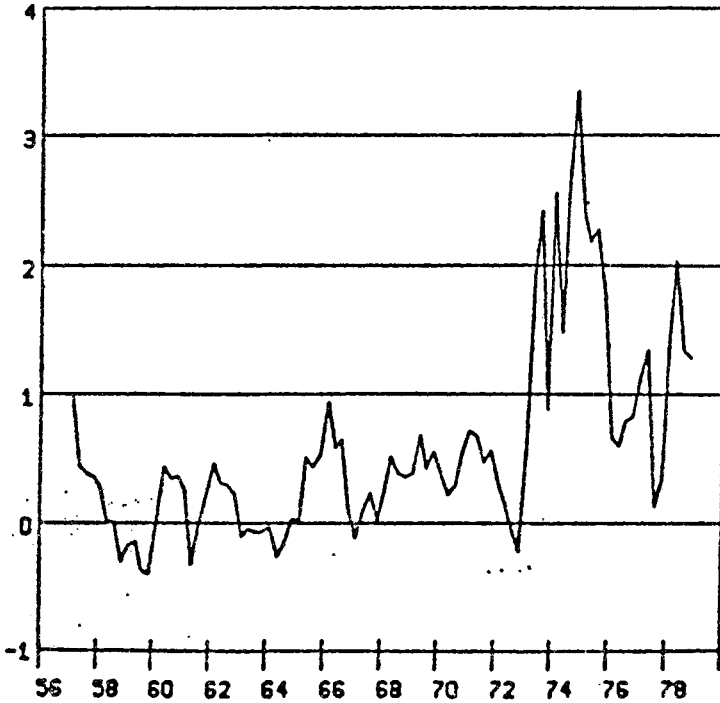


CHART 3.—The Shock Component of Inflation (Percent)

The shock rate of inflation has been particularly troublesome in recent years. Agricultural prices have shown erratic movement throughout the postwar period, but outside of the 1972-73 crop and policy disasters, the declines were as great as the increases. We appear to be in the midst of another, though smaller, such policy episode. On the energy side, the stability of energy prices of the 1960's actually served as a retarder of inflation, and helped the U.S. economy to get through the Vietnam War with its excess demands without a really sharp breakout of the price level. But the constancy of energy prices ultimately had to come to an end, and when it did, shock inflation at least temporarily became the main problem. Chart 4 shows how the huge bulge of 1974 added to the overall inflation rate. We are now in the midst of a second round of massive OPEC boosts which is creating a new shock inflation, whose waves will gradually reach the core inflation rate, several elements in shock inflation have not yet been modeled.

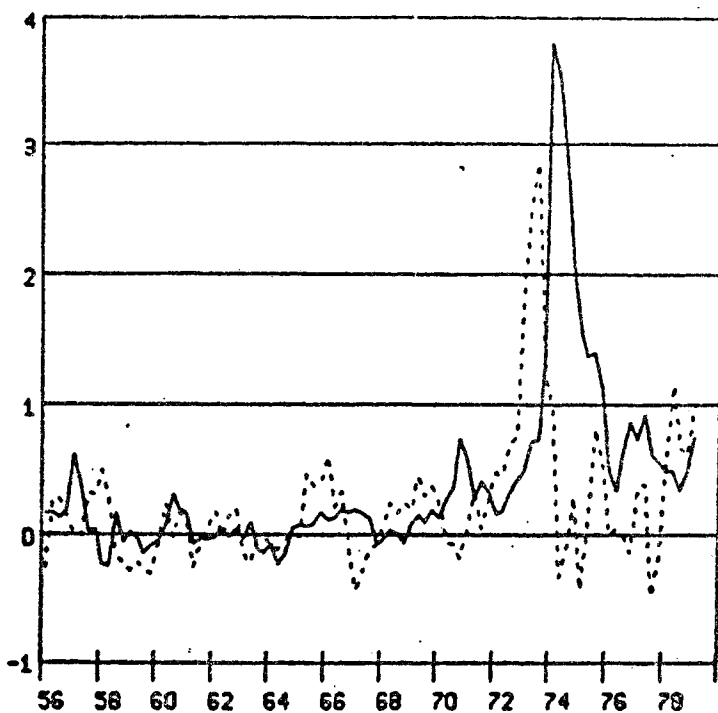


CHART 4.—The Contribution of Energy and Food Price Shocks
(Energy—Line, Food—Dot, Percent)

The government policy element in shock inflation was confined to the effects of changes in the Social Security tax rate and the minimum wage, as calculated through simulation of the DRI model. The movements of world material prices, which are, of course, dominated by the worldwide business cycle, are not treated separately here, although they were of importance in the years 1972-74. Nor is separate allowance made for the movements of the dollar in foreign exchange markets, which added to inflation in 1978 particularly, but which was, itself, a result of the previous U.S. inflation performance.

The demand component of inflation is calculated out of the inflation rate that remains after the shock and core components are accounted for. Specifically, demand inflation was defined as that part of the residual which could be explained, through regression analysis, by two measures of demand: vendor performance, and the GNP gap. Chart 5 shows the estimates derived from the regression, 1957-1978, smoothed over three quarters. It can be seen that demand had a drastic impact after the mid-1960's, and once more in 1973-74.

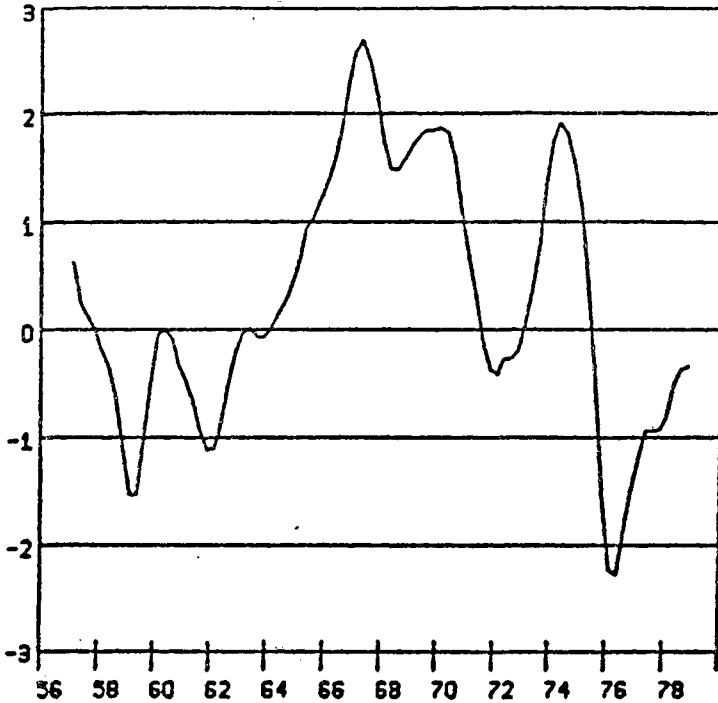


CHART 5.—The Demand Component of Inflation (Percent)
Last Point Plotted, 1978:4

The sum of three components of the inflation rate is shown in Chart 6. The core rate has gotten worse since its near-zero values of the early 1960's. Price controls and the 1975 recession brought short-lived small improvements. The core rate was flat near $7\frac{1}{2}$ percent until the current round of troubles. Shocks and demand were also inflationary, though the effects were concentrated in a few periods. Unfortunately, the temporary effects gradually drove up the core rate.

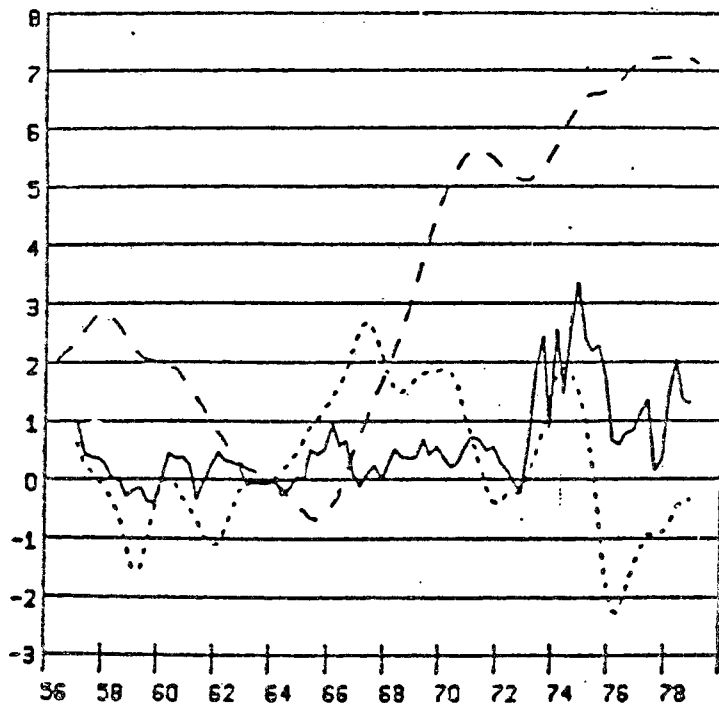


CHART 6.—The Three Components of Inflation: Core (Dash), Shock (Line), and Demand (Dot)

Chart 7 compares the sum of the three estimated components of inflation with the actual inflation record. Much is explained but there remain some residuals. The inclusion of capital costs, world material costs, the exchange rate and more items of government policy should complete the analysis.

The core inflation rate can be decomposed further into its principal sources. Chart 8 shows the movements of long-term unit labor costs as they are created by changes in the productivity trend and long-term rate of wage increase.

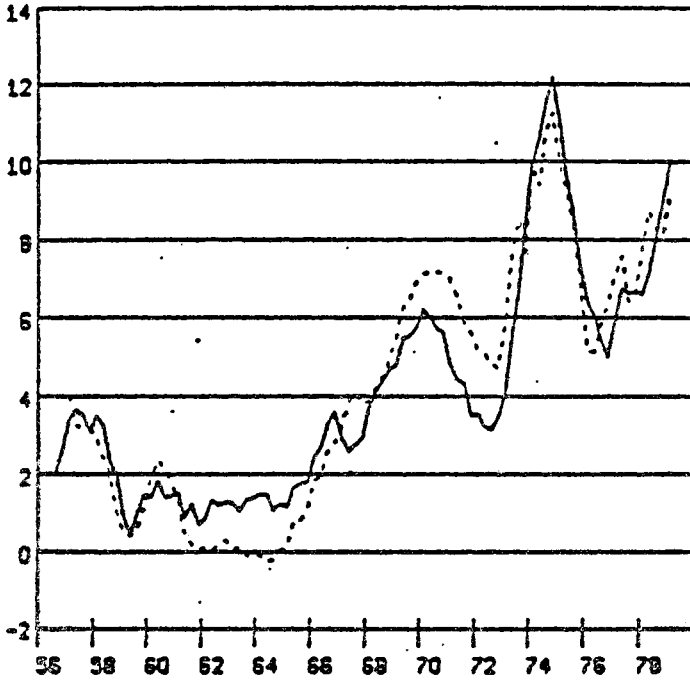


CHART 7.—Year-Over-Year Changes in Consumer Price Index Compared to Sum of Core, Demand and Shock Inflation Components

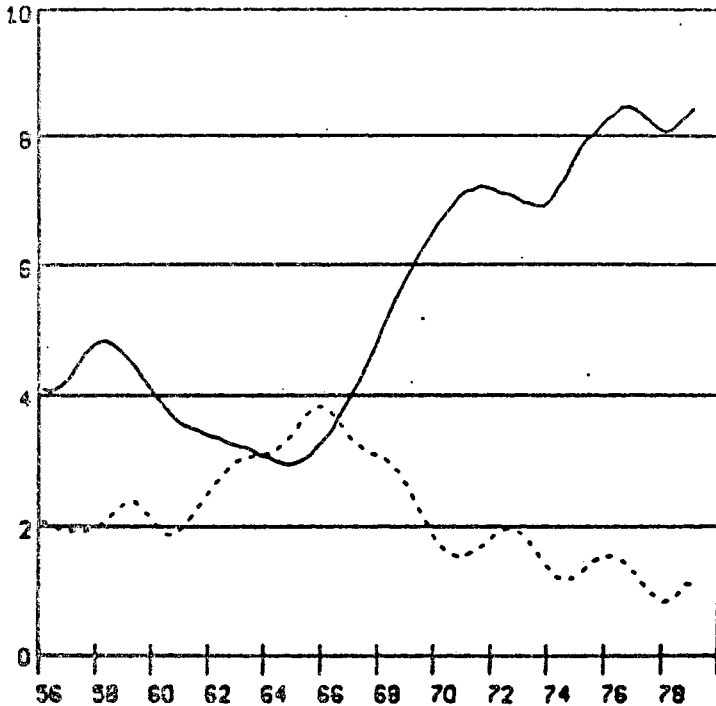


CHART 8.—The Composition of the Core Rate Wage Trend (Line), Productivity Trend (Dot)

INFLATION PROSPECTS

Seen in the light of this analysis, the uncertainty of inflation prospects can readily be understood. The core inflation rate can be identified within a reasonably narrow range because it moves so slowly. Since it ultimately is the product of short-run influences, it cannot be known precisely, but it is evident that it cannot improve more than a point over the next two years even with a recession or price controls. Nor is it likely to get worse by more than a point.

The "shock" inflation rate also has a number of known elements in it. OPEC prices are up, and domestic energy prices are being deregulated, adding close to a full percent to the inflation rate over the next three years. Food prices are much less predictable, but should ease after beef prices reach their new equilibrium after a 15 percent drop of supply. The government seems to have become a little more careful, though payroll taxes and minimum wages keep going up.

It is demand inflation which is most immediately under the effective control of the government. The demand component is just beginning to contribute positively to the overall inflation rate. This is due to the typical lagged response of prices to aggregate demand built into the estimates. Since the economy has just recently moved near boom levels, the full effects of this burst in demand will be felt for the rest of this year. The DRI forecast calls for a mild recession beginning in the second half of this year, and a return to reasonably normal growth for 1980-1981. Under this scenario, although demand pressures are likely to add 0.5 percentage points to the inflation rate over the next few quarters, the recession will work in the opposite direction in the 1981 price performance. If the recession does not occur, i.e., if the current inflation-beating purchases of households and businesses keep the economy moving above its potential trend for another year and a half, the demand factor will continue to add 0.5 percentage points to the inflation rate. Conversely, if the recession should prove to be a lot more severe than DRI forecasts, demand inflation improvement would be bigger.

CAN THE "CORE" INFLATION RATE BE IMPROVED?

The government can do little to change the mechanism by which actual price experience is converted into inflation expectations. The public reacts to actual events and learns from experience, and discounts the statements of public officials. The core inflation rate can only be improved by reducing shocks, keeping demand moderate and by working on the productivity factor.

A recent DRI analysis by Ms. Robin Siegel² decomposes the sources of the slowdown in labor productivity (Table 2). It can be seen that the drop in productivity performance was 1.8 percentage points, comparing 1955-65 with 1973-78. Cyclical factors account for 0.6 percentage points, energy prices 0.7 points, and diminished capital formation 0.6 points. This analysis points the way toward the solution of the productivity element in the worsening core inflation rate.

Reduced U.S. dependence on imported oil will slow the rise of world energy prices and will let a more normal productivity advance be restored. Higher capital formation will directly add to output and productivity and slow the core rate. Measures that promote these goals are the principal means for creating a reversal of the core rate from the supply side.

TABLE 2.—COMPOSITION OF PRODUCTIVITY GROWTH¹

	[Average annual percent change]		
	1973-78	1965-73	1955-65
Time trend.....	2.4	2.4	2.4
Economic utilization.....	-4	.1	0
Labor market tightness.....	.2	-1	0
Output surprise.....	-2	.2	.2
Energy prices.....	-7	0	0
Pollution abatement expenditures.....	0	-5	0
Output mix.....	0	.1	0
Demographic composition of work force.....	-4	-6	-6
Capital-labor ratio.....	0	.7	.6
Tax effect.....	-1	-3	-1
Nonfarm productivity growth.....	.8	2.0	2.6

¹ "Why Has Productivity Slowed Down?" March DRI Review.

Note: Columns may not sum because of residual in equation.

² "Why Has Productivity Slowed Down?" by Robin Siegel, March DRI Review, pp. 1.59-1.65.

Representative BOLLING. Our next witness is Mr. Jerome Hardy, the president of the Dreyfus Corp.

STATEMENT OF JEROME HARDY, PRESIDENT, DREYFUS CORP., NEW YORK, N.Y.

Mr. HARDY. Thank you, Congressman Bolling. I am delighted that you identified me as a publisher rather than an economist. It may explain the mystery of some of the things I am going to say or why I am here.

Your invitation to appear here this morning is, like all compliments, hugely gratifying and mildly mystifying. I am neither a planner nor an economist.

My remarks will be neither learned nor technical.

I have, however, spent a number of years reading and talking and thinking about the nature, the pace, and the effects of change, and simultaneously figuring out what motivates people to behave in certain ways in spending or hanging on to their money.

Since your schedule for the next 10 days will involve your hearing from, I think, seven more of the country's most distinguished economists, I will limit myself to a few observations about the nature of change and how I believe it should affect your study. I will also urge you to consider some radical alterations in the composition of our society that are now rapidly developing and may well become dominant in fixing economic policy. I hope I will be helpful; I promise not to take more than 10 minutes.

Resolution 248, which established this study, raises a number of questions—among them, whether or not “numerous profound changes in the United States and world economies have rendered ineffective traditional remedies—for solving unemployment problems.”

The answer to that question is probably going to be “yes,” but in the course of getting to the answer, I suspect that several other conclusions will be reached.

One will, I think, be that changes in the U.S. and world economies have been companion to changes now occurring in attitudes, goals, and even in deep beliefs within our society and others.

You will be handed a great many papers and studies, more than you can read. One I hope you will read carefully is called “Prospects for the Future: Metamorphosis Through Metanoia,” by Willis W. Harman. Mr. Harman is a professor of engineering-economic systems at Stanford University. The metamorphosis which he believes is now upon us is nothing less than a basic change from the rational, secular, scientific, and technological period which began 8 to 10 centuries ago. The metanoia, or total change in the underlying beliefs which permit the common consent every social paradigm needs has now begun, he believes, and may proceed with startling speed. Mr. Harman's paper will not be the most important document you read—unless he's right. If he is, and he may be, your entire assignment will be vastly changed.

Meanwhile, at the heart of our problems of unemployment, inflation and rigid institutions with their cynical stake in perpetual continuity, there is a long history of accepting as “good” that information which is useful and productive in a scientific or technological sense, and thus

in an economic sense. And so we have focused on curing disease, not on holistic health, on economic productivity as if it were somehow indifferently related to the passions of the worker.

When a future reporter writes the story of our days, he may note that by 1979 we had reached the place where we referred to the goal and value of a project as "the bottom line," a phrase that comes to us not from a philosopher, but from the practice of accounting. Amongst those familiar with money, it is called, affectionately, the old bottom line.

We know that questions of personal growth and fulfillment, the desire of people to have meaning in their lives, is important. But do we yet know that these yearnings are important to economics and economic planning?

I believe that we are near a change that will no longer permit us to base our economic planning on the assumption that people work almost entirely to acquire things and that their appetite for material goods and services is insatiable.

Science, people now perceive, will not bring heaven to earth. Applied science, in fact, has been getting some very bad press on the subjects of clean air, clear water, the greed that mars land use, and the contrary nature of nuclear reactors.

I urge you, too, to pay close attention to the rising volume of talk about "quality of life." Such talk is not just California psychobabble, and it does not refer just to goods and services. I believe it also refers to work that is useful, meaningful and even enjoyable.

People do spend a large part of their lives working and at last they know work should be a decent part of living. That's what happens in an educated democracy.

I hope you can weave into this study a serious and continuing attempt to find out why people work—beyond the cruel assumption that they have to. We should try to find out what is happening to the social organization that will change our perception of good work, useful work, interesting and rewarding work. No economic plan will succeed that fails to understand why people work, why they will want to work, what they will want to do and—most of all—how and why all that is changing so fast.

Now to my second point of two.

There is another change, much talked about, subject to pretty accurate projection in its numerical aspects, but little understood yet in its revolutionary social, political and therefore economic aspects.

The accelerating growth in that part of our population that is at or near what John McCloy calls sixty-five: the age of presumptive incompetence is unique in all history.

In a few years people 65 and over will be dominant in the voting population. They are the generation that survived the Great Depression, won World War II, and built the technological society that produced the age of affluence. They have endured revolutionary behavior in their own children, and contempt from former allies and enemies alike. Up to now they have been bemused but not troublesome.

Now I suggest a giant meltdown is forming in the threescore-year-old group which is going to change the economy, if not the country, in ways no social containment structure can hold.

For example:

Thirteen percent inflation for people living on social security is a betrayal of 40 years of promises.

For example, our retirement policies are transported intact from a past that no longer exists. Most of the working population now is dependent on some institution to work effectively—a company, a school, a government body, a hospital, a big store. Arbitrary, forced retirement at any age leaves competent, energetic people without the institutional connection which enabled them to be effective.

Abrupt retirement from an institution-related job stigmatizes a person as worthless. That is bad enough. But I doubt that any economy can stand the weight of 30 to 35 percent of its population living longer and longer without contributing to the GNP. Advancing compulsory retirement to 70 for those people whose retirement pay is under \$27,000 is not a good solution. It continues compulsory retirement in the old tradition, although at age 70, but says achievers and successful contributors ought to be kicked out at 65. Exempt, of course, are lawyers, doctors, writers, artists and successful politicians. But that leaves a lot of us victim to a foolish custom.

For example, there are strange and inexplicable aspects in our public policy toward the old. If one is retired and has only social security, he or she must either work or live in poverty. But, as you know, if he or she earns enough to relieve the poverty, the law reinstates it by cutting off social security. That's weird.

Last, the concept of vesting retirement benefits after 10 or 15 years celebrates the institution over the individual. It is interesting that our educational system, where a high proportion of bright people work, has had portability of pension benefits for decades.

And so I submit, in all seriousness, that the growing older population will soon feel so alienated and betrayed that it will be likely to respond to the kind of demagog who can focus fear and anger behind a few oversimple promises. Proposition 13 was a warning. It would be a good idea now to reread the story of the Townsend Plan in the 1930's. The plan was advanced as a way to cure the Depression. It promised every person over 65 a check for \$200 a month, then a comfortable living wage.

The recipient had only to prove that he or she had spent the \$200 to get the next check.

At that time when there were only 100 million people in the United States, there were 2.5 million dues-paying members of Townsend Clubs.

By the way, when the Townsend Plan was turned down in the Congress, four-fifths of the House was absent, perhaps through some discomfort at turning it down.

So my second of two suggestions is to include in your study, as one of its most important components, a total reexamination of this country's unconscious and historically unique rejection of its most experienced and wise people, and its most organizable voting minority.

Finally, I would like to offer three brief comments on inflation. For the person with a comfortable margin of his or her income at the discretionary level, inflation is different—totally and fearfully differ-

ent—than it is for the vast middle-income group who are above the poverty level and below the level of modest affluence. Recent months have revealed that an overall inflation figure of, say, 10 percent can include inflation of 14 percent for food.

For the worker at the lower end of the middle-income scale, the inflation rate for daily necessities—food, shelter, and necessary transportation—is the real and only rate of inflation.

They are not fooled by published figures that differ from numbers stamped on supermarket shelves. In my working life in New York City, the price of a subway ride has gone up 1,000 percent. I can remember when each increase made a difference.

In the same way there is a bitter joke in the way inflation hits both the very poor and the upper-middle-income salaried worker. The very poor live, for the most part, in the city.

Food prices in the city are consistently above those in the outlying suburbs, as reported once again in yesterday's New York News inflation watch.

For the person rising toward a comfortable salary level, the graduated income tax has a special Alice in Wonderland quality in inflationary times. Because each new increase in salary puts him or her in a higher tax bracket, a raise that appears to offset inflation passes through a tax table which actually reduces take-home purchasing power.

I will leave to your economists the answers to questions of the effect of Federal deficits on inflation. I know these are difficult and complex questions, although something convinces me that Dr. Keynes never urged us to have large deficits in good times and huge deficits in bad times.

My plea is that you approach the worthy goals of this study knowing that powerful social and political changes are already preparing to write some of your answers, and that, as always, economic planning will succeed only if it harmonizes with people's dearest concepts of what is good, fair, and just.

As for time, you already know that events are moving swiftly and that inflation always produces a bitter harvest.

Thank you.

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

I think Mr. Hardy's statement is a good point from which to take off, both in comment on the study, and the panel approach, we have found it necessary not to have certain witnesses who were unwilling to appear in panel. We had a few witnesses who told us that unless they could be here by themselves, they were not going to appear.

Some of them were very distinguished, but we did not include them in our plans.

But we are delighted that we have with us four very distinguished gentlemen who aren't afraid to appear with each other. Nor do they feel that it's beneath them to appear with each other.

But having said that, the purpose of the panel approach is to get exchange among different kinds of people. I, of course, am like Mr. Okun in one respect. I have for 25 years advocated something that is revolutionary in Congress. And that is that the President have certain discretion with regard to raising and lowering taxes, so that we get some additional flexibility into the system.

But what I would like is to have everybody comment on Mr. Hardy's point that, essentially, we are dealing with a fundamental change in the attitude of the society toward itself. I think that is a fair way to say it. If you agree or disagree, I would just be curious to hear.

Starting with Mr. Okun.

Mr. OKUN. I think there have been fundamental changes in social attitudes. Maybe in any 15-year period, we observe some of them. I really think that what has been unique about this period has been the chronic stagflation that we have developed. As I have indicated, some of the feelings of greater divisiveness, less gloom in the society, less sense of fairness and justice, really turns on the inflation, and that while solving that problem won't solve all our ills, I think it would turn around a number of developments that have given people a feeling that they have no basis for planning, no sense of fairness.

Money is a language in our society. It's a way people have learned to think. It's a way they have learned to plan. We talk about how people make out in real income. There isn't a soul in the world who knows how he's made out in real income, except by taking his money income and then asking what's happened to the prices.

I couldn't tell you what's happened to my real income over the last 25 years, except by going through that two-step process. And I think that all of the aspirations of people have been built into a set of thinking in nominal terms. People who had some kind of an income objective in mind early in their career, then reached that objective and found that it doesn't mean what they thought it was going to mean, are bound to feel frustrated.

The whole search for the villain of the piece, the guy with the long end of the stick, is a function of a society whose calculus has been distorted by a shrinking yardstick. It doesn't know how to do its reckoning anymore.

The typical kind of thing I am confronted with at cocktail parties is getting cornered by a young lawyer who wants to know how much he needs to save in order to put his kids through college and makes the point that his father knew—it might not have been easy for his father to find the amount to save, but his father knew what it took, and he doesn't know what it takes, and I don't know what it takes.

The whole ability to do any long-run planing in this society, and to achieve anything that you can call security for retirement, the amount of life insurance and so forth is vastly distorted by the inflation.

Representative BOLLING. How does that relate to the fact, and I think it clearly is a fact, that, for a variety of reasons, let's say, in the period 1946 to 1966, the nature of the society changed in almost absolute terms, a very, very large number of millions of people came into an income bracket which they had never had in their families at any time in their past. Economic growth and a variety of other things changed the nature of the society itself.

And I think that is fairly obvious and fairly clear that that was a fundamental change. The current situation comes in on top of our acceptance of that change.

The new middle class, middle income, whatever you want to call them, that had education, had trades, had professions, whereas in the whole history of their families there had been no education, no pro-

fession, no trade over time. And they really basically existed on the edge of poverty or something very like it.

Now this second change coming on top of that does do something to the expectations, and maybe it's evening out. I don't know; I am curious.

Mr. OKUN. Well, the whole commitment to rising aspirations and progress and upward mobility certainly were important points in the very favorable experience of the postwar era. We tend to forget that the record over the last 30 years certainly, taken as a whole, has been the best record of performance in American history.

I think it did lead to lots of hopes, lots of expectations, lots that were realized. And that both the slowdown in real income and the perception problems associated with interpreting one's economic status in an inflationary world have created a backlash.

They knocked us down from a very high level, so to speak, of social attitudes.

Representative BOLLING. How about you, Mr. Feldstein, or is this too much of an abstract? Is this too political?

Mr. FELDSTEIN. Well, I am not sure that I have any particular competence to comment on the question. But I think what you have said at the end here about changing aspirations in response to the period of economic growth is a problem that exists quite apart from the inflation. Even if we turn around the inflation situation, I think we are not going to have the same kind of real income mobility in the future, for many of our citizens, as we have had in the past, simply because we have run out of opportunities to upgrade education.

Over the last generation it was very typical for sons and daughters to have much more education than their fathers and mothers, and so even if the economy grew relatively slowly, they themselves moved ahead in real terms in comparison to the economic circumstances in which they grew up.

Now there isn't that kind of automatic dynamics carrying a large part of the population to a relatively higher standard of living, and there is bound, as a result, to be greater frustration.

The slowdown in the rate of growth that will come from the exhaustion of the opportunity to simply increase the amount of education and training in the population, also is going to mean that more people will slip behind the real income that they had when they were young. And that is bound to have uncomfortable consequences for the way in which people think about the whole economic system.

But I don't know whether that or the current inflation has caused a greater change in thinking than the experience of the Depression, the Second World War, or the great growth of income in the postwar period or the sense of defeat associated with the Vietnam war.

In terms of the impact of all of this on the stagflation problem, I suspect, but I have no way of quantifying that changing attitudes may have had an important impact on our productivity growth.

Various things that one hears about things like absenteeism, relative number of hours worked per hour paid, a general change in the attitudes toward risktaking, all of that, if true, and if symptomatic of much more of the same, would help to explain some of the slowdown in our productivity that goes above and beyond the reduction in capital formation.

Representative BOLLING. Speaking directly to Mr. Hardy's point, it would seem to me that one of the implications of the point that he makes which, I think, is valid, is that we might have a rather different view of what kind of education should be available for aging people.

We do remarkably ill, we don't really do very well in our education of younger people. We certainly do desperately badly in our education of older people. It would seem to me that there was an enormous potential in terms of just plain raw economics if one looked rather seriously at the problem of the education of the elderly—the reeducation of the elderly.

One does not have to be very elderly to know the difference between being young and old. I would be interested to hear what you have to say.

Mr. ECKSTEIN. Mr. Chairman, before I respond to your question, could I make two requests?

One, would you enter my prepared statement as written on the record?

Representative BOLLING. Absolutely, without objection that will be done.

Mr. ECKSTEIN. Second, I made a comment in trying to illustrate one portion of my theory in relation to the Teamster settlement. I was not arguing that that would be a decline in real wages, but rather, that it was predicated on the belief that we can bring our current extreme inflation under control, that this is temporary, so the settlement would represent a real gain averaged out over the life of that contract.

I mention that because it's a sensitive matter. On the question of age, I think Mr. Hardy's point is well taken. The problem will be exacerbated by the inescapable fact that we are, in fact, going to be pursuing more cautious budget policies.

We are not going to be able to add vast new claims to the budget because in the end, the American people will insist that we reduce inflation by a more conservative approach to fiscal policy.

And we will have to be very, very sensitive to meeting the needs of the older people. They are still, despite escalation of social security, the main victims of inflation.

And we are currently for the first time since we began the social security system, examining how to reduce its benefits. We will have to do that.

We have been very generous in adding in every revision of social security law more benefits of this or that type. Some of them of a rather marginal and questionable sort. We are losing track of the fact that we are eroding the basic value of the hard-core pension for the typical American family because we have been very generous with the low-income benefit, disability benefit, a variety of loosely administered pieces of it.

And there is a danger in that. So we are going to have to look very closely at the economic and financial circumstance of the typical middle-class aging family.

I know there is a White House conference study underway to try to pull together the facts and figures on that, and as for education of the older people, to me, that is simply one of many ways in which you can enrich their lives. I am not an expert on that.

I really have no comment on what kind of program should be offered to the aging. Certainly that is one good one.

Representative BOLLING. Mr. Feldstein.

Mr. FELDSTEIN. I was just going to add one further thing on the problem of protecting the retired middle-class person.

Social security, as Professor Eckstein just commented, is, of course, indexed. Private pensions to a greater or lesser extent are able to protect their value because those funds invested in short-term assets have at least kept pace with inflation and are not subject to excessive taxes.

It's the saver who has accumulated some funds and put those savings into a bank account or mutual fund, and who's dependent upon that income, who suffers most heavily under our current system.

They are not only unable to get interest rates on these small savings that keep pace with inflation, but on top of that, are taxed on that nominal yield.

The saver who received 8 percent last year didn't keep pace with the 9-percent inflation, but, nevertheless, was taxed on that 8 percent as if it were real income.

So I think, if we are looking for ways to try to protect the older individual who has some savings, we ought to be thinking about policies that other countries follow of exempting some part of interest income, perhaps restricting that to older individuals, particularly during this period of high inflation.

Representative BOLLING. What about the question of the need for the Congress to finally face the fact that it has to provide some kind of flexibility in the tax system, greater flexibility than the Congress is able to provide through its own mechanisms?

Mr. OKUN. I have become a little less enthusiastic about that in the last 5 years. I suspect that the most misconceived fiscal proposal in the postwar era was a proposal for an increase in taxes made by President Ford in October 1974. I fear that, if he had discretionary authority to institute it, he would have.

Congress paid no attention to that recommendation, and Congress was wise in so doing.

Again last year, we had an ultimate tax bill enacted which at least in its total fiscal impact was a lot more appropriate than the one that had initially been recommended by the President.

So the question comes down to, are Presidents most likely to be right, or wrong? And if one doesn't want to bet that they are most likely to be right, perhaps it's wise not to give them excessive discretionary authority.

Representative BOLLING. Isn't the behavior of Congress correct when that coincides with the fact that Congress likes to cut taxes?

Mr. OKUN. It didn't cut taxes nearly as much as President Carter had initially asked last year.

Representative BOLLING. That's right, because it couldn't figure out how to pass a bill that would do it.

Mr. FELDSTEIN. What would be your own reaction to an authorization for the President to raise taxes but not necessarily to lower?

Representative BOLLING. That would not be the approach that I would take. I still think that we have got to build in some flexibility that does not depend in essence on a 2-year cycle.

I am perfectly aware that Presidents make mistakes, too. But it seems to me that the system works best when we have a considerable amount of flexibility. I think we are in a very inflexible situation in terms of responding to economic circumstances.

I am not sure that that's right. Obviously, the majority of my colleagues surely don't agree with me.

Mr. OKUN. One thing that certainly speaks for your side is the fact that every time we get into a debate about a cyclical change in taxes, up or down, we go through months of agonizing about what the right form and the right distributional aspect of that should be. It seems to me that is something one should be ready to argue in the abstract and one should be ready to argue as a principle for at least some significant period of time.

We ought to be able to say that we want any tax rise or tax decline that is meant to deal with a cyclical situation of where we are trying to cool off the economy, or trying to fight an overly deep recession, to take a particular form.

We ought to be able to decide on that. There were hearings back in 1966. I think Martha Griffiths, trying to develop some kind of consensus on this. I think as I recall, at least the Joint Economic Committee was able to provide that consensus. But it never sticks.

And the whole can of worms has to be opened and inspected worm by worm, it seems, every time we get into this.

I mean, what looks like a simple task of arguing this out and settling on it would save us an enormous amount of time when we are asked to act fairly promptly on a tax bill.

Representative BOLLING. I suppose that is partly because the political process is always—involves struggles between groups.

I suppose that the difficulty that we have in dealing with taxes from year to year is that different interest groups have different expectations at different times in the overall political process.

Senator, do you wish to become involved in this?

Senator JAVITS. Well, I came because I do wish to become involved.

Representative BOLLING. I thought so.

Senator JAVITS. But I am just looking over the prepared statements, so you go right ahead.

Representative BOLLING. One housekeeping matter.

I want the witnesses to be assured that their prepared statements will appear in full in the record. The staff reminds me that I hadn't taken care of that problem.

Well, I am beginning to wonder, I am not an economist, of course, but I have been involved in this committee for a very, very long time.

I'm beginning to wonder if it's possible to separate what I think I am from what everybody else is, political economists. I don't see how you can demonstrate as wise as all of you are, and I am not being sarcastic, I admire each of you, it does not seem to me that we are in a very good position to really do any predicting as to what is going to happen to the American economy.

Not because we can't define it in our own terms, but because we have so little control over the essential aspects of it. I don't see any sign of our getting better control.

What about the relationship of this economy today to the world as opposed to the economy of the United States with relationship to the world economy 30 years ago? Is there an enormous difference? Is there a significant difference? What level of difference do we have in our situation, our ability to control our destiny in that 30-year period?

Mr. ECKSTEIN. Congressman, I think there are two massive changes that have made events less controllable and we will be well advised to have policy approaches that recognize that.

The first is that the United States 30 years ago was the preeminent industrial economy and could really have its own way in almost any matter that it wished. Today we are competing with at least two major economies that have done a better job of both licking inflation, and of operating in the world market, Japan and West Germany. And much of our own ability to revive our productivity growth will depend upon our talents in matching their industrial strategies to get our own exports advancing, because we cannot have high productivity growth without better export performance.

Also, of course, the dollar is no longer what it used to be. We no longer have the fixed rates of most post-war periods and we have no ability to control the dollar, and it is just as well if we don't try very hard to do it.

The other area where we have lost our independence—and this is more decisive, really, is on energy. We see in the current recovery the moment the world economy really gets going OPEC raises the price by another, in this case, 39 percent, and brings the world industrial economy up short.

Until we reduce our dependence on OPEC oil, we are going to find it impossible, either to get rid of the stagflation or to achieve full employment.

Representative BOLLING. Why are Japan and West Germany doing better than we are? Is there any reasonable answer to that, any generalized answer that makes any sense?

Mr. ECKSTEIN. To some extent it is a historical circumstance. They were able to weather the OPEC storm better because they did not have a domestic oil industry and, consequently, simply swallowed the full bit of OPEC, I mean the full shock of OPEC, and went on from there.

The other factor is, and I don't think it is a plus, by all means, but they do have weak unions, again for historic reasons.

In Germany they destroyed the union movement. In Japan they never let it develop. So the employers are more powerful and are able to persuade labor that modest wage increases are really in their self-interest.

We could not operate the way they do. Ours is a much more pluralistic society, in some regards a freer, more open society with a better balance of power between management and labor.

Mr. OKUN. May I add a couple things to that?

One is that Japan has had substantially more inflation than we have from 1973 to date. It has a lower inflation rate currently; it had a far higher inflation rate in 1974, 1975, and 1976. Some of that is a reflection of just what Mr. Eckstein pointed out, that they took the whole brunt of the price increase in oil and took it all at once.

You can like that better or you can like it worse, but that is the fact. Some of the Japanese volatility in both directions reflects a very different kind of labor market. They seem to have a way in which every spring wages are determined from ground zero, so to speak, whereas ours have enormous inertia over time with wages following wages in the nonunion sector, with overlapping 3-year contracts in the union sector, and so forth.

It is just inconceivable that we could have experienced what they did, which was wage increases above 20 percent in 1975 and something approaching 5 or 6 percent last year.

In the German case, I think a critical institutional factor is that they export their unemployed. The German labor market has operated throughout the post-war era using a very substantial fringe of foreign workers. And the consequences of slack, recession, fiscal monetary restraint in Germany is that those other folks have to go home. They don't vote. They don't collect unemployment insurance. They don't do any of the things that American unemployed do that make us a little more concerned about it.

Representative BOLLING. Did you have something, Mr. Feldstein?

Mr. FELDSTEIN. I agree with what my two colleagues have just said. But I think it is worth emphasizing that the outcome of this process that Mr. Eckstein described as employers convincing employees to "take less" has been over a long period of time that in real terms they have been getting much more.

What was being described was not real wage increases, but rather nominal increases that have contributed so much to the inflation increase here rather than in Germany.

Indeed, that has come back to roost, as I understand the situation in Germany now, because they tend to think more in real wages rather than nominal wages.

A number of German experts believe that the wage rates have been sticky in real terms in Germany. That's been helpful for bringing down wages after a period in which prices rose and then prices dropped. It was possible to bring wages down without the stickiness to which Mr. Okun referred, but there is a feeling in Germany that the high unemployment rate they have now is a reflection of the fact that wages have stuck at too high a level and unless they do something to increase productivity so their ability to pay wages is commensurate with the real wages they are paying, they are going to continue to have a higher unemployment rate than they are accustomed to.

Representative BOLLING. What about the question of the relative role of Government in the three countries, the United States, Germany, and Japan?

Mr. ECKSTEIN. I think in Germany the role of Government is greater than here. In Japan, clearly not. The share of Government in the GNP is lower in Japan than here and is higher in Germany than here.

But one difference is that you do not have the adversary situation that is normal here. Whether it is a different political system or what. But business simply finds that Government accommodates itself more to its needs.

Certainly when they get outside their own country, they are like a team, whereas ours, we have no team abroad between business and Government.

As a result, they have had this tremendous export performance.

There is one other point. Both of these countries have had much higher rates of capital formation, but that was made possible by their success abroad. So even though we may find it advantageous to have the Government regulating in a tough-minded fashion what business ought to do, and I don't think there is any real choice about that, when you get to the frontier, we might find it smarter to have them operate as a team.

Representative BOLLING. Mr. Hardy?

Senator JAVITS. I would like to say a few words here, now that I have gone over your prepared statements. The two things that interest me are these:

One, what do you gentlemen think about this statement? We were not in all that horrendous a situation as long as inflation remained under the double-digit figure. But we do have great reason to be very much alarmed now, with this sudden surge.

Or, do you discount my statement. Are there other reasons for it? It seems to me that the double-digit level puts the pressure on us much more greatly than we had expected. After I get your views, I would like to pursue some other questions.

Professor Feldstein, perhaps you could start.

Mr. FELDSTEIN. Well, certainly the experience in the last few months, with a return to double-digit rates, has made everybody much more worried. Yet I don't think you would be saying we should be comfortable with 8-percent inflation.

Senator JAVITS. If you would be kind enough to yield, what I am saying is that 8 percent certainly didn't make us feel comfortable and gave us great need to deal with the problem. But it didn't give us a sense of urgency or crisis. That is all I mean.

Mr. FELDSTEIN. Maybe it should have. Maybe we need double digit and should welcome it as giving us that sense of crisis. But I think our economy suffers very substantially even at rates of 6- or 8-percent inflation.

So our target should not be merely to get back to the misery of last year.

Senator JAVITS. Do you agree with that, Mr. Okun?

Mr. OKUN. Yes.

Senator JAVITS. The same here? Everybody agrees with that? That is, that double-digit inflation has not really changed the situation except in order of its magnitude.

Mr. HARDY. I would like to make the point that the only change that is consequential to any human being is the change that occurs in his lifetime. The change in the language from Chaucerian to modern English went unnoticed by every generation that participated in it.

But inflation at 10 percent, if you are on a fixed income, halves that income in about 8 years. That occurs within your expected life. An inflation rate of 8 halves it in 10 years, slightly more tolerable, but still it leaves you unable to exist at the end of 20 years.

Senator JAVITS. Well, the two things that impress me from just glancing through the papers—just to get some concept from all of you about the situation—are: One, the noticeable impact upon our situation of both the lack of productivity and the lack of an adequate export opportunity to sustain our situation.

And, second, the interest in work which Jerry Hardy has raised, I think in a very important way.

Looking to the first, that is productivity, I think Professor Feldstein points out the difficulty which arises out of our tax law which fails to take account of replacement cost in the equation of determining corporate profits.

By the way, that has a very, very powerful political effect. Politics could be given an entirely different twist if the people took it into their heads that you need to curb business enterprises, as you did in the 1930's, without a new surge of business buccaneers scalping the public for big profits.

By the way, the profit question has a lot to do with the disbelief about the energy crisis. People think that it is the oil companies that have got it in their back pockets.

So, what I would like to question, if I may—just to lay it on the table—is the decisiveness of these positions that give the idea that you can run these things with mirrors by fooling around with interest rates and the policy of the Federal Reserve, when we all know that the only thing that really counts is the bottom line: What do you make and how much and can you sell it.

What worries me is that we are not pointed at the right target, which is productivity on the one side and marketing on the other, and that the marketing suffers from a grave insufficiency of the supply of development capital to the areas of the world where development is both politically and economically feasible.

Yet, we have these great examples of middle-income countries like Brazil, South Korea, Taiwan, and some others around the world. So my question is this: If you are going to mass your means at a given target, because that is a military doctrine which is in my judgment very valid, what target should it be? Should it be productivity? Should it be the tax system? Should it be interest in work, as Jerry Hardy wishes us to do? Or should it be monetary policy and fiscal policy?

Mr. OKUN. I think it should be the wage-price spiral. I think that has been the fundamental factor in our recent inflation. It has been somewhat exacerbated by the productivity slowdown.

The productivity slowdown has enormous consequences for our real living standards over the long run. But it has been a fairly modest element in the inflation picture so far. And the way it gets into the inflation picture is because we do have a set of wage targets and wage institutions which are not lowered by a slowdown in productivity growth.

To me the dismal failure of the 1974-75 recession to produce any significant lasting effects on the economy are all associated with the way we make wages and prices in this society. And there isn't anything wrong structurally with that, but it does produce an enormous amount of inflation inertia.

You have to find a way to talk business and labor, or reward business and labor, or constrain business and labor from playing a game that will put oil prices into the price level by putting them into the wage level. It would then get it into the core inflation rate that

Mr. Eckstein talks about. There would be equally serious effects from putting the productivity slowdown in the inflation rate. I think that is what we have to prevent.

Senator JAVITS. So are you for controls right now?

Mr. OKUN. No; I do not believe that a mandatory structure of wage and price controls would settle the problem. I really think there is more potential in the program that the administration has advanced than people are giving it credit for.

So far it has done, I think, a significant amount on the wage front. I think the failure on the price side has to be looked at much more carefully.

I do not believe that when you take food and fuel out of the story that you get a set of price performance which is at all consistent with the price guidelines. I think there must be enormous violations going on out there. I think it is a matter of nailing it down.

Senator JAVITS. Thank you, Mr. Okun.

Professor Feldstein.

Mr. FELDSTEIN. Let me comment first on some of the things that Mr. Okun has just said. I don't see any real difference in the wage- and price-setting process now, in the late 1970's, from the process in the early 1960's.

There may be small changes, but there has been a decline rather than a growth of private sector unionism. There has been no growth in the concentration of industry. There has been a greater opening up of the U.S. markets to world competition. So all of those rigidities, which I will grant are there, are, if anything, smaller today than they were before.

Yet our economy managed to function without excessive inflation during that period because it wasn't overheated by excessive demand.

I don't think we need to change the way in which we have wage and price setting in order to get back there, either.

Again, I quoted before you came, Senator, just to remind everyone, that—what the experience was when the economy went through a contraction in 1975. The inflation rate was 12 percent in 1974. It was less than 5 percent for 1976. Finished goods inflation came down from 18 to 3 percent.

Mr. Eckstein's chart identifies what he refers to as the demand component of inflation, which therefore, takes out things like OPEC spike in the earlier period. But that shows a 4 percentage point drop over a 2-year period in the demand component of inflation.

So my sense is that if we have slack in the economy, if we operate with a margin of safety in the unemployment rate and our labor markets and our capacity utilization, we will see the inflation rate coming down.

And that we are not likely to find success by trying to tamper with the wage-price mechanism.

Indeed, I also wonder whether we should be so optimistic as Mr. Okun seems to be about the success of the program so far. I don't feel I fully understand what happened in the Teamsters settlement. But the number that I have looked at, the first-year number, looks like 11.9 percent.

I don't, frankly, know whether that has in addition to it any cost of living adjustment if that inflation rate during the first year exceeds 6 percent or if it only takes effect in the future, but it is at a minimum of 11.9 percent in the first year.

There are going to be a lot of workers who are going to wonder why they should accept 7 percent for the coming year even though they have been told that the Teamsters have been in compliance, when in fact the Teamsters have received close to 12 percent or more.

Let me come back to your where-would-I-miss-my-effort question.

Many of the things you identify are either methods or intermediate goals. It is clear our long-run goal is the growth of real income. Productivity growth is one way in which we achieve that. Capital formation is one of the ways in which we achieve overall productivity growth. Tax policy and aggregate demand policy are the ways in which we can encourage capital formation, by going back through that route I have indicated the things that I think are important.

I think we need better demand management that gives us that margin of slack so that the inflation rate goes down, and a change in our tax priorities so that we no longer are penalizing capital formation.

If we do that, I am optimistic that we can increase our rate of capital formation, although I think there are other things which are at least as important that would have to be done to get that capital formation up.

Senator JAVITS. Mr. Eckstein.

Mr. ECKSTEIN. Well, Senator, Mr. Okun and I served together on the Council of Economic Advisers in the mid-1960's and my job was the micro aspect of prices and wages and his job was macro aspects.

But I did convince myself that the specific price-wage dimensions are really abstractions. When inflation becomes acute, the pressure on the Government is to do something. One way to relieve that pressure is to call up Sears and Roebuck. In fact, however, that is not going to do much to fight inflation.

Indeed, the only practical way we have of intervening in prices and wages in a meaningful way is to freeze them. I think that is the only price-wage policy that can be considered a policy rather than a public relations gimmick or sideshow.

The battle of inflation will be won or lost in the macro area. We currently have an industrial boom. Until that boom is over, everything else will fail. So, to me, you have got to fight the fire you have got, although our meaning today is to look at the long-run forest rather than the fire. That fire is an excess demand fire. But that, in the long-run, we must improve our productivity and export performance.

If we straighten those out, our economy will return to the fantastic material progress we have experienced for 120 years.

Senator JAVITS. I just thought perhaps Mr. Hardy would like to say a word.

Mr. HARDY. I guess I am focused on what is in people's heads and hearts more than I am in what goes on in the numbers that measure the economy.

If I were trying to focus my firepower, as you said, for greatest effectiveness, I think I would do those things which would reassure people that the whole thing is going to stick together. There is a

growing conviction that something is very wrong out there, a growing conviction, I think I said earlier, that somebody is betraying the promises of a lifetime.

I have no way of measuring it. But in talking both to people and to businessmen, I find them behaving in the most logical possible fashion. That logic is the very dangerous logic of self-survival.

Businessmen are now borrowing money in the firm conviction that if they can get 20-year money they will pay it back with 10- or 20-cent dollars. People are buying all kinds of things that they know they don't need today, but are going to need next week or next month or next year. They are buying because they have an absolute conviction that things are going to be more expensive down the road. They have only to watch the automobile companies raise their prices six times in a single year, and they know they are right. They know what they are doing is right.

People do behave in a pretty logical self-survival fashion. They are beginning to lose faith in the whole structure, in my opinion. And I would try my damndest to find ways to reestablish that faith because its loss is exhibiting itself in a cynicism about productivity insofar as commitment to work is concerned.

Nobody wants to do a lot of the jobs that have to be done now. We know what is happening in New York. It is dirtier than Guayaquil, Ecuador. That is the dirtiest city I can remember ever having visited. Pride in the city and pride of work deteriorate together.

We are coming back a little in New York, but we have a long way to come.

Senator JAVRS. Thank you so much, Mr. Chairman. I deeply appreciate this opportunity.

I might say you have a highly eminent panel. I couldn't think of four men I would rather have together than these.

Representative BOLLING. Nor could I. And, with that, I think we will close the hearing with our gratitude to all of you. Thank you.

[Whereupon, at 11:53 a.m., the committee recessed, to reconvene at 10 a.m., Monday, May 7, 1979.]

STAGFLATION

MONDAY, MAY 7, 1979

CONGRESS OF THE UNITED STATES,
SPECIAL STUDY ON ECONOMIC CHANGE OF THE
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:05 a.m., in room 6226, Dirksen Senate Office Building, Hon. Richard Bolling (vice chairman of the committee) presiding.

Present: Representative Bolling.

Committee staff present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director (SSEC); and Stephen J. Entin and Mark R. Policinski, minority professional staff members.

Special Study on Economic Change staff present: George D. Krumbhaar, Jr., counsel; Douglas N. Ross, senior economist; Richard D. Bartel, economist; and Sandra Adams, Michael J. Lockerby, and Carolyn H. Crowley, research assistants.

OPENING STATEMENT OF REPRESENTATIVE BOLLING, VICE CHAIRMAN

Representative BOLLING. The committee will be in order.

This morning, we are continuing the second day of public panel discussions on stagflation as a part of the Joint Economic Committee's Special Study on Economic Change.

I might explain for those not familiar with the Special Study project that it grew out of discussions with the majority and minority members of the Joint Economic Committee and with the leadership in the House and the Senate.

As I said at the beginning of the hearings last Monday, we prepared a prospectus about 2 years ago which calls for a 3½ year study to identify the nature of major economic changes occurring in the United States and the world that may have rendered ineffective the traditional methods for achieving aims of the Employment Act of 1946. We believe thorough analysis of these profound changes would yield not only a better understanding of long-term problems confronting Congress, but would also suggest fresh policy options for our consideration.

On the basis of this prospectus, House Concurrent Resolution 248 was introduced in the House and passed overwhelmingly, then was approved by the Senate by unanimous consent on July 18, 1977.

The underlying thesis of the study is that economic, social, political, international and technical conditions have changed, and are still changing markedly. This suggests that conventional wisdom and established economic tools may not be equal to the challenge of making sound policies in the economic sphere.

The so-called laws of economics have not been repealed, but all guiding principles presuppose certain environmental conditions, customs, and practices. When these change, the implementation of new policies and modes of adjustment have to change also.

This comprehensive project now has underway papers and reports on the nature and consequences of economic change in nine major areas: Human resources and demographics, materials and energy resources, research and innovation, stagflation, government impact, Federal finance, State and local finance, pensions, and the international sector.

Today, we continue our discussion of the twin problems of inflation and unemployment which our study addresses under the heading stagflation. The recent releases of both consumer and wholesale prices make us all acutely aware of accelerating, double-digit inflation. We still have to worry about first stopping the accelerating upward spiral of prices and then to bring our overheated economy down to a soft landing.

We are not here today to talk about the short-run aspects of stagflation. What we want to discuss is where will the typical American family be in the next decade? How long can they go on altering their spending and borrowing habits to protect their purchasing power and standard of living? How long before continuing inflation corrodes the basic institutions of our free society and market economy?

The Joint Economic Committee's Annual Report pointed out that in order to correct deeply entrenched inflation and unsatisfactory levels of unemployment requires the Federal Government to put its financial house in order and to meet the major challenges confronting us on the supply side of the economy.

On the supply side, we look for higher production, not lower. We take no satisfaction when our index of industrial production rises little or not at all. We look for more efficient production processes, more effective management, higher investment, more skilled labor and higher total productivity. It is our target to achieve price stability in an expanding economy, not a declining one. We cannot make our peace with either rising inflation or rising unemployment.

If we do not solve both of these problems of inflation and unemployment, not one but both, we may encounter in these United States not far down the road challenges to both our economic and political institutions of a seriousness we have not recently hitherto contemplated. This was certainly a primary concern that emerged from our discussions last week.

Accordingly, the Special Study has invited a number of preeminent economists, business leaders and labor authorities to join us in a dialog on the longer term outlook and solution to the problems of inflation and unemployment. As in our hearing last year, we have organized today's discussion as a panel. Our experience with panel discussions

since the fifties confirms our belief that the democratic process works in an intellectual sense. The best ideas, the best insight often emerge from free exchange from a spirited dialog among a variety of people.

Our distinguished panel last week, after debating the problems of our persistent inflation and unemployment in the 1970's, suggested no quick fix. They, too, believe our current inflation to be caused by a complex set of forces, only some of which respond to macroeconomic restraints. While our earlier panel discussions led to a general consensus that inflation must be attacked simultaneously on a number of policy fronts, the emphasis on particular policies varied. Fresh, new policy options, however, seemed as remote as ever.

As a matter of fact, our panelists posed a painful dilemma. On the one hand, if we allow inflation to persist, social divisiveness may intensify. On the other hand, anti-inflationary policy that triggers severe economic fluctuations and higher unemployment will also generate social unrest and political instability. Thus, a do-nothing or a do-too-much strategy may have equally damaging effects on our traditional social and political institutions, while undermining the vitality of our market economy.

We have to recognize that demographic changes may well reinforce the kinds of social divisiveness that economic dislocation sets loose. To cite an example, retired Americans will become an increasingly large group in our population as the turn of the century approaches. They are the one segment of the population that feels most cheated by the unjust tax of inflation. Their plans for retirement are destroyed as inflation wipes out the savings of decades and hopes for a reasonable living standard in retirement.

In today's panel discussions, we hope our experts will look beyond the immediate questions of near-term money supply growth and budget policy and out into the 1980's and beyond. Certainly, our long-range prospects are colored by the short-run policy options we take in the Congress today.

But what do you envision for the long-range future? How do you expect the economy to shape up? What do you feel we should as a nation strive toward in the more distant future? Are our current policies carrying us toward those objectives, or do they lead us to quite unexpected and unintended scenarios for the American economy and society?

In the beginning, I would like to state that the prepared statements of each witness will appear in full in the record.

Without any objection, it is so ordered.

Our first witness will be Mr. Phillip Cagan, professor of economics, Columbia University, and research associate, National Bureau of Economic Research, an adjunct scholar of American Enterprise Institute, Ph. D. from the University of Chicago, he has served as a member of the senior staff, Council of Economic Advisers, from 1969 to 1970, and was a member of the Federal Reserve's Advisory Committee on Monetary Statistics from 1974-75.

We will be delighted to hear from you, Mr. Cagan.

**STATEMENT OF PHILLIP CAGAN, PROFESSOR OF ECONOMICS,
COLUMBIA UNIVERSITY, NEW YORK, N.Y., AND RESEARCH AS-
SOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH, CAM-
BRIDGE, MASS.**

Mr. CAGAN. Thank you, Mr. Vice Chairman.

My remarks concern my views of the nature of inflation. And I could bring these across well within your desired 10-minute limit.

STAGNATION IN THE U.S. ECONOMY

Since 1975 the U.S. economy has been recovering from a severe business recession and at least until 1978 had considerable unemployed productive resources. Yet during this period the rate of inflation by any measure has been appreciable and has been rising, and even began to rise before 1978 when the economy was still producing far below its potential capacity. This combination of business recession and inflation which has come to be called "stagflation" continues to puzzle and exasperate the public. I believe that economists have previously offered satisfactory explanations for all but one piece of this phenomenon, however, and I wish to offer an explanation for the missing piece this morning.

The explanation of stagflation raises two questions: One, why, in the face of slack demand in the economy, do prices not only fail to decline but actually continue rising? And two, why do increases, which decelerate in a business recession, begin to accelerate as soon as business activity begins to recover, long before the economy reaches full capacity when we might expect inflationary pressures to intensify?

The first question, which economists have been discussing now for some years, can be answered with the observation that inflationary movements have momentum. By this is meant that most prices and nearly all wages are not determined from day to day by current demand and supply conditions but are set for a period of time—weeks, months, or in some contracts for 1 to 3 years. The setting of prices for a period of time is a convenience to buyers and sellers and is necessary except on commodity exchanges or in highly atomistic markets where prices are the outcome in every moment of current demand and supply conditions. Price setting largely ignores short-run changes in demand and tends to follow the anticipated path of prices that is consistent with demand and supply conditions over the long run. Consequently, these prices are based on unit costs of production at normal levels of output and will continue to rise as costs rise in reflection of past inflationary pressures irrespective of current demand conditions. In addition, price setting will tend to follow expected future increases in costs as well as current increases of input costs reflecting past developments. The influence of past price increases working through the economy and passing from earlier to later stages of production as a rise in costs, plus price and wage increases in anticipation of future costs increases which pass forward to raise costs in other industries, combine to maintain the momentum of inflation.

The result is to delay and stretch out the effect of demand pressures on prices. When aggregate demand rises in a business expansion,

most industries expand output without raising the path of their prices. Their demand for resource inputs increases and is passed back along the production line. Some markets, and particularly markets for basic commodities, respond quickly to demand changes, and their prices rise in the face of expanding demands of a business expansion. These price increases work forward through the production pipeline to raise costs and prices along the way. When the prices of finished goods rise to increase the cost of living, workers receive cost-of-living raises, which pass forward as further cost increases. When a business expansion slackens and turns into a recession, these cost increases continue coming through the system, and prices continue rising despite a falling off of demand in most industries. In addition, most sellers expect continuing inflation despite a temporary recession and incorporate those expectations into their price setting.

Notwithstanding this general pattern of price setting, we should recognize that demand does influence prices, through the prices of basic commodities and products of atomistic industries which are determined by current demand and supply conditions and which are passed forward as costs raising prices in other industries. And, of course, deficient demand produces some price shading and discounts in nearly all markets. When a business recession develops, therefore, firms maintain prices and reduce output, but prices of basic commodities and atomistic industries decline and as these declines work forward, other prices rise less rapidly. Wages then decelerate, and expectations of future inflation moderate. All this takes time, however, and the first stages of a recession do not display much decline in the momentum of inflation.

Yet recessions display a decline in the rate of inflation, reflecting a reversal for those prices which in the preceding business expansion were temporarily raised above the basic momentum rate of inflation due to shortages and demand pressures on raw material supplies. In 1973-74 the rate of inflation rose above 10 percent per year and in the subsequent contraction of activity fell by one-half to 5 percent per year. The former rate was above, and the latter rate was below, the basic momentum rate of inflation of about 6 to 7 percent as reflected in wage contracts and subsequent developments.

The important consequence of these cyclical fluctuations in the rate of inflation is that since they are temporary, they do not affect the momentum of inflation unless a pressure of deficient demand on prices lasts long enough to produce perceptible effects.

How long do such effects take? Past behavior suggests that reductions in the momentum of inflation occur slowly. I estimated that 1 percent excess unemployed resources would reduce the basic momentum of inflation by eight-tenths of a percentage point a year, and perhaps less—see "Contemporary Economic Problems 1978," edited by W. Fellner, American Enterprise Institute, 1978—and other studies have found even smaller effects.

This is the explanation for the rise in the inflation rate when business recovers from a recession. The recession decline in demand reverses previous boom increases in some prices, but the reversal, too, is temporary, and as business recovers so do these prices. Any declines taking place in the momentum rate of inflation due to slack demand in the

recession and recovery are too small to be seen immediately and in any event are swamped by the temporary cyclical fluctuations.

How then do we subdue inflation? We must maintain some slack in the economy to impose a persistent downward pressure on prices, allow the cost increases coming through the system to peter out, keep actual inflation below the expected rate, and gradually push down the expected rate and thus the momentum of inflation. It is a task that requires a steady policy over a long period. Overexpansions of the economy that bring new inflationary pressures must be avoided. If an average 1 percent excess unemployed resources is maintained over a business cycle of typically 4 years, the reduction of inflation by the previous estimate would be 3.2 percentage points.

Expectations play an important role in the momentum of inflation, but I do not see how we can bring down expectations of inflation until policy has demonstrated over the course of a business cycle that the temporary fall in the inflation rate which occurs during the recession phase will not all be reversed by overexpanding the economy during the expansion phase. If policy can negotiate one business recovery without allowing overexpansion, expectations will begin to form that policy will subdue inflation, and the momentum of inflation will decline faster than is implied by past periods in which the credibility of policy was gradually eroded. That is why success in combating inflation can breed further success, and the process may not take as long as past experience suggests, though I do not wish to soft-pedal the long and difficult road of subduing inflation.

One of the serious mistakes we have made in the past and may continue to make is to misjudge the position of the zone of increasing inflationary pressures. Past policy was conducted with the apparent intention of pushing the economy to the edge of this zone without leaving any room for the risk of error, with the result that we have in recent past business expansions overshot the zone and overpressured the economy. Furthermore, current pronouncements of this zone in recent CEA reports as being around 5.1 or even 5½ percent for total labor unemployment are too low. Past behavior of prices and unemployment, after adjusting unemployment for structural changes in the labor market, indicate that the zone where inflationary pressures intensify begins around 6 percent or somewhat higher. I derived that estimate in a paper published 2 years ago—see “Contemporary Economic Problems, 1977,” ed. by W. Fellner, AEI, 1977—and the recent surge of inflation when unemployment fell to 6 percent convinces me that I was right. Moreover, we must hold the economy above that zone. That means 7 percent or more unemployment, which appears high, but we must recognize that it is only about 1 percent in excess of a level of 6 percent that we cannot reduce via aggregate-demand management without intensifying inflationary pressures. I doubt that aggregate monetary and fiscal stimulus can reduce the deplorable pockets of unemployment among youths and minorities. In an effort to do so, we have exacerbated inflation with only slight benefits in terms of lower unemployment. Other methods must be used to lower youth and minority unemployment.

No one is sanguine about pursuing a policy aimed at average excess unemployed resources of 1 percent or more over a sustained period, but we have misled ourselves into searching for alternatives that do

not exist. How much longer are we going to divert our efforts with various kinds of voluntary or mandatory controls, without success, before we face the hard fact that subduing inflation requires a steady dose of monetary restraint on aggregate demand? What disturbs me is that I doubt whether such a policy can be carried through unless there is a clear political consensus behind it which makes it credible that the policy will be maintained until inflation is subdued. If not, expectations will not respond in a way that supports such a policy, which will make it more costly and difficult. Yet I do not yet see such a consensus. I would hope this committee might start building the basis for one. As I see it, our choice is not whether to keep the present rate of inflation or subdue it. Our choice is to subdue inflation or see it gradually escalate. We cannot hold it at a given rate, as our past experience has shown.

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

Our next witness is Ms. Leslie Ellen Nulty who has an economics degree from Cambridge in England. She is an economist for the International Association of Machinists and Aerospace Workers, Washington, D.C. Formerly, she was an economist for the National Economic Development Law Project and the Exploratory Project for Economic Alternatives.

From 1973 to 1974, she was a staff economist with the United Auto Workers, and earlier a consultant to the European Research Bureau from 1971 to 1973.

Ms. Nulty, we will be glad to hear you in any way you would like to proceed.

STATEMENT OF LESLIE ELLEN NULTY, PROFESSIONAL ECONOMIST, INTERNATIONAL ASSOCIATION OF MACHINISTS & AEROSPACE WORKERS, WASHINGTON, D.C.

Ms. NULTY. I hope I can do as well on the time as Mr. Cagan has.

Before I begin my oral statement, there are two corrections in my prepared statement that I have submitted for the record that I would like you to take note of.

The paragraph beginning "Between 1972 and 1978 * * * production of fossil fuels * * *" the comma should become a period and be moved over to the right one place.

Second, the paragraph beginning "Public policy * * *" the copy of the paper that I received incorrectly attributed the solar study to joint sponsorship of the JEC Subcommittee on Energy and the Special Study on Economic Change. I have been informed that that was corrected in a later print and that, in fact, sole responsibility for that report lies with the Subcommittee on Energy.

I would like to express my very deep appreciation to the chairman, vice chairman and members of the Joint Economic Committee for affording me this opportunity to present my views.

Finding myself to be something of a voice in the wilderness, it is at least comforting to know there is someone who might want to listen to what I have to say.

While I do believe that it is possible to make a significant impact on persistent unemployment and inflation, I do not believe that the

solutions are simple or politically easy. Therefore, I have submitted a much longer statement for the printed record. And I am sure you all have copies.

Before getting down to the nitty-gritty, I think it would help clarify the discussion today to have a brief statement of first principles. In my opinion, if economics has earned for itself the label the "dismal science," it is largely because economic discussion in this country at least has largely been confined to a few narrow schools of thought which have lamentably little to offer policymakers who are sincerely committed to doing something about the problems troubling their constituents.

The U.S. economics profession "runs the gamut," as one professor has said, "from A to B." My own approach to the evaluation of national economic performance and the efficacy of public policy is to measure them directly against their contribution to the improvement in the level and stability of economic well-being of the broad majority of the population.

In contrast, much of the conventional macroeconomic fiscal and monetary economic analysis focuses on indirect indicators such as private capital formation, productivity trends, budget deficits, and so forth, that reflect a narrow selection of means rather than policy ends in themselves.

Thus, stagflation is a problem for the economics profession as it is for the broad mass of the population, but for very different reasons.

Confronted with the contradiction between reality and conventional theories that do not allow for simultaneous unemployment and inflation, the overwhelming response of our profession has been to dodge the issue by claiming that it is really just a measurement problem rather than to confront the weaknesses of theory.

Thus, enormous effort has been expended on revisions, adjustments or redefinitions of the unemployment rate and more recently analogous efforts attempting to estimate overstatement in the Consumer Price Index.

Indeed, by some definitions, we have already reached full employment. The 6 to 8 million unsatisfied jobseekers in this country are merely statistical artifacts beyond the reach of public policy.

While I do not deny that these statistical measurements can stand improvement, their imperfections do not change the basic facts which are plain for all to see. We have too much unemployment and too much inflation. And if anything, in recent years, they seem to be going up and down together rather than in opposite directions.

I for one hope that we will not have to see our cities burn again before the dismal view that we can never do anything about either inflation or unemployment without exacerbating the other is discredited and finally laid to rest.

As guide to policy, these are nonsolutions. For the vast majority of the American population, the 80 percent or so whose past, present or prospective major source of income is wages and salaries, the notion of a trade off between unemployment and inflation is meaningless. The loss of purchasing power through inflation has an impact equivalent to the loss of a job or the threat of unemployment produced by a slackening labor market.

In both cases, claims to real goods and services are reduced, and the basic sense of insecurity is heightened. Inflation and unemployment are, in effect, the same problem. They are simply different manifestations of the general threat to the living standards of working people.

From this perspective, the only effective meaningful solutions to the problems of unemployment and inflation are joint solutions or at least policy approaches that recognize their commonality.

I hope that the members of this committee will find that by keeping the ends of economic policy well focused while maintaining an unrestricted open approach to potential means, even the dismal science can provide a richer and more optimistic forecast for economic progress. Because the recent onslaught of inflation has not been evenly distributed across all commodities and services and because its major thrust has been concentrated on expenditure categories that are essential necessities in the household budget, its character has been especially pernicious.

Prices for food, energy, housing, and health care, the four basic necessities that account for roughly 70 percent of average family consumption budgets, have been going up roughly twice as fast as the rest of the consumer price index. For these expenditure categories, we have been experiencing double-digit inflation since the late sixties. With the tightest squeeze on nondiscretionary expenditures, inflation is even more painful than it would otherwise be.

While it has long been recognized the poor are hurt most by inflation, the impact of the new inflation reaches beyond the poor. Despite the popularization of the image of the affluent worker, most workers' families are among the 80 percent of the population who are most vulnerable to the new inflation. Indeed, for the working classes, as they may be called, the new inflation is particularly burdensome because unlike the bottom 10 percent and those over 65—retirees—their income is just high enough to disqualify them from public subsidies such as food stamps, medicare and medicaid, or rent allowances that offer some partial protection.

On the other hand, they differ from the top 20 percent of the income distribution in that their portfolios of income-producing assets are much less diverse. The protective devices of hedging, arbitrage, tax shelters, capital gains, superior interest rates paid on large denomination commercial paper, CD's, or Government securities and self-determined professional fees are largely unavailable to them.

Consumer price inflation has been so severe and earnings have lagged so far behind that pretax average weekly earnings for production and nonsupervisory workers on nonagricultural payrolls in constant 1967 dollars are now at their lowest level since 1967.

Of course, because money wages have risen, workers are now in higher income tax brackets—not to mention the impact of the more regressive increase in the social security taxes—so that in terms of take-home pay, they are even worse off.

As the purchasing power of the wages of traditional head of household is reduced by inflation in the necessities, more family members have to try their luck in the labor markets in an attempt to maintain a constant standard of living.

Thus, it is not surprising to find, as we have, quite dramatic changes in labor force participation rates which will tend to raise aggregate unemployment rates to the extent that new labor force entrants' demand for jobs is not satisfied. For more and more families, one income is no longer sufficient to protect living standards.

The increased demand for jobs by new labor force entrants, youth, and married women, pushed as they are to the end of the labor queue, has resulted in more part-time jobs and an increasing proportion of jobs offered at the bottom of the wage distribution both in terms of occupation and industry.

In my prepared statement, I have produced some data to show you that not only has the distribution of employment shifted down the pay scale, but the ratio of earnings in lower paid sectors to higher paid sectors has deteriorated very substantially and significantly since the fifties.

As these earnings become less and less adequate in preserving real family income under persistent inflation, there will be continuous upward pressure on labor force participation rates. Even though the teenage "bubble" will eventually mature, this factor may be more than compensated for by further increases in the labor force participation rates of future teenage cohorts, not to mention increases in the rate for adult women.

Despite the effort to counteract the "new inflation" by adding more family workers, the vast majority of American families have continued to fall behind. Median family income in constant dollars, pretax, has essentially been stagnant during the seventies, and in 1977 was below the levels achieved in 1972 and 1973.

As the problem was summed up by one member of the IAM, "the only trouble with sending your wife out to work is that the law only allows you one wife."

By looking at the combined effects of inadequate employment opportunities and inflation in this manner, which reflects more accurately the way ordinary people experience them, one realizes that counterinflation programs that focus on budget cuts, dampening wage increases, planned recession or attempts to curb the growth of the money supply by raising interest rates are inevitably going to miss the target because all of these mean either further cuts in real wages or higher layoff rates for some, if not all, family members.

Unfortunately, it is not widely understood that even when average unemployment rates are as "low" as 6 percent, around 20 percent of the labor force experiences involuntary unemployment during the course of the year. If policymakers truly want to cut the Gordian-knot of stagflation, they must begin by altering the structure of supply, not simply the quantity of supply, and the character of demand in the four basic necessities in ways that will stabilize employment and living standards for the majority of the population.

While inflation in each of the necessity sectors has its own special distinct character, many common elements pervade them. If the common problem elements could be summed up in a few words, they would be "relatively restricted choice on the demand side, concentration of economic power on the supply side."

These are not intractable problems. Public policy can make a significant contribution to dispelling stagflation through well-designed sectoral initiatives that aim at increasing the elasticity of demand by increasing consumer choice on the one hand and increasing the elasticity of supply by reducing corporate market power through a variety of means on the other.

In my prepared statement I submitted for the record, I have used a discussion of policy options for the energy sector to illustrate what a positive counterstagflation program might look like. A counter-inflation program that essentially ignores or exempts these four sectors as the administration's guidelines program has done is almost worse than no program at all.

Any program that fails to address directly the unfilled demand for jobs is no program at all.

Unfortunately, if recent economic policy is any guide to the future, one may anticipate protracted and possibly accelerated inflation rates in necessities, hence perpetuation of stagflation. This prognosis is made because up to now at virtually every opportunity where a price- or supply-sensitive policy choice has presented itself, the option chosen for the necessity sectors has been inflation promoting rather than inflation abating.

Part of this may be attributable to the selectivity with which the inflation issue has been used; that is, principally to justify the retreat of government and to forestall improvements in occupational health and safety and environmental rehabilitation, all of which are part and parcel of enhanced living standards for our population.

Public policy makers have to make choices. If they continue to work for "them" and against "us," stagflation will indeed be with "us" for many years to come.

Representative BOLLING. Thank you very much, Ms. Nulty.
[The prepared statement of Ms. Nulty follows:]

PREPARED STATEMENT OF LESLIE ELLEN NULTY

Problems of Persistent Unemployment and Inflation in the U.S. Economy—Can Solutions Be Found?

1. *Defining the economic problem—Analysis and policy should focus on the well-being of the broad mass of the population.*—Before we can determine whether we can realistically look forward to ending simultaneous unemployment and inflation, economists and policymakers have first to agree on what the problems really are. The conventional wisdom of the present only offers trade-offs: inflation it is claimed can be reduced only through higher unemployment. Unemployment can be reduced only at the cost of higher rates of inflation.

But these obviously are non-solutions. For the vast majority of the American population, the 80 percent or so whose past, present or prospective major source of income is wages and salaries, the notion of a "trade-off" between unemployment and inflation is meaningless. The loss of purchasing power through inflation has an impact equivalent to the loss of a job, or the threat of unemployment produced by a slackening labor market. In both cases, claims to the real goods and services offered by society are curtailed and the basic sense of economic and social insecurity is heightened. Inflation and unemployment are in effect the same problem—they are simply different manifestations of the general threat to the living standards of working people. From this perspective, the only effective meaningful solutions to the problems of unemployment and inflation are joint solutions, or at least policy approaches that recognize their commonality.

Confronted with the contradiction between reality and conventional theories that do not allow for the simultaneous occurrence of unemployment and inflation, the overwhelming response of the economics profession has been to reduce the issue to a measurement problem—to attempt to alter the assessment of what is happening in the real world, rather than to confront the weaknesses of the theory. Most efforts to date have taken the form of revisions, adjustments or re-definitions of the unemployment rate.¹ Very recently analogous efforts attempting to estimate overstatement in the Consumer Price Index have begun to flower.² Indeed, by some definitions we have already reached full employment—the 6–8 million unsatisfied job seekers are merely “statistical artifacts” beyond the reach of public policy.

I for one hope that we won't have to see our cities burn again before this dismal view is discredited and finally laid to rest. To avoid such a prospect one must first admit that there are real economic problems and to develop explicit statements of what they are.

The analytical perspective from which this discussion proceeds is one that measures the efficacy of public policy and national economic performance against their contribution to the improvement in the level and stability of economic well-being enjoyed by the broad majority of the population. It differs from conventional macroeconomic fiscal and monetary approaches in measuring success directly in terms of the ends of policy, not in terms of indirect indicators such as private capital formation, productivity trends, budget deficits, etc. that reflect a narrow selection of means. Moreover, unlike conventional macroeconomic fiscal and monetary policy, which basically assumes competitive, “efficient” markets, no *a priori* assumptions are made about market structure, nor is there any *a priori* determination of the appropriate limits to government intervention in the economy; each situation is considered on its own merits. I hope that the members of this committee will find that by keeping the ends of economic policy well-focused, while maintaining an unrestricted open approach to potential means, even the “dismal science” can provide a richer and more optimistic forecast for economic progress.

2. *Understanding the new inflation—Disproportionately high rates of inflation in the basic necessities.*—From my own work I am convinced that particularly with respect to the problem of inflation, macroeconomic policy has failed because it proceeds from a much too highly aggregated level. In the words of John Blair: “To the extent that they have empirical bases, “demand-pull,” “cost-push,” and the “Phillips curve” have been derived from studies involving the use of measures of the general price level. But, as Gardiner C. Means showed some forty years ago, the distribution of the price structure is U-shaped: that is, the movements of the overall price series are not indicative of the movements of most individual prices which have either low amplitudes and frequencies of change or high amplitudes and frequencies. The average is the exception. Moreover, recent evidence indicates that in recession, different groups of prices change in opposing directions, causing the overall series to conceal more than it reveals. The proper study of prices, therefore, is prices, not the general price level.”³

It can be argued that inflation has become an issue for the economics profession for two principal reasons: first, because the actual magnitude of the inflation rates experienced recently have so far surpassed anything in recent memory, especially in peacetime and during periods of high unemployment, and secondly because virtually all econometric forecasting models based as they are on changes in the general price level, failed to predict the phenomenon.

Regrettably the vast body of the profession has yet to come to terms with the special character of post-1960's inflation, namely the dramatic shift both in relative prices and in relative rates of inflation in critically important expenditure categories.⁴

¹ Major recent contributions as well as helpful review articles of the most important work in this area were published in the March 1979 Monthly Labor Review.

² cf. comments by Robert J. Gordon and Richard Ruggles in “Inflation: Do We Count Quality as Part of the Cost,” by Art Pine, The Washington Post, Apr. 15, 1979, pp. F1 and F5.

³ John M. Blair, “Inflation in the United States,” in Gardiner C. Means, John M. Blair and Alfred E. Kahn, “The Roots of Inflation,” Burt Franklin & Co., Inc., New York, 1975, p. 34.

⁴ Interestingly enough, the Carter administration's guidelines program perversely recognized the special character of our current inflation by exempting the most inflationary components in whole or in part from the price standards. For this reason alone the program was destined to fail.

Because the recent onslaught of inflation has not been evenly distributed across all commodities and services, and because its major thrust has been concentrated on expenditure categories that are essential necessities in the household budget, its character has been especially pernicious. By definition, necessities are items of consumption for which near substitutes cannot be readily found and for which a reduction in the quantity consumed represents a net loss of "welfare" (in the sense that it cannot be compensated for by increased consumption of some other commodity or service). Because of this especially burdensome aspect, it is convenient to designate the experience of the 1970's as "the new inflation."

As illustrated by Charts 1-4, the disproportionately high inflation rates of the 1970's for food, energy, housing and health care followed a period when their prices were stable or falling vis-a-vis the Consumer Price Index as a whole. Moreover, the discrepancy between inflation in the necessities and in the remainder of the CPI has increased year by year. With 1967 as the base year, the necessities index in 1970 was only 3.5 percent higher than the non-necessities index. In 1977, on average, it was 21 percent higher. In 1978, the gap between the two was 26 percent. For the 12 months ended February 1979 the gap has continued to widen: necessities prices were increasing at an average annual rate (12.1 percent) nearly double that of non-necessities (6.6 percent).

Using the data published from the 1972-73 Consumer Expenditure Survey, (CES) as shown in Table 1, one can estimate that for 80 percent of our population, expenditures for food, energy, shelter and medical care account for a conservatively estimated 70 percent of the household consumption budget.⁴ The CES was carried out just prior to price explosion in the basic necessities. Given the subsequent acceleration in inflation in the necessities, it would not be surprising to find the proportions even higher today. Payment for the four necessities is predominately non-postponable; indeed roughly 30 percent of such payments are billed to households monthly by utility companies, insurance carriers, landlords and financial institutions. Food and gasoline of course are purchased weekly if not more frequently.

3. *The impact of the new inflation on households' budgets—The squeeze on family incomes across eighty percent of the income distribution.*—Of course it has long been recognized that the "poor" are hurt most by inflation and in the charitable tradition of most societies some partial protective devices such as food stamps, rent subsidies and Medicaid have been put in place in recognition of this need. (These programs, of course, pre-date the "new inflation" and were adopted as pure social welfare efforts.)

However, the impact of the "new inflation" reaches beyond the poor. Despite the popularization of the image of the "affluent worker," most workers' families are among the 80 percent of the population who are most vulnerable to the new inflation. At the time of the CES, as shown in Table 2, families in which the family head was a non-supervisory worker fell well below the top of the family income range within which expenditures on the four necessities constitute a major burden on the budget. For these people, the overwhelmingly major source of income is wages and salaries (see Table 3). Temporary layoffs or longer term unemployment shift the family further down the income scale, where necessities account for an even higher proportion of the consumption budget. Thus the burden of the "new inflation" extends far beyond the poor and low-income retirees—it bears heavily on the vast majority of the population. Indeed for most of the "working class" as they may be called, the "new inflation" is particularly burdensome, because, unlike the bottom 10 percent and those over 65, their income is generally sufficiently high to disqualify them from public subsidies such as food stamps, Medicare and Medicaid, or rent allowances that offer some partial protection. They differ from the top 20 percent of the income distribution in that their "portfolios" of income-producing assets are much less diverse. The protective devices of hedging, arbitrage, tax shelters, capital gains, superior interest rates paid on large denomination commercial paper, certificates of deposits, or government securities and self-determined professional fees are largely unavailable to them.

⁴L. E. Nulty, "Understanding the New Inflation," Washington, D.C. "Exploratory Project for Economic Alternatives, 1977." Expenditures for the four necessities range from over 40 percent of the consumption budget for families in the eighth decile to more than the entire consumption budget at the bottom of the income distribution (illustrating that families at the bottom of the income scale have to go into debt or fall behind in bill payments just to provide themselves with food, energy, housing and health care).

The widespread lack of understanding of just how vulnerable to the new inflation workers' families are, was recently illustrated dramatically by Alfred E. Kahn's remarks at the AFL-CIO "Price Watch" conference. An IAM representative had asked Dr. Kahn how one could explain to IAM members that their wages had to be held to 7-percent increase while prices were rising at double-digit rates and the Administration was pushing for decontrol of oil prices. Dr. Kahn replied that he had recommended against oil decontrol at this time, precisely because he was keenly aware of the burden imposed on family budgets. He went on to say that he supported some form of compensating relief from the effects of oil price decontrol for poor families, but not for families of IAM members (who presumably were well enough off not to merit relief). Under the most charitable assumptions one can only presume that Dr. Kahn was unaware that the average IAM member earns only around \$13,000-\$14,000 per year, if he or she is fortunate enough to work 40 hours a week for 52 weeks. In autumn 1978 it cost \$18,546, or 30-40 percent more than an average IAM member could expect to gross, for an urban family of four (including a non-working wife) to maintain a moderate standard of living, according to the estimates of the U.S. Bureau of Labor Statistics.

4. *Inflation's effect on the unemployment rate*—*The impact of increasing labor force participation rates*.—In this inflationary environment it is not surprising to find as we have, quite dramatic changes in labor force participation rates, which will tend to raise aggregate unemployment rates to the extent that new labor force entrant's demand for jobs is not satisfied. For more and more families one income is no longer sufficient to protect living standards. As the purchasing power of the wages of the traditional "head of household" is reduced by inflation in the necessities, more family members have to try their luck in the labor market in an attempt to maintain a constant standard of living.

Although considerable attention has been devoted to the impact of demographic changes on the apparent persistence of high unemployment rates in recent years (particularly the "teenage bubble"), a recent study indicates that since the late 1960's, the effect of higher labor force participation rates on the overall unemployment rate has increased steadily and dramatically, while in the past 2 or 3 years the impact of demographic factors has lessened.⁶ The basic thrust of these sorts of studies, however, is they leave one with the conclusion that if we can all just "sit tight" until the 1980's (when the post-war baby boom cohorts will have matured sufficiently to enjoy lower unemployment rates) demographic trends will accomplish a substantial reduction in unemployment that public policy has thus far failed to achieve. In fact, even if we could overlook the social and economic burdens imposed on the affected population in the intervening years, one cannot be so sanguine about the future.

For a wide variety of reasons, our economy's partial and incomplete accommodation to the demand for jobs by new labor force entrants (youth and married women) has taken the form of more part-time jobs and an increasing proportion of jobs offered at the bottom of the wage distribution, both in terms of occupation and industry.⁷ Non-agricultural workers on voluntary part-time schedules as a percent of total numbers employed has risen from 9.6 percent in 1957 to 14.5 percent in 1977. At the same time, the structure of employment has shifted, such that relatively lower-paid clerical and sales occupations in lower-paying service, financial and related industries account for a larger and larger proportion of employment. As shown in Tables 4 and 5, these trends have been extremely powerful and have persisted even through our current unprecedentedly long recovery. Manufacturing's share of total employment has fallen from 34.7 percent in 1948 to 23.7 percent in 1978. The share of employment in services rose over the same period from 11.5 to 18.6 percent. Similar trends are shown for employment in wholesale and retail trade and banking, insurance and finance. At the same time, the gap between average earnings in the latter sectors and in manufacturing has widened: average weekly earnings in trade fell from 76.8 percent of manufacturing earnings in 1948 to 61.5 percent in 1978. In bank-

⁶ See Paul O. Flaim, "The Effects of Demographic Changes on the Nation's Unemployment Rate," Monthly Labor Review, March 1979.

⁷ It cannot be argued that employers are merely responding to the preferences of job seekers. In 1977, 80 percent of all job seekers were looking for full-time jobs, including 2.5 million adult men (90 percent of all jobless adult men), 2 million adult women (80 percent of all jobless adult women) and nearly 1 million teenagers (60 percent of all jobless teenagers). Gloria P. Green, Richard M. Devens and Bob Whitmore, "Employment and Unemployment—Trends During 1977," Monthly Labor Review, February 1978.

ing, insurance and finance the percentage fell from 85.6 to 71.6 percent. As these earnings become less and less adequate in preserving real family income under persistent inflation, there will be continuous upward pressure on labor force participation rates. Even though the teenage "bubble" will eventually mature, this factor may be more than compensated for by further increases in the labor force participation rates of future teenage cohorts, not to mention increases in the rate for adult women.

This has certainly been the experience to date. As Table 6 illustrates, the decade of the 1960's was characterized by a dramatic decline in the labor force participation rates for youth aged 14-20. That trend was reversed in the early 1970's even for 14 and 15 year olds. Their labor force participation rates are now at the same level as at the end of World War II and the beginning of the 1950's.

Despite the effort to counteract the "new inflation" by adding more family workers, the vast majority of American families have continued to fall behind. As shown in Table 7, median family income in constant dollars has essentially been stagnant during the 1970's and in 1977 was below the levels achieved in 1972 and 1973. In fact these figures are pre-tax income, not take-home pay, and do not reflect the recent increases in payroll taxes or the push into higher tax brackets (let alone the effects of marginal tax rates on additional family earners' income). The most recent average weekly earnings figures for production and non-supervisory workers on non-agricultural payrolls show average pre-tax earnings in constant 1967 dollars for March 1979 to be at the lowest level since 1967. In the words of one member of the IAM, "The only trouble with sending your wife out to work is that the law only allows you one wife." Moreover, the \$16,000 median in 1977 was substantially below the \$17,106 the Bureau of Labor Statistics estimated it cost an urban family of four (with a non-working wife) to maintain a "moderate" standard of living (including tax liabilities) in autumn of that year.

5. *The failure of macroeconomic policy.*—By looking at the combined effects of inadequate employment opportunities and inflation in this manner, which reflects more accurately the way ordinary people experience them, one realizes that counter-inflation programs that focus on budget cuts, dampening wage increases, planned recession or attempts to curb the growth of the money supply by raising interest rates are inevitably going to miss the target. The appropriate target being, in this writer's opinion, the real living standards of the overwhelming majority of the population.

These conventional economic procedures were devised to deal with inflation that resulted either from the push of rising wage costs or the pull of excess demand, both phenomenon usually associated with a period of rising real incomes. Similarly, conventional "stimulus" policies, whether they take the form of deliberate increases in budget deficits (as opposed to "natural" deficits and surpluses created by the business cycle) or interest rate manipulations, were essentially devised to reverse economic trends during periods when both money incomes and prices were falling. They are designed to "inflate" the economy by calling forth additional output in response to additions to demand, implicitly assuming that the private business sector goal of enhanced income (profits) will be met more by increased volume than higher unit prices.

Attempting to use these conventional "tools of the trade" in an era when an increasing share of production is subject to administered prices, and when attempts to "inflate" the economy indiscriminately merely contribute to the decline in real incomes for the majority, is bound to be self-defeating.

If policymakers truly want to cut the Gordian Knot of stagflation, they must begin by rehabilitating the real incomes of the broad majority of the American people, and by altering the structure of supply in key sectors that critically determine real living standards. The issues involved for each of the four necessity sectors are sufficiently important and complex to warrant individual series of Joint Economic Committee hearings—and indeed the JEC can take credit for sponsoring much good work in many of these areas. Therefore, to keep the discussion manageable, this paper will merely summarize some of the relevant questions with respect to inflation in each of the four necessities, energy, food, housing and health care and use some policy options for the energy sector to illustrate what a positive "counter-stagflation" program might include.

6. *Inflationary biases in the structure of supply of the necessities.*—It seems as though every year since 1972 food inflation is "explained away" either by bad weather, acts of God, or acts of villainy on the part of foreign countries. Some-

how it strains the imagination to think that none of these kinds of "exogenous shocks" impinged on domestic food supply in the "golden years" of the 1950's and 1960's. The "exogenous shocks" argument also diverts our attention from longer-run problems that are nonetheless more amenable to change through public action. While recently food inflation has been sustained by increased farm price supports and supply curtailments supported by both Congress and the administration, there are deeper underlying reasons for persistent food price inflation. Among these the trend, since World War II, toward rapid growth in world demand stemming from rising incomes and population overseas; the increasing number of intermediary stages between consumption and production; and the growing influence of agribusiness corporations such as Beatrice Foods, Iowa Beef Processors, and Tenneco (many of them conglomerates and some virtually unknown ten years ago). The first two factors render food prices more vulnerable to short-run shocks such as climactic conditions or large foreign grain sales, like the famous sale to the Soviet Union in 1972. The third enables well-placed vertically integrated corporations to create and extract profits from both consumers and primary producers, not to mention industry employees.

Although the food sector has traditionally been viewed as a "low concentration" industry, several recent studies identify strong upward trends in monopoly-type practices at both the retail and food manufacturing levels which add an upward thrust to price trends, regardless of the state of demand or of raw food supplies.⁷

In housing, far and away the most inflationary components of the shelter price index have been financing, taxes and insurance costs. For these elements, attempts to use conventional policy to reduce inflation by curbing growth through higher interest rates translates directly into accelerated inflation. This occurs not only because of the flow-through effects on mortgage interest rates but because of the high degree of leveraging in the construction industry. Rising new home prices pull up the price of used homes. Inflated market values in turn generate rapid increases in property taxes for existing homeowners and push up rents. Absent public subsidies counteract these forces, builders and developers are pushed to build for the "upper end" of the market, raising the median new home price even further and accelerating the spiral. Although it would indeed be true that a simple new home price index would fail to capture such "quality improvements" (hence inflation would be to some slight degree "overstated") such "quality improvements" have the effect of completely pricing many potential buyers out of the market.

A similar "quality" argument is often put forward with respect to medical care, in which it is alleged that our relatively high cost system of health care delivery is merely a response to consumer demand, fueled as it is by the "sheltering" effects of third-party insurers that effectively insulate health care consumers from the real cost of their "choice" of treatment. This type of analysis is at best a misleading presentation of supply/demand relationships in health care. According to the 1972-73 CES, most average income households paid at least 50 percent of their medical care expenditures directly (insurance absorbed the remainder). Even Medicare and Medicaid typically cover only around 75-80 percent of treatment costs. Secondly, the choice of treatment is made by health care professionals, not by patients. Finally, to the extent that insurers offer better coverage for hospitalization, and little or no coverage for preventive care or paraprofessionals, the high-cost bias is determined by the carriers, not by "consumers". Finally, given the power interlocking directorates between hospital boards and regional hospital associations with medical supply manufacturers, drug firms, medical schools, etc. it is not surprising to find chronic over-investment and underutilization of plant and equipment.

Clearly, while inflation in each of the necessity sectors has its own special history and character, many common elements pervade them. If the common elements could be summed up in a few words they would be "relatively re-

⁷ Bruce Marion, et al., "The Profit and Price Performance of Leading Food Chains," a study prepared for the use of the Joint Economic Committee, Apr. 12, 1977.

Russell C. Parker, "The Status for Competition in the Food Manufacturing and Food Retailing Industries," "Political Economy of Food and Energy," Louis J. Junker ed., University of Michigan Press, Ann Arbor, forthcoming.

Russell C. Parker and John M. Connor, "Estimates of Consumer Loss due to Monopoly in the U.S. Food Manufacturing Industries," N.C. Project 117, "Studies of the Organization and Control of the U.S. Food System," University of Wisconsin, September 1978.

stricted choice on the demand side; concentration of economic power on the supply side." A close look at the energy sector shows that these are not intractable problems—public policy can make a significant contribution to dispelling stagflation through well-designed sectoral initiatives.

7. Energy as a case study—Breaking stagflation through changes in the structure of supply and demand.—In the year of the Consumer Expenditure Survey, 1972–73, energy expenditures averaged over 14 percent of the consumption budgets of households below the top 20 percent of the income distribution (and this figure excludes energy, especially gasoline, consumed for recreational purposes). Since that time energy prices in the Consumer Price Index have increased 93 percent.

In 1975, in testimony before the JEC Subcommittee on Consumer Economics, Charles Schultze pointed out that recent energy price increases had had powerful income re-distribution effects that were related to the massive recession suffered by the economy at that time:

"The sudden run-up in oil prices drained some \$35 billion in purchasing power from America's consumers. As a consequence they had that much less to spend on buying other goods and services. The proceeds of this 'oil excise tax' went principally to OPEC countries and the domestic oil companies."⁸

The current proposal for oil decontrol entails an immediate and direct transfer of \$17 billion between the effective date of the legislation and October, 1981, from American consumers to domestic energy companies, for oil already discovered.

Thus, the principal difference between then and now is that the income distribution that was then lamentable is now explicitly enshrined in public policy. The transfer of real income referred to by Schultze is now seen as desirable, indeed the lynchpin of energy policy. Decontrol of natural gas prices last year and the supposedly inevitable decontrol of oil prices in this and ensuing years, bear witness to a decision that an acceleration of energy price inflation is seen to be a desirable objective. With energy inflation disproportionately high even during a period of partial government price control, other objectives, principally domestic self-sufficiency and supply expansion, are now offered as justification for neglecting the income distribution consequences. The only problem with these is that they fly in the face of recent experience.

As indicated above, the \$17 billion in additional energy company revenues produced by decontrol can in no way be regarded as an incentive. It is a pure windfall: the oil has already been discovered. Moreover, the Congressional Budget Office estimate of decontrol's effect on domestic supply is a mere 2 to 2½ percent increase (400,000 to 500,000 barrels a day) over what would be available under a continuation of existing oil price policy. The Department of Energy itself concurs with the CBO assessment that most of the projected additions to supply will be the result of oil being pumped out of the ground a little sooner than otherwise, not of more oil being discovered. Moreover, a study done for the Department of Energy by ICF, Inc., concluded that decontrol of domestic oil may actually deter oil companies from discovering new reserves as they seek to maximize profits by drilling in known reservoirs.⁹

Between 1972 and 1978, while the CPI for energy rose 93 percent, and combined after-tax profits for the top 15 energy companies rose 123.7 percent,¹⁰ domestic production of fossil fuels fell from 5,934 to 5,499 quadrillion BTUs, despite a significant increase in the total number of oil and gas wells drilled and in the percentage of successful wells. Over the same period of time, not only has the import share of domestic consumption increased from 16 to 24.2 percent, the proportion contributed by all of OPEC has risen from 43.5 percent of all imports of petroleum to 68.5 percent, while the share of all imports contributed by Arab members of OPEC has risen from 10.2 to 35.6 percent.¹⁰

⁸ Statement before Joint Economic Committee, Subcommittee on Consumer Economics, hearings on the economic impact of forthcoming OPEC price rise and "old oil decontrol," July 10 and 14, 1975, pp. 65.

⁹ ICF Inc., "Capital Resources and Requirements for the Petroleum Industry under the National Energy Plan," study for the U.S. Department of Energy (contract No. EJ-78-C-01-2835), January 1979.

¹⁰ Combined net-income (profits after tax) of Exxon, Mobil, Texaco, Standard Oil of California, Gulf, Standard Oil of Indiana, Atlantic Richfield, Shell, Continental Oil, Tenneco, Sun Oil, Phillips, Occidental, Union Oil, and Standard Oil of Ohio as reported in *Fortune* magazine.

¹⁰ U.S. Department of Energy, "Annual Report to Congress, 1978," vol. 2, tables 1, 13, and 18.

These trends are most plausibly explained by the multi-national, multi-resource character of domestic energy corporations and their links to OPEC governments and each other. They are extremely well positioned to determine not only the fuel composition of our domestic energy supply, (with profit maximization being the guiding objective, but relative import/domestic shares as well. While minimizing supply costs to themselves, their extensive vertical integration permits widening margins between production or acquisition costs and final sales (note the dramatic disappearance, since the early 1970's of independent and franchised gas stations and the recent increase in directly-owned self-service pumping stations).

With oil price decontrol looming as the one remaining vestige of what was once called a national energy policy, it is appropriate to ask whether the economic and social costs of sustaining this kind of market power, in a sector as critical as energy, is worth the highly speculative "benefits". It is even more appropriate to ask whether there might not be other ways to achieve the same objectives more efficiently, more equitably and with greater confidence in their probable success.

There are many such paths that could be followed. To begin with, it seems apt to take a leaf from the corporate book and begin thinking about minimizing risk through diversification. From the perspective of the ordinary American family, what is needed is an increased range of choice with respect to the manner in which energy is consumed. Like other major undertakings, this objective is not likely to be accomplished without public subsidy in its early years.

Large corporations, either through retained earnings or through their advantageous position in the financial system, are able to subsidize their own diversification programs. Moreover, many of the largest corporations also continue to reap benefits from the subsidy provided by federal research and development contracts, not to mention actual production contracts. A recent study analyzing the use of government subsidies to promote various forms of energy found that of the approximately \$217 billion spent over the last 30 years (including tax expenditures), roughly 47 percent or \$101.3 billion went to the petroleum industry, 8.3 percent or \$18 billion went to nuclear, 7 percent (\$15.3 billion) or 3.7 percent (\$8 billion), depending on estimating methodology, went to hydroelectric power (most of which remains publicly owned), 4.5 percent or \$9.7 billion to coal, 7.6 percent or \$16.5 billion to natural gas (much of which redounds to the benefit of the same corporations that enjoy the petroleum subsidies), and 26 percent or \$56.6 billion to electricity generation and transmission. Over the time period studied, incentives for various forms of solar power were negligible.¹² In the current federal budget solar development continues to be dwarfed by allocations for high-risk, capital-intensive undertakings, especially the nuclear program.

Although Congress has enacted tax credits to promote uses of solar energy, insulation, and other conservation retrofitting measures, tax credits benefit only those who have the financial means to make the often substantial "up front" lump sum outlays. It effectively restricts the access of the vast majority of households caught in the squeeze of stagnant or falling incomes. By restricting access, it limits the size of the market thereby inhibiting development of economies of scale, more efficient techniques, and ultimately falling costs. Clearly more direct, "up front" subsidies are required.

One route is outright grants to households for purchase of existing technology. However, to accelerate major technological breakthroughs, such as commercialization of photovoltaic apparatus and other renewable energy sources, larger scale support appears to be necessary.

As a renewable resource amenable to decentralized distribution, solar energy development in all its forms should rank near the top of our energy outlays. Moreover, as described in a report recently issued by the JEC's Subcommittee on Energy and Special Study on Economic Change, solar development has a powerful job-creating potential.¹³ Thus, it should be a major component of national policy to overcome stagflation, as well as more narrowly defined energy policy. Yet, solar development continues to play a minor role in national energy policy.

¹² A study prepared for the Division of Conservation and Solar Applications, U.S. Department of Energy, "Analysis of Federal Incentives used to Stimulate Energy Production," B. W. Cone, et al., Pacific Northwest Laboratory, Richland, Wash., December 1978.

¹³ "Employment Impact of the Solar Transition" by Leonard S. Rodberg, a study prepared for the use of the Subcommittee on Energy of the Joint Economic Committee, Apr. 6, 1979.

Public policy for promoting conservation in transportation use of energy is at present anchored in oil price decontrol. Yet raising the cost of private transportation will merely make it even harder for average-income families to afford essential transportation; they will simply have to give up something else. Data collected for the Ford Foundation Energy Policy Project indicate that middle and lower-income households with cars already log fewer miles and own more fuel-efficient cars on average than "well-off" households.¹³ If, as this evidence suggests, middle and lower-income households do relatively little "luxury" driving, policies that use higher prices to "induce" efficiency in automobile use will squeeze real living standards for a major part of our population even harder without reducing consumption. There simply is not very much that people can do to change the distance they must travel between home and work or shopping, or about the availability and relative cost of public transportation over those distances.

Thus, if transportation policy is going to be one component of energy policy, and if policy is to concern itself with protecting real living standards, in the face of oil price decontrol, gasoline price escalation must be offset by a vigorous program to expand and improve public transportation, and some form of gasoline voucher/"white market" scheme to assure universal access to a basic amount of gasoline, in recognition of the fact that efficient public transportation systems that provide an adequate level of service are simply not available to the majority of our population.

The extent to which administered prices can be made to stick depends a great deal on the elasticity of demand, which in turn is in part determined by the availability of substitutes. Public transit and solar development are examples of two relatively job-intensive undertakings that potentially should exert some discipline on energy price inflation by increasing the degree of substitutability among forms of energy consumption, thereby increasing the elasticity of demand for fossil fuels. However, depending on the scale of public commitment, both these undertakings may entail very long lags before they reach a scale sufficient to have a significant impact at the level of the overall national economy. In the interim it will be important to introduce some kind of countervailing power on the supply side to curb the cost-push effects of energy inflation on all other sectors of our energy-intensive economy.

Substantial shares of the reserves of all fossil fuels are located on Federal lands. In relinquishing control of the pace, timing and product mix of exploration, production and sale of these resources by essentially handing those decisions over to the energy corporations as has been the case up to now, the Federal Government has actually abrogated its own sovereignty. A Federal Fuels Corporation (FFC) is needed to make the critical decisions over the disposition of these increasingly priceless resources in the broad public interest. Creation of an FFC would not entail nationalization of any existing firms since the resources to be managed are already in the public domain. In addition to its resource management capability, such a body would also be well positioned, through its control over critical supplies, to intervene in the market, in a manner analogous to buffer stock operations in food supply, (with which we already have considerable experience), to break up administered price power in the energy sector.

Such an institution would also have another extremely potent capability: that of incorporating a domestic policy element into the foreign trade component of domestic energy supply. A Federal Fuels Corporation would be able to negotiate bilateral barter agreements with technology-hungry less developed countries (such as Mexico) that will soon be in a position to play major roles in contributing toward world petroleum supplies. In such a manner oil imports could be increased without adding to the overseas dollars surplus which continues to exacerbate the balance of payments problem, in turn raising the cost of all imports. Some preliminary work on the details and potential benefits of such a scheme are already under way at the Congressional Budget Office.

These examples from the energy sector are intended to illustrate that indeed we are not without good answers, as long as we get the questions right.

Unfortunately, if recent economic policy is any guide to the future, one may anticipate protracted if not accelerated excessive inflation rates in the necessi-

¹³ Cited in "President Carter's Energy Proposals: A Perspective," Congressional Budget Office staff working paper, June 1977, table X-2, p. 119.

ties, hence perpetuation of stagflation. This is not merely because of the long-term and difficult nature of the policies needed. This prognosis is made because up to now, at virtually every opportunity where a price—or supply-sensitive policy choice has presented itself, the option chosen for the necessity sectors has been inflation promoting rather than inflation abating. Part of this may be attributable to the selectivity with which the inflation issue has been used—that is principally to justify the retreat of government and to forestall improvements in occupational health and safety and environmental rehabilitation—all of which are part and parcel of enhanced living standards for our population.

Public policymakers have to make choices. If they continue to work for “them” and against “us” stagflation will indeed be with “us” for many years to come.

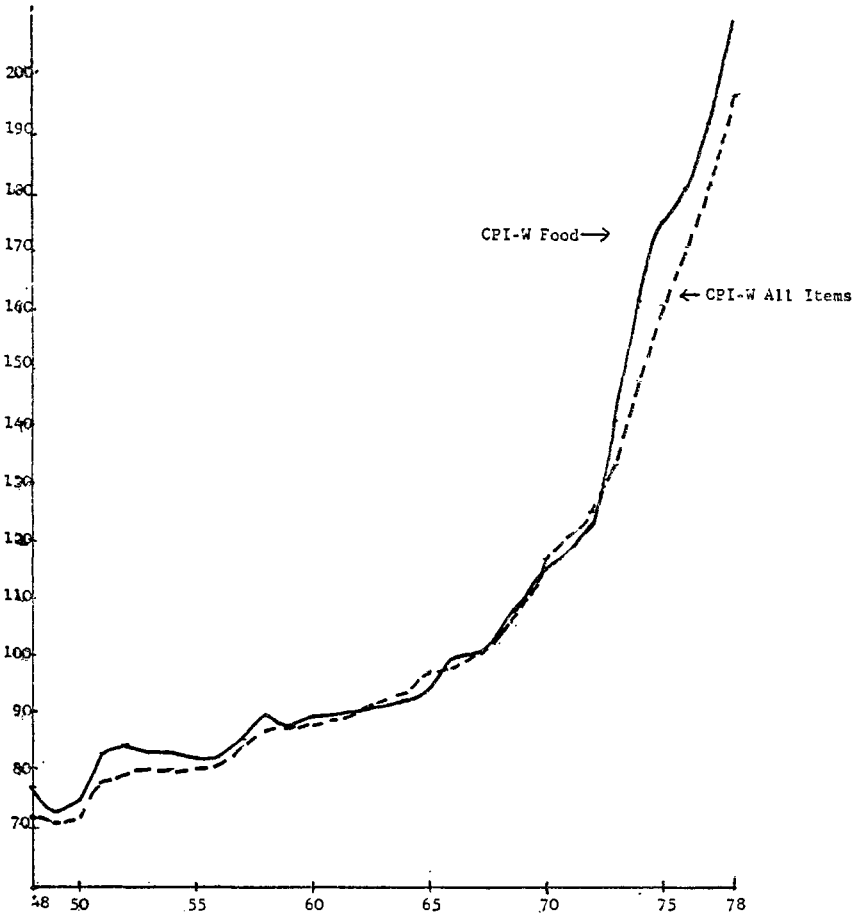


CHART 1.— *Consumer Price Index for urban wage earners and clerical workers (1967=100) comparison of all items and food 1948-78*

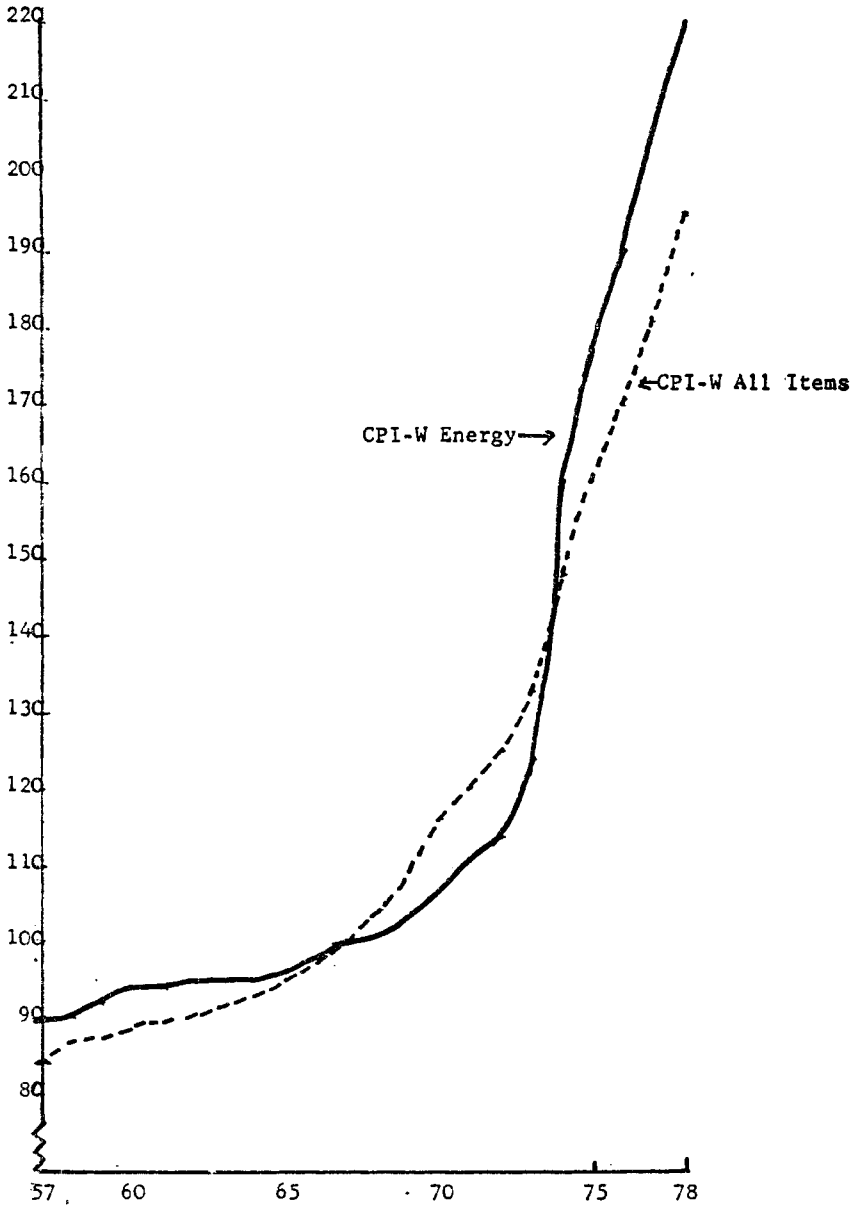


CHART 2.—Consumer Price Index for urban wage earners and clerical worker (1967=100) comparison of all items and energy 1957-78

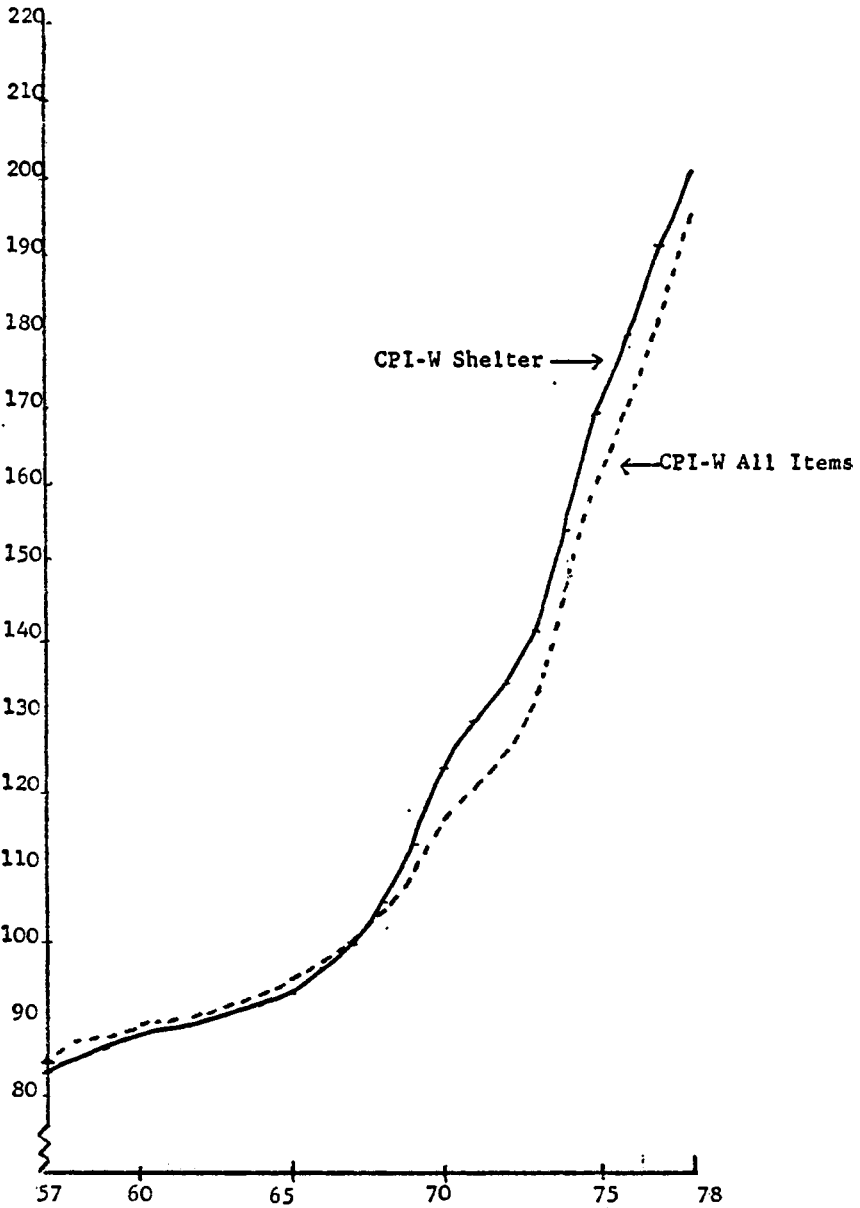


CHART 8.—Consumer Price Index for urban wage earners and clerical workers (1967=100) comparison of all items and shelter 1957-78

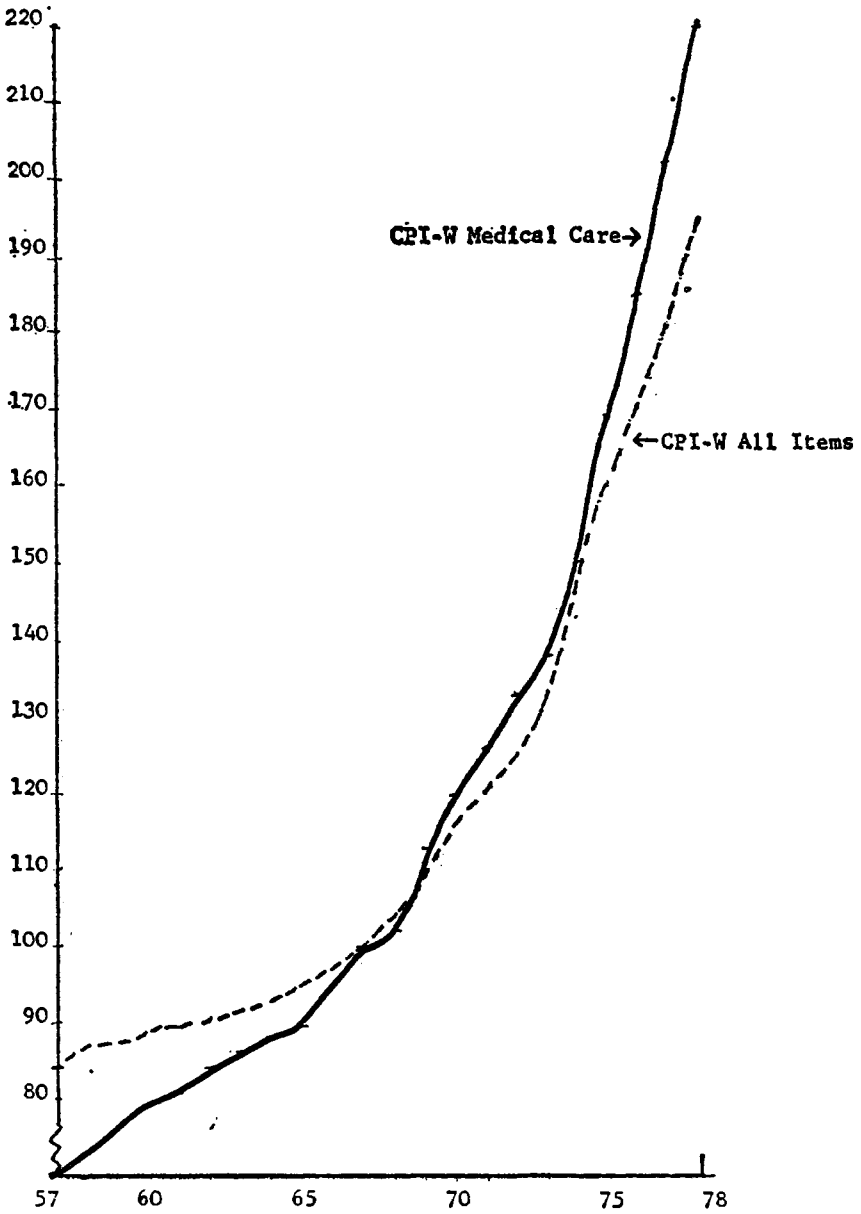


CHART 4.—Consumer Price Index for urban wage earners and clerical workers (1967=100) comparison of all items and medical care 1957-78

TABLE 1.—EXPENDITURES ON BASIC NECESSITIES BY FAMILY INCOME DECILES 1972-73 (COMPLETE REPORTING)

	Bottom 10 percent	2d 10 percent	3d 10 percent	4th 10 percent	5th 10 percent	6th 10 percent	7th 10 percent	8th 10 percent	9th 10 percent	Top 10 percent	Average shares 1st-8th deciles
Average family income before taxes.....	\$1,559	\$3,268	\$5,081	\$7,063	\$9,112	\$11,244	\$13,466	\$16,116	\$19,747	\$31,974	-----
Less: Personal income taxes.....	(1)	(1)	487	778	1,120	1,495	1,916	2,437	3,178	6,219	-----
Income after taxes.....	1,559	3,268	4,594	6,285	7,992	9,749	11,550	13,679	16,569	25,755	-----
Less: Pensions and insurance.....	108	165	262	396	586	770	948	1,139	1,408	1,955	-----
Less: Gifts and contributions.....	176	213	276	345	377	403	461	568	677	1,524	-----
Amounts available for consumption.....	1,275	2,890	4,056	5,544	7,029	8,576	10,141	11,972	14,484	22,276	-----
Expenditures on:											
Food.....	666	967	1,169	1,334	1,534	1,690	1,941	2,170	2,405	2,905	-----
As percent consumption.....	(52.2)	(33.5)	(28.8)	(24.1)	(21.8)	(19.7)	(19.1)	(18.1)	(16.6)	(13.0)	27.2
Energy.....	466	478	580	635	700	748	882	932	1,015	1,135	-----
As percent consumption.....	(36.5)	(16.5)	(14.3)	(11.5)	(10.0)	(8.7)	(8.7)	(7.8)	(7.0)	(5.1)	14.3
Shelter.....	728	889	972	1,075	1,246	1,260	1,409	1,516	1,712	2,251	-----
As percent consumption.....	(57.1)	(29.7)	(24.0)	(19.9)	(17.7)	(14.7)	(13.9)	(12.7)	(11.8)	(10.1)	23.7
Medical care.....	213	304	395	452	506	550	590	634	739	889	-----
As percent consumption.....	(16.7)	(10.5)	(9.7)	(8.2)	(7.2)	(6.4)	(5.8)	(5.3)	(5.1)	(4.0)	8.7
Total expenditures on necessities.....	2,073	2,638	3,116	3,496	3,986	4,248	4,754	5,252	5,871	7,180	-----
As percent consumption.....	(162.6)	(91.3)	(76.8)	(63.1)	(56.7)	(49.5)	(47.5)	(43.9)	(40.5)	(32.2)	73.9

¹ Shown for personal income taxes for the bottom and 2d deciles indicates that less than half the families reported paying income taxes.

Sources: With the exception of expenditures for medical care, all data are taken from the Bureau of Labor Statistics, Consumer Expenditure Survey Series: Interview Survey, 1972-73, vol. 1, Bulletin 1977, 1978. Medical care expenditures in that volume excluded expenditures on nonprescription drugs and other medical aids. This data were taken from the Integrated Diary and Interview Survey data,

Bulletin 1992. Expenditures for food, shelter and energy exclude recreational or vacation expenditures. Energy expenditures include fuel oil, coal, bottled gas, gas and electricity delivered by utilities, gasoline and lubricants. All items reflect actual expenditures made by families purchasing the particular item. Thus, for example, expenditures on gasoline are not averaged over the entire sample as is the case in the published expenditure figures, but are adjusted for the proportion of the sample actually purchasing that item.

TABLE 2.—OCCUPATION OF FAMILY HEAD AND AVERAGE FAMILY INCOME, JULY 1973 THROUGH JUNE 1974

Occupation of family head	Number of families reporting	Percent of total reporting	Average family income before taxes	Nearest decile equivalent
Craftsmen and operatives.....	17,917	27.7	\$12,361	6-7
Clerical and sales workers.....	7,709	11.9	11,213	6
Laborers and service workers.....	8,576	13.3	8,580	4-5
Retirees.....	10,228	15.8	5,523	3
Self-employed.....	3,675	5.7	13,584	7
Armed forces personnel.....	704	1.1	11,785	6
Professionals and managers.....	15,772	24.4	17,754	8-9
All families reporting.....	64,582	100.0	11,419	6

Source: Bureau of Labor Statistics, Consumer Expenditure Survey, Integrated Diary and Interview Survey data, 1972-73, Bulletin 1992, tables 6 and 7.

TABLE 3.—SOURCES OF INCOME—ALL URBAN AND RURAL FAMILIES AND SINGLE CONSUMERS, FAMILY INCOME BEFORE TAXES—COMPLETE REPORTING OF INCOME

	Total (complete reporting)	Lowest 10 percent	2d 10 percent	3d 10 percent	4th 10 percent	5th 10 percent	6th 10 percent	7th 10 percent	8th 10 percent	9th 10 percent	Highest 10 percent
Percentage shares of total money income:											
Wages and salaries, total (percent).....	74.9	21.0	28.6	46.1	63.2	73.0	80.4	82.9	84.9	86.4	72.6
Self-employment income, total.....	7.6	1.1	3.6	5.0	5.7	5.8	5.3	5.0	4.9	4.4	14.7
Social security and railroad retirement.....	4.9	45.5	36.0	22.9	11.3	6.3	3.6	2.4	1.8	1.0	.9
Government retirement, veteran's payments, and unemployment compensation.....	2.5	4.7	5.9	5.6	4.7	4.0	2.4	2.3	1.7	1.9	1.4
Estates, trusts, dividends, rental income royalties, income from roomers and boarders, total.....	4.6	4.7	6.5	6.7	6.4	4.7	3.3	2.8	2.9	2.9	7.0
Income from all other sources, total (welfare and public assistance, private pensions, regular contributions for support, other income, includ- ing workers' compensation).....	5.2	22.7	19.1	13.5	9.5	6.1	4.7	4.3	3.6	3.1	3.2

Source: Bureau of Labor Statistics, Consumer Expenditure Survey, Integrated Diary and Interview Survey data 1972-73, Bulletin 1992, table 6.

TABLE 4.—PERCENT SHARE OF EMPLOYEES ON NONAGRICULTURAL PAYROLLS

	Manufacturing	Wholesale and retail trade	Finance, insurance, real estate	Services
1948.....	34.7	20.7	4.0	11.5
1950.....	33.7	20.8	4.2	11.9
1955.....	33.3	20.8	4.5	12.3
1960.....	31.0	21.0	4.9	13.6
1965.....	29.7	20.9	4.9	14.9
1970.....	27.3	21.2	5.1	16.3
1975.....	23.8	22.2	5.4	18.1
1976.....	23.9	22.4	5.4	18.3
1977.....	23.4	22.5	5.4	18.5
1978.....	23.7	22.6	5.5	18.6

Source: BLS, Employment and Earnings, March 1979, and Handbook of Labor Statistics, 1970.

TABLE 5.—PRODUCTION OR NONSUPERVISORY EMPLOYEES AVERAGE WEEKLY EARNINGS AS PERCENT AVERAGE WEEKLY EARNINGS IN MANUFACTURING

	Wholesale and retail trade	Finance, insurance, real estate	Services
1948.....	76.8	85.6	¹ NA
1950.....	76.4	86.6	NA
1955.....	72.9	84.4	NA
1960.....	73.6	83.7	NA
1965.....	71.5	82.7	68.4
1970.....	72.0	84.5	72.5
1975.....	66.3	77.7	70.6
1976.....	63.9	74.3	68.6
1977.....	62.3	72.2	67.0
1978.....	61.5	71.6	65.7

¹ Not available.

Source: BLS, Employment and Earnings, March 1979, and Handbook of Labor Statistics, 1970.

TABLE 6.—CIVILIAN LABOR FORCE PARTICIPATION RATES FOR PERSONS 16 YR AND OVER, BY RACE, SEX, AND AGE: ANNUAL AVERAGES, 1948-77

[In thousands]

Item	Total, 16 yr and over	16 and 17 yr	18 and 19 yr	20 to 24 yr	25 to 34 yr	35 to 44 yr	45 to 54 yr	55 to 64 yr	65 yr and over	14 and 15 yr
All workers:										
1948.....	58.8	41.7	63.4	64.1	63.1	66.7	65.1	56.9	27.0	20.0
1949.....	58.9	41.2	63.3	64.9	63.1	67.2	65.3	56.2	27.3	19.7
1950.....	59.2	40.7	62.9	65.9	63.5	67.5	66.4	56.7	26.7	20.8
1951.....	59.3	42.5	62.6	64.8	64.2	67.6	67.2	56.9	25.8	20.9
1952.....	59.0	42.7	61.2	62.2	64.7	68.0	67.5	57.5	24.8	18.6
1953.....	58.9	40.7	60.9	61.2	64.0	68.9	68.1	58.0	24.8	17.8
1954.....	58.8	37.9	60.0	61.6	64.3	68.8	68.4	58.7	23.9	14.5
1955.....	59.3	38.5	60.7	62.7	64.8	68.9	69.7	59.5	24.1	14.0
1956.....	60.0	41.9	61.2	64.1	64.8	69.5	70.5	60.8	24.3	16.1
1957.....	59.6	40.2	60.4	64.0	64.9	69.5	70.9	60.1	22.9	18.9
1958.....	59.5	37.3	59.4	64.4	65.0	69.6	71.5	60.5	21.8	18.1
1959.....	59.3	36.9	58.9	64.3	65.0	69.5	71.9	61.0	21.1	18.7
1960.....	59.4	37.6	50.5	65.2	65.4	69.4	72.1	60.9	20.8	17.5
1961.....	59.3	36.3	58.4	65.7	65.6	69.5	72.1	61.5	20.1	17.6
1962.....	58.8	34.9	58.2	65.3	65.2	69.7	72.2	61.5	19.0	16.5
1963.....	58.7	34.4	58.5	65.2	65.6	70.1	72.5	62.0	17.9	16.4
1964.....	58.7	35.1	57.2	66.3	65.8	70.0	72.9	62.0	18.0	16.5
1965.....	58.9	35.8	57.1	66.4	66.4	70.7	72.5	61.9	17.8	16.8
1966.....	59.2	38.5	58.3	66.5	67.1	71.0	72.7	62.2	17.2	17.6
1967.....	59.6	39.0	58.4	67.1	68.2	71.6	72.7	62.3	17.2	18.5
1968.....	59.6	39.1	58.5	67.0	68.6	72.0	72.8	62.2	17.2	18.5
1969.....	60.1	40.5	59.3	68.2	69.1	72.5	73.4	62.1	17.3	18.5
1970.....	60.4	41.0	59.9	69.2	70.0	73.1	73.5	61.8	17.0	19.2
1971.....	60.2	40.7	59.6	69.3	69.3	73.2	73.3	61.4	16.3	19.3
1972.....	60.4	42.3	62.4	70.7	70.8	73.3	72.7	60.1	15.6	19.4
1973.....	60.8	44.6	63.6	72.6	72.2	73.9	72.5	58.5	14.6	20.0
1974.....	61.2	45.5	64.9	74.0	73.4	74.6	72.7	58.0	14.1	20.2
1975.....	61.2	44.4	64.2	73.9	74.3	75.0	72.6	57.4	13.8	19.2
1976.....	61.6	44.6	64.8	74.7	75.6	75.9	72.6	56.8	13.2	18.9
1977.....	62.3	46.3	66.3	75.7	76.9	76.9	72.8	56.6	13.1	20.9

Source: Employment and Training Report of the President, 1978, table A-4, p. 186.

TABLE 7.—MEDIAN FAMILY INCOME IN 1970 TO 1977 IN CURRENT AND CONSTANT DOLLARS, AND PERCENT CHANGE

Year	Median income	
	In current dollars	In 1977 dollars
1977.....	\$16,009	\$16,009
1976.....	14,958	15,923
1975.....	13,719	15,447
1974 ¹	12,902	15,855
1974.....	12,836	15,773
1973.....	12,051	16,433
1972.....	11,116	16,102
1971.....	10,285	15,389
1970.....	9,867	15,399
Percent change:		
1977-76.....	7.0	0.5
1976-75.....	9.0	3.1
1975-74 ¹	6.3	-2.6
1974-73.....	6.5	-4.0
1973-72.....	8.4	2.1
1972-71.....	8.1	4.6
1971-70.....	4.2	-.1

¹ Based on revised methodology.

² Significant at the 95-percent confidence level.

Source: Money Income and Poverty Status of Families and Persons in the United States: 1977 (Advance Report), U.S. Bureau of the Census, Current Population Reports, Series P-60, No. 116, July 1978.

Representative BOLLING. Our next witness is Beryl W. Sprinkel, executive vice president and economist, with the Harris Trust & Savings Bank, and in that position for more than 25 years. He heads the economics research office and is a member of the bank's investment guidance trust investment and asset liability management committees, member of Time magazine's board of economists, served as chairman of the Economic Advisory Committee of the American Banker's Association, also served as consultant to various Government agencies and congressional committees.

In addition to his Ph. D. from the University of Chicago, he has a CFA from the Institute of Chartered Financial Analysts.

Mr. Sprinkel.

STATEMENT OF BERYL W. SPRINKEL, EXECUTIVE VICE PRESIDENT AND ECONOMIST, HARRIS TRUST & SAVINGS BANK, CHICAGO, ILL.

Mr. SPRINKEL. Thank you, Mr. Vice Chairman. I am pleased to have the opportunity to testify at this committee's important hearings concerning the adequacy of policies for dealing with stagflation—that is, high inflation and slow real growth.

My basic conclusion is that policies in recent years have directly promoted high inflation and slow growth and were clearly inappropriate for achieving economic stability. Monetary-fiscal policies fostered excess demand which resulted in high and escalating inflation, while tax policies encouraged consumption and Federal spending while discouraging private savings and investment.

In addition, aggressive regulatory and environmental controls also inhibited growth.

Finally, the present "voluntary" wage and price guidelines tilt with symptoms and promise to reduce further the efficiency of our market system, thereby contributing to stagflation.

Inflation per se has always resulted from too much money creation relative to the output of goods and services. This is nothing new. It has been true of all countries I have observed. It is certainly true for the United States.

A chart in my prepared statement indicates that the faster the rate of growth in money per unit of real output, the higher the rate of inflation. We have had very high rates of monetary growth for many years, and we are getting our just deserts, unfortunately, on the inflation front.

There is perhaps one difference—namely, that since the spring of 1975, as a result of congressional initiative, the Federal Reserve has stated that its objective was to slow gradually the rate of growth in the money supply until eventually it grew at a pace in line with economic growth. But that hasn't happened. Monetary growth has accelerated. Inflation has accelerated. And the question is why?

Certainly, large and frequently growing deficits contributed to the problem. The Federal Reserve must be concerned that the Federal Government have sufficient funds to finance the deficit. Consequently, there is fairly constant pressure on them to increase the money supply.

The large deficits have not only encouraged more money creation, but they have also absorbed private savings which reduced the funds available for the private sector of the economy.

Second, there has clearly been a temptation on the part of policymakers to enjoy the short-run benefits of stimulative policies while either denying or disbelieving the ultimate price to be paid on the inflation front.

For example, during this administration in the first 22 months of office, there were constant pressures by the administration, criticism of the Federal Reserve policies, that it was too tight even though the money supply was soaring. This undoubtedly added to money creation.

Third, during this same period and for a long time, the Federal Reserve has chosen a technique of executing monetary policy which in my judgment tends to add to monetary growth. The Fed focuses primarily on the Federal funds rate and other short-term rates. During a period of expanding business and a period of accelerating inflation, interest rates tend to go up.

The Fed attempts to prevent the Fed funds rate from rising and in the process add to Government purchase of securities and bank reserves. Consequently, the money supply rises for those reasons.

There has been significant improvement in employment during this economic expansion. Yet, unemployment remains high by many measures, certainly well above the long-term objective of 4 percent. It is my judgment that stimulative demand policies cannot permanently reduce the rate of unemployment. Inflation expectations inevitably get in the way.

If we have stable expectation as to the rate of inflation, an increase in demand in the short-run, we will indeed reduce the unemployment rate and raise the rate of employment. However, once the marketplace recognizes that inflation is accelerating—not stable—then, of course, we move back to the prior natural rate of unemployment.

In my judgment, an attempt to reduce continuously the unemployment rate by gradually and continuously increasing the stimulus has the effect of producing runaway inflation, not a permanent reduction in unemployment.

Furthermore, unemployment that exists today and typically exists, is pocketed unemployment to a considerable extent. The Congress unfortunately passed a very high minimum wage, \$2.90 currently. This has a very severe impact on new entrants to the labor force, young people, teenaged blacks, for example, who presently have 33½-percent unemployment which I personally think is a national disgrace.

At the same time, we have had increasingly liberal unemployment and welfare benefit payments which make it less desirable to search for work. Many of those individuals find they are better off not working than working. And consequently, they end up on the unemployed rolls.

Growth is slow. The major reason for the slowdown in real growth has been slow improvement in productivity.

In my prepared statement I present some data over the last few years. And I conclude that productivity improvement has declined from the 2- or 2½-percent rate which seemed to be characteristic of our economy some years ago down to somewhere between zero and one-half of 1 percent.

That means that with any given level of demand, we get about 2 percent more inflation than we used to believe was the case. It is not a surprise that productivity has deteriorated. Productivity growth has deteriorated. So has capital formation.

I present data in my prepared statement which are well known, concerning "Growth in the Nonfarm Capital Stock Per Hour Worked." And it has declined from 2½ percent in the decade ending in 1965 down to approximately zero recently.

Furthermore, the United States saves a smaller percentage of its total income than do other developed nations, and capital investment as a percentage of total GNP for the decade is the lowest of developed countries.

In addition, regulatory activities have risen very rapidly in recent years from 1970 to 1979. Federal expenditures on regulatory efforts for business were up 568 percent to about \$5.75 billion.

Murray Weidenbaum, St. Louis, has estimated business must spend about \$100 billion a year in fiscal 1979 in compliance with Federal regulations. These regulations may have helped achieve social objectives; they certainly reduce the capacity of this economy for growth.

Our tax system is a highly efficient revenue generator, but unfortunately, it penalizes savings and investment while encouraging Government spending and consumption. As the inflation comes along, we all move into higher marginal tax rates, corporations report income which is not real income, on which they must pay tax.

Consequently, this is a drag upon the savings investment process.

I present a chart in my prepared statement showing that the higher the effective corporate tax rate on earnings, the lower the trend in our productivity improvement. This is especially true during the periods of high inflation which have characterized the last decade.

Obviously, an indexing of the tax system or elimination of inflation would help on that front. Unfortunately, we have the worst of worlds. We are promised price stability, yet we continue to get accelerating inflation and a system that continues to increase the penalty on savings and investment.

How do we get out of this mess? I agree, Mr. Vice Chairman, there are no quick fixes. Patience and proper policy over several years are needed to extricate ourselves from high inflation and slow growth.

The GNP-gap analysis, which has been widely used, in my opinion is almost certain to result in go-stop policies which have been characteristic of the past 15 years or so. And we must get out of the go-stop syndrome if we are going to correct our basic problems.

If we have a recession this year, as I suspect will occur, I would hope that the Congress, the Federal Reserve, and the administration will respond in a moderate, not in a massive way. The real objective so far as money supply is concerned should be to reduce gradually the rate of growth in the money supply until, eventually, it does grow at the same pace as the growth in our real economy. And instead of moving in the opposite direction that has been characteristic of most recent years, lower deficits are critical.

This means restraint on Government spending. It might even suggest a cut in Government spending. Certainly, growth in Government spending below the growth in the total economy is critical.

We must all recognize the lags in the economic process. If we insist on getting the short-run benefits of stimulus, we will end up with massive inflation later.

I would hope that the Federal Open Market Committee could move from concentration on the Federal funds rate to a concentration on overall growth in the monetary base.

We must tilt the tax system if we want to get out of the slow-growth syndrome, toward encouraging savings and investment and less Government spending and consumption.

There is a cost to be paid. That is, we can't live it up as highly as we have in the past. And we must limit Government spending. But the benefits will be greater economic growth, more jobs, and higher standards of living.

There are many things that can be done, and I list several in my paper, including indexing taxes, restraining Government spending, lower corporate tax rates, reduced progressivity of personal income tax so greater savings and savings investment occur, higher depreciation allowances, further reduction in the capital gains tax, elimination of double taxation of dividends, reduced taxation of savings and investment, moving toward a value-added tax system, and elimination of Reg Q, which I think places a very severe penalty on small savers.

We, as bankers, savings and loans associations, and mutual savings banks are unable to pay a decent rate to people who want to save money with us, I think this legal restraint should be eliminated, and I am very pleased to see a discussion taken up by other groups recently.

We must slow down the growth in Government regulation and make sure that the costs incurred actually have some relation to the benefits that are to be achieved.

In summary, we can whip stagflation if we are willing to change our present policy thrust. The costs will be high, but the benefits greater. Unless we are willing to change our profligate ways, inflation may threaten the very fabric of our democratic capitalistic system to the immense detriment of all our citizens.

Thank you.

Representative BOLLING. Thank you, Mr. Sprinkel.
[The prepared statement of Mr. Sprinkel follows:]

PREPARED STATEMENT OF BERYL W. SPRINKEL¹

Escapes From the Dilemma of Stagflation

INTRODUCTION

I am pleased to have the opportunity to testify at this Committee's important hearings concerning the adequacy of policies for dealing with stagflation, i.e. high inflation and slow real growth.

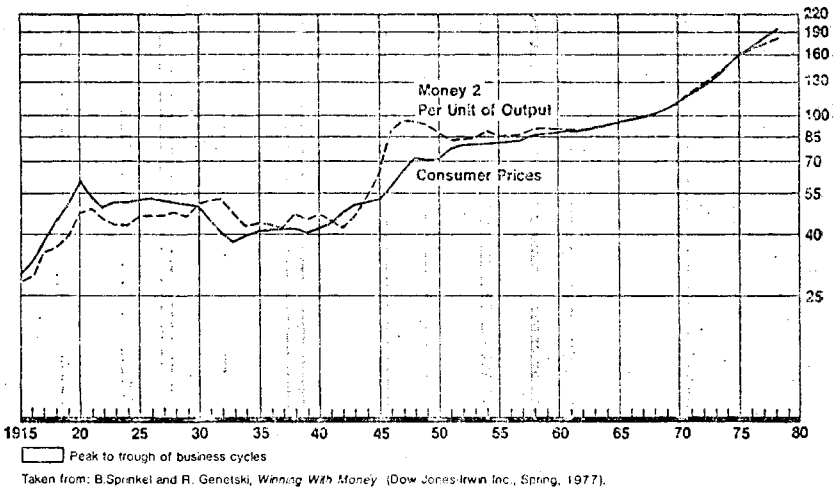
My basic conclusion is that policies in recent years have directly promoted high inflation and slow growth, and were clearly inappropriate for achieving economic stability. Monetary-fiscal policies fostered excess demand, which resulted in high and escalating inflation, while tax policies encouraged consumption and Federal spending while discouraging private savings and investment. In addition, aggressive regulatory and environmental controls also inhibited growth. Finally, the present "voluntary" wage and price guidelines tilt with symptoms and promise to further reduce the efficiency of our market system, thereby contributing to stagflation.

INFLATION'S ROOTS

Inflation is and always has been primarily a monetary phenomenon—i.e. too much money chasing too few goods. Whenever the money supply grows at a rate exceeding the rise in real output, inflation accelerates, but with a 1½ to 2 year lag. The following chart traces this relationship for the United States from 1915 to the present. Since monetary growth has accelerated sharply in recent years, we are reaping our just but painful rewards on the inflation front.

Even though monetary growth accelerated until recently, it has been the objective of the Federal Open Market Committee since the spring of 1975 to slow gradually the rate of monetary growth until it was commensurate with the growth in real output. Why have results contrasted so sharply with stated objectives? Let me cite three contributing factors, although there may be more.

Money, Real GNP, and Inflation



¹ The views are my own and not necessarily those of my employer, the Harris Trust & Savings Bank of Chicago.

(1) Since 1975 the Federal budget deficit has been large and frequently increasing. Deficits must be financed either with new money creation or savings. Undoubtedly, the Federal Reserve's concern about adequate financing for the Treasury contributed to the high rate of monetary growth while savings absorption reduced private capital formation.

(2) There exists a political temptation to enjoy the short-run benefits of rapid monetary growth while denying or ignoring the ultimate inflation price to be paid. For example, during the first 22 months of President Carter's administration there was frequent criticism of Federal Reserve policies by representatives of the administration who believed the policies were too tight, even though growth in the money supply was soaring. Undoubtedly, those pressures fostered excessive money growth and higher inflation.

(3) Finally, the Federal Reserve's technique of monetary policy execution also tended to encourage excessive money growth during periods of expanding business activity when interest rates were typically rising. The Federal Open Market Committee's attempt to peg the Fed funds rate at too low a level usually resulted in excessive purchases of government securities, thereby increasing the monetary base and the money supply. Conversely, during periods of recession, reluctance on the part of the FOMC to permit a decline in the Fed funds rate sometimes severely depressed monetary growth. The current expansion is now 49 months old and until last fall, growth in monetary aggregates continued to accelerate. This technical complication could be readily avoided if the Federal Reserve focused on regulating growth in the monetary base and permitted the Fed funds rate to be determined by private market forces.

EMPLOYMENT INHIBITORS

The growth in total employment during the current expansion has been enormous and the unemployment rate has declined, but the present 5.7 percent rate of unemployment is well above the frequently stated objective of 4 percent. Many believed that massive stimulus would inevitably result in declining and low unemployment rates, but as yet that has not occurred.

The basic reason relates to inflationary expectations. If the inflation rate is stable and market participants believe it will remain so, demand stimulus will indeed reduce unemployment. However, once greater inflation develops and expectations escalate, there is no reason for believing that unemployment can be permanently reduced through further demand stimulus. To achieve such an objective would require continuous acceleration in the inflation rate, and that of course would be the route to financial disaster.²

In addition, there have been important structural changes affecting the reported level of unemployment in recent years. For example, sharp escalation in the minimum wage to the present level of \$2.90 denies employment opportunities to many unskilled workers. The high minimum wage is a direct contributor to high unemployment among teenagers and especially teenage blacks, who have a current unemployment rate of 33.5 percent. The sharp increase in transfer payments in recent years has also reduced the incentive to search actively for employment. Liberal unemployment compensation benefits plus rising welfare payments reduce the penalty for unemployment, and in some cases cause lower-income groups to be worse off by working than by remaining idle.

PRODUCTIVITY DRAGS

The capacity of the U.S. economy for growth has clearly declined sharply over the past decade. Falling productivity has been the major contributing factor. The following table indicates the deterioration since 1955.

	<i>Productivity improvement</i> ¹ (annual rates)	<i>Percent</i>
1955-65	-----	2.6
1965-73	-----	1.9
1973-78	-----	0.8
1979 (1st Qtr.)	-----	-4.5

¹ Output per hour of all persons in the nonfarm business sector.

Source: Department of Labor.

² Friedman, Milton: "Nobel Lecture: Inflation and Unemployment," *Journal of Political Economy*, University of Chicago Press, June 1977.

At the Harris Bank, our economic forecasting effort places a great deal of emphasis on productivity trends. Unfortunately, our recent conclusions are very discouraging. On the basis of our latest research we have concluded that for all intents and purposes the U.S. economy is no longer experiencing any productivity gains. This means that today, for a given increase in money, the U.S. economy will generate 2 to 2½% less real growth, and therefore, 2 to 2½ percentage points more inflation than we have come to expect.

Capital formation in the United States has been weak for many years and has contributed to slowing productivity improvement. Growth in the non-farm capital stock per hour worked has declined as follows:

	Percent
1955-65	2.55
1965-73	2.51
1973-78	1.07
1977-78	-1.1

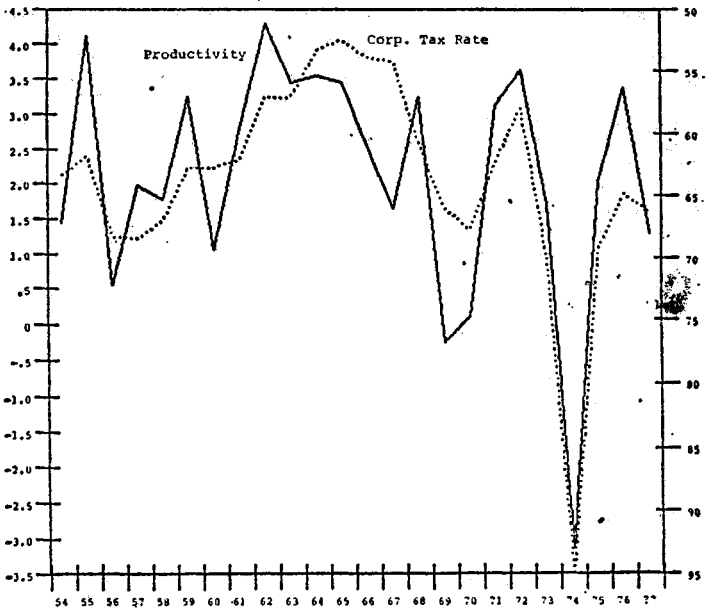
Source: Department of Commerce.

Furthermore, savings in 1977 as a percentage of after-tax income in the United States were by far the smallest of the six major developed Western countries, and U.S. investment as a percentage of real GNP for the decade 1966-76 also was the lowest.*

To compound the difficulties, the cost of Federal regulatory activities have soared. From fiscal 1970 to fiscal 1979 Federal outlays for regulation rose 568 percent to \$5.78 billion, while real outlays rose 269 percent. In addition, economist Murray Weidenbaum, Director of the Center for the Study of American Business, has estimated that for fiscal 1979, business will spend \$97.9 billion on compliance with Federal regulations. Those funds may have helped achieve social objectives, but they reduced productive investment.

PRODUCTIVITY CHANGES AND CORPORATE TAX RATES

Productivity: Private Non-Farm Sector (% Change) Effective Corporate Tax Rate



Source: Bureau of Labor Statistics; National Bureau of Economic Research; Feldstein and Summers, *Inflation and the Location of Capital Income in the Corporate Sector*, January, 1977.

* "Capital Formation Follo," the American Council for Capital Formation, 1979, Washington, D.C.

Our Federal tax system is a highly efficient generator of Federal revenues, but it discourages private savings and investment while encouraging consumption and Federal expenditures.

Actually, our search for the main cause of the recent deterioration in productivity has centered on the impact of high U.S. tax rates. Although our research in this area is still preliminary, we are finding that there has been a strong relationship between corporate tax rates and productivity changes. As the following chart shows, the rapid increases in the effective corporate tax rate, as measured by the National Bureau of Economic Research, has been closely related to the sharp decline in productivity. As the effective tax rate has risen, productivity has declined.

The tax effect has been particularly evident over the past decade of accelerating inflation which resulted in proportionately larger Federal revenues and greater penalties to the savings-investment process. Either elimination of inflation or indexing of the personal and corporate tax system would neutralize this pernicious effect.

ESCAPE STRATEGIES

How can we extricate ourselves from the current inflation-low growth dilemma? There are no quick fixes, but patience, a quality in short supply in our political arena, and proper policies can come to the rescue in the years ahead.

1. Policymakers must avoid the go-stop monetary-fiscal pattern so characteristic of modern times. There has been a pronounced tendency to concentrate on reducing unemployment until inflation reared its ugly head and then to concentrate on stopping inflation until a recession and rising unemployment again changed the target. Reference to fictitious GNP gaps encouraged excessive stimulus while high and rising inflation ushered in excessive restraint. If a recession follows the current pattern of restraint, as I expect, it will be crucial that Congress, the administration and the Federal Reserve Board respond in a moderate rather than a massive fashion. In particular, monetary growth should be gradually slowed over the next few years until it is in line with secular real output increases. Lower deficits would reduce the trend toward excessive money growth and also release savings for the private sector of the economy. Recognition of the inevitable lags in policy impact should help strengthen the political will. Finally, the Federal Open Market Committee should be encouraged to focus on control of the monetary base, not the Fed funds rate. Even with prudence and restraint, low inflation rates are years away in the absence of a massive depression. Furthermore, such a policy would bring slow growth in the few years immediately ahead, followed by better performance. Many years of mismanagement brought double digit inflation, and several years of prudent policies will be needed to restore price stability. But the results would be well worth the effort.

2. Clearly our tax system must be tilted toward encouraging savings and investment while discouraging consumption and Federal expenditures. The cost will be a reduced growth in consumption and Federal outlays, but the benefits will be greater real economic growth, additional productive jobs and a higher standard of living for our citizens. I favor indexing our Federal tax system, but that isn't enough. Slower growth or even reduction in Government spending will release valuable resources for productive private sector utilization. Other tax incentives for encouraging savings and investment include:

- (1) Lower corporate taxes and reduced progressivity in our personal taxes.
- (2) Higher depreciation allowances, designed to represent replacement cost.
- (3) Further reduction or elimination of capital gains rates.
- (4) Elimination of double taxation of dividends.
- (5) Reduced taxation of savings relative to consumption.
- (6) Elimination of Regulation Q which prevents savings institutions from providing a fair market rate for savers, especially small savers.

Finally the escalating trend toward more Government regulation of private sector activities must be reversed by insisting on effective cost-benefit analysis and implementation. Regulation sometimes yields social benefits, but these added benefits must be compared to the added costs. There are no free lunches in this world of scarce resources.

In summary, we can whip stagflation if we are willing to change our present policy thrusts. The costs will be high, but the benefits greater. Unless we are willing to change our profligate ways, inflation may threaten the very fabric of our democratic capitalistic system to the immense detriment of all our citizens.

Representative BOLLING. Our next and final witness is Mr. Albert T. Sommers, a 1953-58 student of Columbia with a masters at NYU. He has been senior vice president and chief economist of the Conference Board for 20 years.

Among the recent articles he has written that seem particularly relevant to our consideration today are: "Inflation, Unemployment and Stabilization Policy," September 1976; "Balanced Federal Budget, an Orthodoxy in Trouble," 1978; "U.S. Productivity, Not a Disaster, but Certainly a Dilemma," 1978; and "A Collision of Ethics and Economics," in July of 1978.

We would be delighted to hear you, sir.

**STATEMENT OF ALBERT T. SOMMERS, SENIOR VICE PRESIDENT
AND CHIEF ECONOMIST, THE CONFERENCE BOARD, NEW
YORK, N.Y.**

Mr. SOMMERS. Thank you.

In the procedure thus far, I have detected a slight degree of disagreement between Ms. Nulty and my friend Beryl Sprinkel. I am going to make an effort at reconciliation of that awkward difference.

Representative BOLLING. Good luck.

Mr. SOMMERS. I am particularly encouraged by your opening statement, Mr. Vice Chairman, because the subject of change is a very difficult one for Congress to handle. Much too often, we ignore the fact that the system we are dealing with is a kind of evolving organic whole that changes greatly over time, partly as a result of inevitable interplay between our social and political systems on the one hand, and the economic system on the other hand.

The changes that we are dealing with pose terrible problems for a doctrinal, law-seeking science such as economics. We would like to be able to prove all our propositions with 30 years of data; the statistical validity rises as the series lengthens. And then the inevitable question, how much of the data back in the fifties and sixties has any relevance to a system that is changing at the rate that this one is?

Let me offer some brief thoughts on the nature of the changes. Most of them are referred to in the article in front of you.

We are living through a conscious effort on the part of this society, as well as every other developed Western economy, to impose a set of desired ethical outcomes on a market system that we have inherited out of a distant past.

What we are after is a more equal distribution of income. We are after more economic security. We have sought to distinguish the labor input from all other inputs, a very natural and inevitable thing to do. It has been going on for 100 years, but we have certainly accelerated the effort.

We are seeking more economic opportunity. And all of this goes on in the context of seeking to accommodate to and to keep humanizing a galloping technology, that has greatly altered the relation of the individual to the society.

If that were not enough, we have sought, I think reasonably, jobs for all who seek them. These goals or targets are part of a democratic ethic; wherever democracy has appeared, systems have sought them. But it is a difficult, painful and ultimately inflationary job.

The democratic ethic is basically—egalitarian markets are basically cumulative. The democratic ethic seeks consumption as an ultimate measure of its performance. And the market requires investment for growth.

We could go on at some length to describe the frictions between what we are seeking to achieve socially and politically while at the same time we are trying to preserve what I think all of us would agree is a highly efficient market mechanism for distribution and the allocation of resources.

But the effort performed as it has been has resulted in lower saving and investment. It has resulted in an astronomically high-consumption society, particularly in the United States.

I do not find it surprising that this society runs a budget deficit. Every other Western democratic society runs a budget deficit.

The reason is very simple. The spending side of the Federal budget seeks those social goals. But the income side of the Federal budget has to be restrained in order to prevent or forestall a degree of impairment of incentive and reward in the system that would reduce its efficiency.

So trying to live with the social goals and with a market system conduces to a budget deficit.

Of course, in turn, the budget deficit conduces to money creation because if we were to force the financing of that deficit on a controlled supply of funds, we would be pricing out part of the private sector and reducing its efficiency.

For these reasons and a number of others we can discuss, the objectives of this society have elevated its Phillips curve. That is, it has produced a situation in which for any given level of unemployment, we now have more inflation than we used to. And for any given level of inflation, we have more unemployment than we used to.

Against that background, let me comment on some of the public policy issues raised in your invitation.

First, with respect to the share of Government in GNP, the deficits and the growth of money. Given the dilemma I described, I can't characterize our behavior as improvement or grossly irresponsible. The Government's share in this system has risen relatively modestly. It rises during cyclical recession. That is inevitable and part of the counter-cyclical functions of Government.

But measuring the share of Government against our full employment output, accepting for the moment those very dubious numbers, it really has not risen dramatically. It has not risen faster than in other countries. And the general level of Government in the United States relative to the total system is lower than it is in most other Western countries.

Our tax rates are among the lowest among a dozen or so Western countries with which we might reasonably compare ourselves. I don't even find our money growth extraordinary in light of the circumstances that dictate it.

The supply of M1 money in the United States in a sense has been sort of indexed. That is, if we adjusted it for inflation, it is no higher today than it was 10 years ago.

I suspect a response from Mr. Sprinkel on that one.

Representative BOLLING. You are getting it.

Mr. SOMMERS. As I indicated earlier, I don't think the deficits are clearly irrational. The growth of our public debt looms very large in dollars. As a percentage of our GNP, our public debt now constitutes about 38 percent of a year's output.

At the end of World War II, it was 100 percent of a year's output. It fell substantially between the end of the war and about 1970. It has since moved insignificantly; there is no appreciable trend in it.

This is a relatively high percentage. The only higher one I think of right off is the United Kingdom, but the reason here is simply that both the United Kingdom and the United States, being victors in World War II, honored the Government debt incurred in World War II.

In both West Germany and Japan, we, of course, installed new governments. And the public debt of those countries was repudiated. They started the postwar years with a zero relationship. They are now up to 20 or 22 percent and rising, while we are stable or falling.

Now, it is nevertheless true that those deficits and the financing of them are what might be called the enabling conditions of inflation. And I attribute inflation to the social efforts that we have been engaged in. But neither the inflation nor the growth nor the social efforts could have been accommodated without budget deficits and rising general money supply.

With respect to the performance of these policies on the labor market, I think they have been generally effective. We have the best growth in jobs in the West. Our employment ratio relative to population has been rising dramatically. It is at the highest level it has ever been.

Our unemployment rate is certainly higher than we would wish, and higher than our own estimates of full employment. But these are technical consequences of the structure of the labor force, on which I don't think you will hear any disagreement from any of us.

We have a problem of absorbing a very large postwar generation. We have had a fundamental sociological change in the role of women in the economy. And we have a large and perhaps growing disadvantaged population. At this moment, we have really no general unemployment.

This system is experiencing high prosperity and is, in fact, in imminent danger of labor shortage even in the presence of the 5.7 percent unemployment rate.

Next, let me comment briefly on high employment budgeting. I don't think anybody would say this is a perfect device for policy-making by any means. And the latest revision, just a couple of months old, revealed many of its defects. In the course of reducing the measure of full employment potential, we elevated the full employment budget deficit from about \$8 billion, which looked like we were about on target, to \$23 billion, which looks as though, in the high prosperity I am describing, that is a relatively high full-employment budget deficit.

It is probably true that high-employment budgeting misled us in the 1970's, and that it in some degree misled policies. But it didn't mislead us in the 1960's and may not in the 1980's.

In any event, it is a useful tool used with the necessary moderation. And I prefer it to a wholly unquantified hypothetical offering of the Laffer curve, which seems to me is simply playing hardball in the dark.

It calls for immense tax reductions with no quantification of what the response would be.

Now, I do have some recommendations, and they are hopelessly non-ideological. They will frustrate liberals and irritate conservatives. But I offer them quickly anyway.

First, we have had very bad cyclical experience in the 1970's, more cyclical than any other Western economy, and more cyclical than our own experience in prior periods.

I do agree with Mr. Sprinkel that in a way, we have had stop-go. We have had alternating bursts of fiscal stimulus followed by monetary restraint. What used to be a natural business cycle that had its uses, has been amplified by policy, I think unnecessarily, doing a lot of damage to our investment rate. It is easy to consume through these waves of uncertainty. It is very hard for business to make long-term investment-type and capital-type decisions. I think we can do better on that.

I think we should certainly explore an independent economic commission, isolated as much as possible from politics. We are almost alone in the world in not having such a long-term planning agency of high respect available to us.

And I think to do better here, we may well require a greater range and greater selectivity of both fiscal and monetary powers. We were born in a revolution against power, and we really have delivered very little to our Government. This is not a matter of the size of government. It is a matter of the power of government to achieve public national objectives.

Second, I agree with Mr. Sprinkel again that we are investing inadequately. I think our saving rate is too low. Our investment rate is too low. There are alternatives here, not all of them terribly pleasant.

A value-added tax is appropriate for this problem. And I think it is highly desirable on at least eight grounds.

Then, we have the worst depreciation laws in the Western World. To get rid of that tail of very low efficiency, but now fully written-off capacity that exists in most industries, a much faster depreciation writeoff would be a very useful solution.

I think selective credit restraints deserve to be studied. And I do not believe that the existing credit control act should be removed from the books without exploration of its potential.

Third, public capital formation in the United States is sinking almost out of sight. It is a very little-watched figure, but since the end of the road-building program and the end of that wave of school-aged kids through the public educational system, the rate of public capital formation has subsided so far that I would say we are deferring maintenance on the U.S. infrastructure.

The enlargement of public capital formation which is mainly a construction function, all of it contracted out to the private sector, I think would reduce the need for the volume of transfers that now moves through the Federal budget. The transfers are high-consumption oriented. And we would do well to control them.

Finally, I think that we make less use of public capital in general than most other countries. I am not speaking about public ownership of productive resources, although that is rather widespread throughout the West now in response to some of the dilemmas that I have mentioned. But the Government's role in stimulating investment

even if it has to make some tough decisions as it would if we allowed certificates of necessity, somebody has to decide we need this industry to enlarge from a public interest point of view.

Those are tough decisions to make, but I think we should try to use our Federal powers in order to stimulate the basic productive base of the system.

Joint ventures between government and business, very widely used in the rest of the world, are almost negligible in the United States. Energy is an obvious instance where such collaboration between business and government might be extremely profitable.

Well, I will rest there. Thank you.

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

[The prepared statement of Mr. Sommers follows:]

PREPARED STATEMENT OF ALBERT T. SOMMERS

I am grateful to the committee for this opportunity to offer views on questions that confront the committee's Special Study on Economic Change. I'm particularly grateful, since I consider the issues posed by your letter of invitation, and by the announcement of the hearings, to be the right questions, and very important questions. There have indeed been "numerous and profound changes" in the U.S. economic system that call for re-examination of economic policies and objectives, particularly with respect to identifying obstacles in the way of achieving the goals of high employment and reasonable price stability.

I will comment specifically on the questions raised in your invitation. However, it would seem useful to preface those comments with a brief characterization of the "changes" to which the committee's Special Study is directing itself. I think it would be a mistake to treat the reference to "change" in the committee's Special Study as simply indicating a need for the study. "Change" should be a large, substantive subject of the study itself.

In testimony before the Senate Banking Committee in November 1978, I submitted an article entitled "A Collision of Ethics and Economics," that describes the nature of the changes in our economic system (and really in all Western democratic systems) as a continuous stream of legislation, and of policy, intended to accommodate a democratic social ethic to a free-market system. The article appeared in the publication of the hearings for November 15, 1978. I have provided copies of the article for the members of this committee. There is certainly no reason to summarize it now; I refer to it only because my views on the achievements and failures of economic policy over the past two decades rest on the proposition that we have been facing a unique social and economic challenge—a national effort, inevitably by government, to apply ethical criteria to the outcomes of a market system and to alter those outcomes where they do not meet the criteria. Nobody should have expected this to be easy, and it has turned out to be not only difficult, but inflationary.

It is often said by monetarists (often, I'm sure to this committee itself) that throughout history all inflations have had the same cause—namely, the excessive creation of money. I think that statement is a partial truth, and misleading; it does not disclose the reasons for the excessive creation of money, and very different reasons, of differing degrees of respectability, have prevailed in different inflations. If there has been excessive creation of money this time around, it is because we have wanted the equal opportunity, more equal income distribution, greater security and greater dignity of labor that are part of the democratic ethic. We have wanted jobs for all who want to work; and we have wanted to impose these objectives directly on a free-market system that is efficient, but cumulative, not egalitarian, in its distribution of rewards.

Modern Western inflation is a measure of the friction developed in the course of this effort. The budget deficits experienced by Western economies result from efforts to mandate socially acceptable outcomes while retaining the efficiencies of a market system; the spending side of the budget seeks the social outcomes, while the revenue side is suppressed to avoid further impairment of the incentives required for free-market activity. The deficit (and the money creation to finance it) thus pours oil on the troubled interface between democratic ethical

goals and free-market institutions. We'll never know, of course, but I doubt that Emperor Diocletian, who presided over a great Roman inflation to which monetarists often point as a monetary parallel to our own, would have described his situation quite that way. Same with Robespierre (who resorted to mandatory price controls), the rules of the T'ang dynasty, and others who encountered monetary inflation in the course of their careers.

The Full Employment Act of 1946 expressed a social conviction about jobs and the wide sharing of prosperity. It demanded little or nothing in the way of action of the part of government, and recollections of the 1930's were such as to raise grave doubts about the government's ability to fulfill the commitment. In any event, nothing much in the way of policy was necessary to maintain the system at high levels of employment (with occasional business-cycle interruptions) during the first postwar decade; enormous liquidity generated by the war, together with the deferred real demands from a decade of depression and then a half-decade of war, insured high economic performance. In the late 1950's, this energy was largely expended. In the early 1960's, the mandate of The Full Employment Act confronted a stagnant economy, and the stimulative measures undertaken from 1962 to 1964—the period of the so-called "new economics"—produced a highly successful return to full employment, in the presence of a balanced budget, low inflation, and rapid improvement in investment.

The successful application of policy to the commitment of the Full Employment Act seemed to demonstrate that government had the power, as well as the intention, to achieve and maintain high prosperity. The commitment thus acquired some of the character of a guarantee. The guarantee was naturally accompanied by a reduction of perceived risk, and the guarantee was progressively liquidated by an explosion of private debt, which has resensitized the system to recession. At the same time, having apparently solved the problems of aggregate growth and prosperity, policy in the middle 1960's switched heavily to programs to achieve distributive justice—to the disadvantaged, the ill-housed, the ill-educated, the poor.

Now a dozen years or so later, the powers and commitments of government are very much open to question again. Many of the distributive programs seem to have produced costs without benefits. The business cycle seems to have escaped out from under control again, and the assurance of prosperity has disappeared. Inflation, unaccustomedly large budget deficits, and a deterioration of productivity have produced a deep disenchantment with activist, goal-oriented economic policy. The immense respect for the social functions of government that prevailed in the middle 1960's is now dissipated, and there has appeared a large and growing subterranean economy that has opted out of the social system.

Against this background view, let me turn now to the specific questions raised in your invitation. The first invites comment on the course of fiscal expenditures and deficits, and of money supply growth, on the inflation rate. I can't characterize those policies, including the role in them played by full-employment budgeting, as plainly improvident. They sought outcomes that all developed Western democracies have sought. United States tax rates are among the lowest in a group of a dozen economies with which we might compare ourselves. Popular opinions to the contrary, the effective Federal personal income tax rate is no higher today than it was a decade ago. The share of government in the total economy is also moderate relative to experience in other countries; in terms of our own past record, it is moderately higher than it was in the years before 1966, but there has been no important trend in the share since then, either in terms of the share of actual output or the share of high-employment output. Our experience with budget deficits is not very different from the experience of other countries caught in the same wave of social history. The Federal debt bears about the same relationship to a year's national output today that it did in 1970, and the relationship is lower than in any earlier postwar year. (It should be borne in mind that the postwar governments of West Germany and Japan repudiated the public debt of their wartime predecessors and started the postwar years from scratch, whereas we entered the postwar years with a debt equal to 160 percent of annual output.)

And similarly with the growth of money. The U.S. money stock has by and large, risen less rapidly than the money stock of other developed Western countries. Indeed, as measured by *M₁*, the *real* money stock—that is, the money stock adjusted for inflation—is no higher today than it was a dozen years ago, and it has recently been falling so rapidly as to persuade monetarists that a serious recession lies ahead.

This does not mean that fiscal and monetary policies pursued in the United States over the past dozen years have had no relation to the inflation problem. It does mean, I think, that the ethical effort to fulfill democracy has substantially elevated the United States Phillips Curve, and that the effort to achieve high employment and low unemployment now involves more inflation, and hence more money creation, than was required a dozen years ago. In this sense, budget deficits and their financing in a generally accommodative monetary environment have become the enabling conditions of both high employment and high inflation.

I do not think the policies have been ineffective in the labor market; on the contrary, they have doubtless contributed to a substantially successful record in job creation in the private sector. At this moment, the relationship of employment to population is evidently higher than it has ever been; it has risen dramatically now for several years, and the bulk of the new jobs has of course been in the private sector. The unemployment rate, on the other hand, is still considerably higher than it was at comparable points in past business cycles; there is wide agreement that upward shift in the unemployment rate is traceable to structural conditions within the actual and potential labor force—the high rate of youth entry, the sharp increase in the participation rate of women, and the continued (perhaps enlarged) presence of a disadvantaged component of the labor force that is simply out of the reach of aggregate demand policies. The policies themselves have not, it seems to me, been demonstrably wrong; if the results do not look great, it is because they have been confronting a progressive deterioration in the relationship of inflation to unemployment. This is the same point that the Chairman of the Federal Reserve was making when he commented on “the limitations of monetary policy as the main bulwark against inflation and the need to mount a broad attack on the economic problems we face” (statement to the Congress, August 1978). Aggregate demand policies may appear to have been “excessive” by the criterion of inflation; but they do not appear to have been “excessive” by the criterion of job creation and unemployment, and they do not appear to be excessive in comparison with the policies pursued by other economies confronting similar problems.

I offer the Committee the following conclusions, drawn from this view of our experience with aggregate economic policies over the past decade. In the first place, I do not recommend that we abandon high employment estimates. They are admittedly imperfect with respect to both their labor force and productivity assumptions. The most recent revisions elevated the constructive full-employment deficit in late 1978 from \$6 billion to \$23 billion, because of a one-third reduction in the productivity assumption. The full-employment deficit is now about equal to the actual deficit. This suggests that we are at full-employment now. But the unemployment rate is still moderately above the assumed full-employment rate; rising participation rates have elevated the labor force (and employment, and unemployment) above the projected level.

High employment projections nevertheless constitute a useful guide to policy. In the early 1960's, they correctly diagnosed the cause of stagflation; wartime tax rates were calling for a very large surplus at full employment, unattainable by a private sector that had lost its wartime energies. Now they point to a need for reasonably conservative policies. They may have misled us in the 1970's. But I doubt very much that our social ambitions would have produced very different results if we had eschewed such calculations. And in any event they are far more useful than the Laffer curve, which offers a wholly unquantified promise of a massive real response to massive tax reduction. The Laffer curve plays hardball in the dark.

The unemployment assumption on which the high employment estimates are based should reflect the changed realities of the labor market. Given the present labor market, an unemployment rate below 5.5 percent is an improbable achievement, and would almost certainly be associated with serious general inflation. The approach to that residual unemployment must take the form of structural programs in education, training, government-assisted job creation, and removal of disincentives to work.

There are a number of other possible courses toward restraining the Phillips curve that underlies this inflation-unemployment problem.

1. U.S. fiscal and monetary policies could be better integrated; the history of the past dozen years has been characterized by alternating bursts of fiscal stimulus and monetary restraint, as the overriding criterion of economic policy has shifted back and forth between unemployment and inflation. It should be possible to do much better.

2. We could do better if we were to allow ourselves pragmatic, non-ideological study of ways to improve the equipment of fiscal and monetary policy. For both arms of policy, American tradition has been limiting; The Federal Reserve is not among the stronger central banks of the Western world, and American fiscal policy is far more dilatory than the parliamentary systems that prevail in most of the West.

3. An independent economic commission, isolated as much as possible from politics and free of the short-term concerns that occupy the Council of Economic Advisers, is an inevitable future development in the making of economic policy, and in recommending changes in policy equipment. Most of our international competitors are equipped with such a body.

4. The United States economy has an apparently insatiable propensity to consume, and to absorb the supply of capital in consumption-oriented credit. Restraint on the use of credit in consumption would free real and financial resources for a higher level of private and public capital investment, and for faster growth in productivity and output. A value-added tax would work in the same desirable direction.

In addition, the productivity shortfall that required the revision of the high-employment calculations calls for broad stimulation of investment incentives. The easiest and fairest way to do this is through a substantial improvement in the rate of recovery of historical costs of capital facilities.

5. However one might feel about the aggregate spending of the Federal Government, certainly the relationship between its spending on transfers and its spending on real public capital formation—the infra-structure of the entire economic system—is sadly distorted; a substantial elevation of such public capital outlay (mainly construction work contracted to the private sector) would have a high payoff, and would constrain the need for some of the transfers.

U.S. economic experience does not compare particularly unfavorably with other Western democracies in terms of aggregative policies; but it compares quite unfavorably in terms of a low saving rate, an excessive consumption share in output, insufficient private and public real investment, and in the productivity consequences of investment. Progress on these fronts, together with more effective approaches to structural unemployment made possible by the educational experience of the past dozen years, would have a substantial impact on the Phillips curve and the growth rate, and it would relieve the pressures on both fiscal and monetary policy to accept the high-inflation consequences of a high-employment goal.

Representative BOLLING. Before we go on to a general discussion, I would like to ask you to give me those eight grounds to support the value-added tax that I heard you comment about.

Mr. SOMMERS. I am not sure I can get up to eight, but I can get up to a few.

First, the value-added tax bears on spending of income. For that reason, it is a marginal incentive to save. You can avoid the tax by not spending.

And whatever tax relief it offers for other taxes would also provide relief of the pressure of taxation on incentive.

Second, the tax has certain uses internationally. That is, those who have the tax rebate it on exports, and impose it on imports. The result is that even under conditions of floating rates, the presence of a value-added tax is a small trade advantage.

Third, the so-called subterranean economy which nobody can measure, but I'm satisfied is very, very large—

Representative BOLLING. Could you give me an order of magnitude?

Mr. SOMMERS. Well, the common magnitude is \$200 billion. It is calculated out of the apparent insatiable capacity for currency, particularly of relatively large bills, that has appeared lately. The subterranean economy has a lot of difficulty escaping the value-added tax;

it is a lot easier to supervise business sellers and retailers and have them collect the tax. So even if the income is not being taxed, at least the spending is being taxed.

Representative BOLLING. Very fine. I just wanted to get that in.

Next, I would like to get in the fact that we have at the table with me a staff that is working on this. And the staff that worked on all of this on my right, is Jack Albertine, the staff director of the Joint Economic Committee, and has been most helpful and cooperative on this aspect of the Joint Economic Committee's work, the Special Study.

On my left is the director of the Study, Lou Krauthoff.

To his left is George Krumbhaar who has been very actively involved.

To my right, beyond Mr. Albertine, is Dick Bartel and John Henderson. Dick Bartel is of our staff; John Henderson is working with us from the CRS.

We are very pleased at the kind of cooperation we have gotten, not only from internal institutional support, but also from the outside where we have had very great cooperation.

Now, what I would like to do is to ask the witnesses if they would like to have at each other or do I have to stimulate them further? Because it is very clear that we have some fundamental, important differences of opinion. And while it is a fact, I think, that Mr. Sommers has been able to do some pulling together, some good, solid, political compromising at least in broad, general ideas, I think that we should argue out a few of these points.

Is there any absolute way of proving that anybody is right or wrong in any of this?

Ms. NULTY. The only comment that I would like to make is that most of the policy prescriptions that I have heard put forward this morning have already been tried to some degree or other.

I had the misfortune to be living and working in Britain at the time that a value-added tax was about to be imposed. Shortly after I left, it was imposed. The result was a tremendous acceleration in the rate of inflation, and as far as I am aware, no material effect on the rate of capital formation or investment since those are problems that that economy continues to grapple with.

With respect to incentives for investment through the tax system, I think it is quite documentable that the effective tax rate for the corporate sector has been falling very dramatically in the postwar period. So if we are looking for incentives for capital formation, that one has obviously proven its inefficiency.

The third point that I would like to refer to is that I don't think there is uniform agreement that our market system is efficient, if by "efficiency," we use the standard that I use for my policy analysis—namely, how well it provides a stable and secure standard of living for the mass of the population.

At least with respect to the four sectors that I have studied in depth, the market system as it exists at the moment has proven to be remarkably deficient because it has been the principal engine of reducing living standards.

As mentioned in my prepared statement, the problem is that these are very complicated, and the exposition would be quite lengthy. I didn't want to overweight my longer statement. I certainly don't want to take up a lot of time this morning going into the details.

But certainly what we found, several studies are finding, in the food sector which used to be thought to be a very low-concentration industry, quasimonopoly power, whatever you want to call it, basic concentrated market power, has been a very potent engine of inflation.

In energy, regardless of what concentration ratios may show you, rather more sophisticated and subtle market relationships in the private sector, I feel, are proving to be a major barrier to curbing inflation in energy.

With respect to medical care, I found it quite interesting that when the Federal Trade Commission just a few days ago—in fact, last week—proposed a ruling that would limit the participation of doctors on Blue Shield boards, the medical profession set up a screaming howl because basically, it is that kind of concentrated market power that establishes self-determined fees and prices in the medical sector.

And not only that, but the composition of medical care in the medical sector.

And I think it is quite remarkable to hear not one other person this morning address the issue of what is happening to the structure of the market system because, as far as I am concerned, from my own work, that is the critical factor in this very new kind of inflation that has come to dominate the economy.

Representative BOLLING. Well, there are two contrary points flying around here. I keep hearing, and I think it is probably true, that the various increases in regulation of segments of the economy have added very substantial costs to the cost of doing business.

On the other hand, the performance, it is said, of the market is deficient as has just been said and has an inflationary effect.

It would seem to me there ought to be some discussion of those two things together rather than separately. And it would seem to me it would be important to see how much the Government in its attempt to improve the environment and to regulate monopoly has added to costs and compare that with how much the market itself has added to costs without regard to that.

Is that an irrational thought?

Mr. SOMMERS. I don't think so.

Representative BOLLING. How would you go about doing that?

Mr. SOMMERS. Well, on the points that Ms. Nulty raised in that connection, you would think that market power would be reflected in rate of return on profits, rate of return on sales, or rate of return on investment. And the actual data that I know of do not support the impression that monopolistic powers exist very widely in this system.

I would not disagree with Ms. Nulty in the fact that the market system is highly imperfect and there are concentrations of power in it. I don't think there is any question about that.

We are not living in a world of auction markets such as described in those old textbooks any longer. But the actual evidence of monopoly profits is very difficult to find.

The falling tax rate that you refer to can only be achieved—you can only get that result—if you add depreciation back to earnings. And I am presuming Ms. Nulty is doing that. But depreciation is a real measure of a rise in aggregate investment. And I don't think you can just assume that depreciation is an uninhibited cash flow just like earnings.

Measured without depreciation, I think Mr. Sprinkel can tell you what the tax rate looks like.

MR. SPRINKEL. Congressman Bolling, I have some data in the chart in my prepared statement concerning productivity change and the effective corporate tax changes. They are not my numbers, but numbers generated by Martin Feldstein of the National Bureau of Economic Research. These numbers adjust not only for the effect of inadequate depreciation and inventory profits, but also for taxes paid by the recipients of dividends.

The series is an attempt to get an effective tax on income generated in the corporate sector. And rather than declining or staying flat, taxes have risen excessively. For example, in the early sixties, the effective tax rate was about 53 percent. It is up now to somewhere in the 65–70 percent range and rising, and will continue to rise so long as we keep the tax rate the same and continue to accelerate inflation.

Let me turn to a second issue that was raised. I think it is very dangerous to try to explain inflation by isolating particular prices that have gone up more than the average and say, therefore, the high risers caused inflation.

For example, if we did that recently, we would have to say this inflation is brought on by food and fuel. And if we picked out those sectors that didn't rise as much as the average, we would have to say those prices are holding the inflation rate down.

What we are interested in, at least what I am interested in, and I believe this committee is interested in, is why has the average level of inflation gone up, including both the low risers and the high risers?

You can't explain that by focusing on the ones that have gone up the most. It turns out if you ask that question, then the answer is no different than it always has been. And I suspect it always will be.

That is, when we pump in a lot of dough, people are going to spend it, I am going to spend it, you are going to spend it. And when you pump money at a faster rate, production goes up, but the price rise will accelerate.

The question is whether or not market power accounts for this inflation. I know of no theory that says that there has been more than a doubling in market power over the last some years.

For example, in the early part of 1977, the inflation rate was down to about 5 percent. It is now 10 or 12 percent, depending on what index you want to use and for what month. It is not enough to show that we don't have a perfectly competitive market; we don't. We recognize that. The question is, Is the market getting even more imperfect in such a way that everybody can automatically raise prices irrespective of market demand? And the answer is no. There is just no evidence to support that point of view that I am aware of.

Particular prices may be higher than they should be in a freely competitive market. If so, we will be spending more money on that

good or service, whether it be medical services or something else. We will be spending less on something else. And those prices won't go up as much.

To summarize, then, what I am interested in, what I think we should be interested in, is why have the average level prices gone up? That is what inflation is all about. It certainly cannot be explained by growing market power on the part of American business.

Ms. NULTY. May I respond?

Representative BOLLING. Sure.

Ms. NULTY. In my economics education, there was an explanation of why one would find prices rising irrespective of the state of demand. And it had to do both with the shape of the demand curve and with the existence of monopoly power. Conventional economics has a very ready explanation for that.

Second, my understanding was that these hearings were to devote themselves to the long-range trends. And what I am referring to are the long-range trends in the structure of market power and not whether the degree of monopoly in 1976 when inflation abated was more or less than the degree of monopoly power in 1974-75.

I am referring to the long-range trends which are very well documented in numerous studies which I have cited in my report. What happens when you have a concentration of market power is that whoever has the market power, whether it would be 1 firm or 15 firms, can set their prices to facilitate whatever the particular corporate objective might be. And that might vary from increasing market share to increasing rates of return. And it might change from year to year or from 5-year period to 5-year period.

But basically, they can control what happens to prices more or less irrespective, and I would qualify that, to the state of demand. We saw that very graphically during the severe contraction of 74-75 when demand for automobiles absolutely plummeted, and the response of the automakers was to raise prices very substantially, I believe something in the order of \$1,000 over the course of 18 months because their calculations showed that that was the way in which their profit targets would be achieved.

Representative BOLLING. Did that work?

Ms. NULTY. It sure worked.

Mr. SPRINKEL. It encouraged imports.

Mr. CAGAN. Mr. Vice Chairman, I want to take very strong exception to the proposition that inflation is a problem of market concentration. I have studied this question extensively. I presented a discussion of this subject on April 25 to the Senate Antitrust Subcommittee. They were concerned with mergers, and I testified about the relation of mergers to the inflation problem.

There have been many studies on the question to what degree does market concentration cause rising prices? I want to present you with my present conclusion, which is based on all these studies including the most recent work that has been done.

If you look at price increases across industries in the United States and compare them with the degree of concentration of those industries, there has from time to time been a relationship. It used to be thought that the more concentrated industries raised prices more. You

may remember that Gardiner Means talked about that in the 1930's. Subsequently, it was discussed very much in the 1950's.

But, when you allow for costs, as you have to do, and examine the residual effect of concentration on prices, it turns out that, by and large, there is no relationship at all. In many years, there is a negative relationship; that is, those industries in which concentration is highest have less of a price increase. But, by and large, my conclusion would be—especially in the past half decade when inflation accelerated—there is essentially no relationship.

What is the explanation for this? The explanation is that the setting of prices by firms so as to cover costs without much response to shortrun changes in demand is characteristic of practically the entire economy. The only place where you don't observe this behavior is on commodity exchanges for agricultural products and basic commodities. Generally speaking, retail and wholesale trade and the entire manufacturing sector—especially including wages—exhibit such behavior. Prices are set to be more or less about right for the long run. When a sudden change occurs, as with recession or a sudden increase in aggregate demand, prices sail along at the same rate to cover costs—or, for wages, the cost of living. Prices eventually adjust to demand over the long run, but I think you will find there is no difference between concentrated industries and other industries in this respect.

If we try to cut down the concentration of various industries—which is practically impossible, since we would have to tear the economy apart to do it—there will still be no effect on the dynamics of inflation or the propagation of price increases across the economy. Concentration is not the source of our inflation problem. Our inflation problem is one of pressuring the economy too often and too far into an overexpansion of demand.

Since we tend to be able to focus effectively on only one issue at a time in this country, we should focus public attention on inflation, which the polls say is the No. 1 problem for the public, and convince Congress that this is where they too ought to concentrate their efforts.

We did it in the late 1960's. We had a creeping inflation that everyone said we could never get rid of. Gradually, painfully, it went away. And in the early 1960's we then enjoyed the benefit of a growing economy without inflation.

We simply let inflation start up again in the middle 1960's. But now, after years and years of wishing the problem would go away, it is time to focus our national attention on this problem again. If we do so, I think it can be solved.

Representative BOLLING. The thing that bothers me about the discussion so far is that we have got two different things going on. One leaves out, in essence, social consequences which then are turned very rapidly into political consequences. And the other doesn't leave it out, but it does not, in effect, play back the social consequences of inflation itself.

And we have got two sets of problems, it seems to me, that we have to deal with. We have to recognize that the social costs of the relevantly simple approach to dealing with inflation in a major way are so high that we are not really talking about reality.

There are some politicians, except the extreme conservatives, and there are some of them around now that weren't around before the last

election, Republican or Democrat, moderate conservative or moderate liberal, who are going to sit still when there is a very high unemployment.

Now, we haven't developed the techniques for dealing with the structural unemployment that exists in terms that are satisfactory to a majority. I am not talking about a majority of the people; I am talking about a majority of Congress.

Fairly consistently, right or wrong, the minimum wage has gone up. It may or may not have an overall bad effect. I have been worried about it for about 30 years. I have never been sure which was correct, the conservative argument or the liberal argument.

It worked pretty well in the 20 years after 1946. But we were talking about some solutions that just aren't going to happen. Mr. Nixon, Mr. Ford, were no more likely to use them than Mr. Truman or Mr. Eisenhower. So we have to try to figure out as a people some kind of a compromise that will pull together a viable program.

Now, we came up with a compromise like that once, and it was remembered largely by the business community. And that was the Employment Act of 1946. That was the first time that the people of this country ever, through their policymakers, made a specific decision that the Federal Government was going to deal with its responsibility in affecting the economy.

I think that clearly that is no longer an adequate generality. We have to find some more. I don't know if they have to be more specific, but we have to have a different policy mix.

And the curious thing about that is we never seem to be able to join the debate because the policy mix has to be acceptable both to business and to labor. Thus, it has to become acceptable to a political majority.

How do we get that?

Mr. SPRINKEL. Well, I agree that it is too much to believe or even to wish. And I would not suggest that the Congress, the Federal Reserve, and the President should just sit still and let unemployment grind up to massive levels. No free society should permit that to happen. And this one will not permit that to happen.

However, there is another way to say you can't approach a solution of an inflation problem because of recurring recessions which is to sort of say we can't learn from the past.

We have learned, I believe, over the past 15 to 20 years that the policy of massive response with massive growth in the money supply, large deficits, does indeed in the short run pull unemployment down and raise employment and all those good things that all of us want, but we overdo it.

We forget that the more we stimulate, inflation will accelerate with a lag. So far as I know, the best data show that a rapid increase in the money supply will not cause inflation today or tomorrow. It will be a year and a half or 2 years from now. And if we always opt for the quick fix, the short-run solution, we suffer inflation in the longer run.

We are not dead. We are here today. And we are in that long run, suffering from the massive stimulus over the past 2 years and before.

Representative BOLLING. Let me get at that. The man who in this committee raised the question of dealing with unemployment with a rifle instead of a shotgun, with micro rather than macro, was a Repub-

lican conservative named Curtis and a friend of mine. I have seen him relatively recently.

The dilemma with the solution that is implied, and I think really more than implied, stated in your prepared statement, is that we can all agree that if we could be a little bit softer on the macro end and didn't pour in so much general effect, we would have to be a good deal stronger on the micro end and have to deal very specifically with the structural unemployment of young blacks.

But the dilemma is that when you get in it politically, obviously, that is what I am looking at, and try to get the votes for it, precisely the same people—I am not saying you would or that anybody in the room would—who argue that you can't do the macro things to excess will say, no, you can't afford the money to deal with the problem.

Now, that is going on right now. And if I wanted to, I could name the groups that are doing it. It is absolutely fascinating. We are given solutions, but we have no way of getting them implemented because we don't have the compromise between the major groups to the contest. We don't have the compromise that makes it possible for us to get viable majorities.

And in this society, when you talk about policy change, you are talking about getting majorities in very specific places.

Ms. NULTY. Congressman, I wonder if I could make a comment on that because I have in the past worked quite intimately at a very micro level on the problem of job creation and rifle policies for employment. And while my views are not firmly fixed, I have been exploring certain ideas in this regard.

One of the things that has bothered me whenever we talk about rifle policies and targeted unemployment policies, we look at who the job holders will be, and we don't look at the kinds of jobs they are going to do and what the secondary effects of the Government expenditure on those job programs are going to be.

They are very short-run, narrowly focused, envelope-stuffing-type programs that are basically getting them off the streets and keeping the violence down.

That is in my opinion what has really been behind all these targeted job programs. And that being their nature they are ipso facto doomed to failure. I think there is a bridging position.

Representative BOLLING. You are not telling me they are worse than nothing?

Ms. NULTY. No, I am not. But one thing you should bear in mind is that, especially if you are talking about minority youth—minority youth have been solving their "unemployment problem" in a very interesting way by disappearing from the labor force. And in fact, if we hadn't had a decline in labor force participation rates among minority youth recently, our unemployment rates would be very much higher than they are at the moment.

But to bridge what Mr. Sommers has said and to get back to your earlier question on government regulation, I think there is a tremendous harmony potential, harmony of objectives, between curbing inflation and creating jobs through a targeted capital formation program. And I would like to see it focused in these four sectors where they will have the most immediate impact on ordinary people's experience of inflation.

Because, as I see it, you have killed several birds with one stone this way. In my prepared statement, I used the example of a massive solar energy program.

Representative BOLLING. A la Barry Commoner?

Ms. NULTY. I can't speak to Barry Commoner specifically, but solar energy development in all its forms combined with massive public transportation policy in all its forms which gives you a tremendous public commitment to highly productive capital formation which increases consumer choice on the demand side and, therefore, gives you a lot more leverage, basically disrupts existing market power in the energy sector, at the same time using a very job-intensive vehicle for doing it.

There are a tremendous range of policy options that you could go with in order to implement this. However, what we see coming out of appropriations decisions are absolute peanuts for solar and mass transit, and billions for capital-intensive high-risk technologies like nuclear power.

In fact, when it comes down to making a decision, the decision that is taken at the micro level is one that is going to promote stagflation rather than the opposite that could potentially jointly solve both the inflation problem and the jobs problem.

Representative BOLLING. Does anybody want to comment on that?

Mr. SPRINKEL. Congressman Bolling, you spoke of the necessity of financing job-creating opportunities. Obviously, it doesn't cost much to reduce the minimum wage. It may be politically impossible, but I believe, in incentive systems—it works out there if we give it an opportunity.

I have read numerous stories, as you have, especially in the fast foods industry where we are forced to lay off youngsters after the rise of the minimum wage because it was not profitable to hire them. So that is a very low-cost operation.

Second, I am not an expert on Government efforts to create jobs, but I talk to experts. And I get some of the same impression Ms. Nulty is referring to—namely, you train them to do something where there is no job later on. And it doesn't help them.

So it seems to me the alternative—and we are doing some of that, and I would like to see us do more—is to create incentives for the private sector to hire these low-talented people, give them training, make them more productive, so that they will qualify for wages well in excess of the minimum.

They don't even get a crack at it under present circumstances. They remain in the unemployment camp. And some of them drop out so you don't even measure them. I think that is a tragedy. We should utilize the same motivation that you and I have and encourage them to be trained and qualified for higher rates of pay.

Ms. NULTY. Mr. Vice Chairman, if the minimum wage, the rise in the minimum wage, had had a significant effect on job opportunities, one would have expected to see the results in the lower wage sectors of our economy. And as I said earlier, in fact, it is those sectors of our economy that have been growing the fastest in terms of providing employment opportunities.

So I think there is a problem there of determining just what the correct relationships between the cause and effect are.

Representative BOLLING. Mr. Sommers.

Mr. SOMMERS. Mr. Vice Chairman, I have always wondered what the resistance is to a higher level of public construction activity than the level that we now experience, because construction has a labor input that could be very useful in these circumstances. There is a great deal of relatively unskilled and semiskilled labor required in construction.

And the usual response is that while you get started on a public works construction program, and it goes on and on, and you can't turn it off, when the system gets heated up again, I have never felt a great deal of conviction about that.

There is no reason why a whole arrangement of public construction of varying periods for completion couldn't be developed. And there is no reason why if we get overheated, it would have to be the public construction that would get cut back anyway.

There are other ways of absorbing such circumstances. But the result is that public construction is a very small industry in the United States, and the opportunities, I think, are really large.

Mr. SPRINKEL. Mr. Sommers, as I am sure you are aware, you argue for more Government spending which always results in larger deficits. How do you propose to finance a massive increase in Government expenditures without either creating more money or by increasing the disincentive to private investment?

And I agree with the committee's report of some weeks ago that we have underestimated the supply effects. We create disincentives and wonder why it doesn't happen. It seems to me that moving toward massive Government capital formation is not a free good. It has got to come from someplace. And it is going to either result in more inflation or less resources for the private sector which I think is at least as efficient as the Government sector. And I believe more so.

Mr. SOMMERS. Well, a "massive" is your word, not mine. There is a matter of degree involved here. And anyway, the potential for restricting the transfer payments through public works construction, I think you could get a rather substantial offset in a large number of transfers that now dominate the Federal budget.

If there were a residual excess, that would be a price we would be paying to get at this unemployment problem which I think we all agree, you agree, has to be gotten at. It promises more effect than most of the other ways I know with a moderate cost, with an offset in transfers, and with some real useful output. We have about 30,000 or 40,000 bridges in the United States that have to be crossed very carefully now.

I think a Representative from Pennsylvania has recently introduced a bill that would partly subsidize the interest cost of municipal issues directed at public construction. I think that deserves to be looked at.

Representative BOLLING. I remember a long time ago when we were first working on the interstate highway program foreseeing a little bit how much it would mess up some cities, perhaps including my own, a great many communities, but opting in favor of what we finally worked out after 2 years of attempting to compromise of a program that Eisenhower would accept and we would accept, and opting in favor of it for exactly the reasons that you outline.

It was a way in which to get a public good broadly effective to the society. It was certainly not my first priority. There were a number of others. But it was a way to get a public good at the same time as one provided an enormous amount of employment.

In those days, a good deal more than you would provide to relatively unskilled people.

But I would like to get some of the staff involved in this. I have gone on at some length, and you have gone on at some length. I would like to see if the staff have questions.

Mr. Albertine, you are the leadoff man.

MR. ALBERTINE. I have one question for Mr. Sommers. How do you reconcile the notion that we have very little cyclical unemployment, that perhaps we have been reaching the point of skilled labor shortages, and your call for a substantial or some increase in public works appropriations, public works projects?

The administration last year tried to organize a so-called soft public works program. And it ran into enormous difficulties, mostly from industry people who argued that it was just terribly inefficient use of public facilities.

I would ask you how do you reconcile the two issues?

And also with respect to the question of the time period, as I recall, the Emergency Public Works Act of 1976 was passed sometime in the middle of 1976.

So-called round one, I believe, was a \$2 billion expenditure.

Then, in 1977 we had a \$4-billion additional expenditure or round two.

Here it is in 1979. I don't know the figure, but it seemed to me we still have something on the order of about \$2 billion that is yet to have been expended.

Mr. Sommers. I was thinking of a perpetual reservoir of projects, not an on-again-off-again countercyclical device, and on reconciling this with the view that I offered you about the scarcity of skilled labor now.

I think we are facing the fact in this meeting that the United States has a discontinuous labor force. It is an education-efficiency-training relationship to the real world of jobs out there. Employment moves along just great up to 94 percent of the labor force. Therefore, it tails off very rapidly.

I intended my suggestion really to be the equivalent of a targeted unemployment effort.

Mr. ALBERTINE. So we are advocating something along the lines of some sort of soft public works program that the administration proposed in which you would try to engage large numbers of basically unskilled, untrained, construction industry individuals on the projects.

Again, I am confused.

Mr. SOMMERS. I don't know about "soft." I was thinking about rather brittle public works—bridges and roads.

Representative BOLLING. Railroads, maybe.

Mr. ALBERTINE. I am still confused about where you get this skilled labor force to do those massive and very capital-intensive construction projects. If we are at the point of having labor shortages in that area, how does that help us structure employment?

Mr. SOMMERS. That is true, there are only a limited number of Cat diesel drivers, although a lot of the people we are talking about could learn that skill as well as a number of other construction skills. But, on input of unskilled labor, there is an awful lot of slogging and carrying that goes on in every construction project.

Now, in an overheated time, I suppose it is inappropriate to start on this idea. But as a long-run way of maintaining the system's infrastructure which has productivity implications, I think, for the private sector as well, and of an ongoing source of jobs from low to semi-skilled, that, I think, is a long-run continuing opportunity.

Ms. NULTY. Can I suggest something?

Representative BOLLING. Sure.

Ms. NULTY. You know, we hear a lot of discussion, not only this morning, but in this whole economics realm about finding the right incentives for the private sector. I would like to suggest that one of the best training incentives I could think of would be a skilled labor shortage and that if industry has the demand for its goods and services that it wants to fulfill, it will find ways of training the people it needs. It has done so in the past.

So that I really wouldn't be too concerned about that as a bottleneck. In fact, I look at that as a tremendous opportunity that we should—perhaps that might be putting it too strongly, but we should encourage the creation of labor shortage if, indeed, we want to upgrade our labor force.

The labor market segmentation that we find, I believe, is not inherent in the personal characteristics of the people at the short end of the stick, but rather the effects of discrimination and other kinds of social barriers that have kept them out of apprenticeship and trainee programs in the past.

But if there is a real need for people, they will be brought in.

Representative BOLLING. Mr. Krauthoff.

Mr. KRAUTHOFF. Mr. Sprinkel, you mentioned indexing in terms of taxation. There has been, as you know, increasing talk of indexing and some study of it. Aren't you afraid that once you start indexing that it is difficult to stop?

What do you think of indexing in general?

Mr. SPRINKEL. In general, I think it is an excellent idea. And I wish we would pass that law. I understand that has been debated.

If we have no inflation, which is what we all want, indexing isn't going to affect the tax system. The only way it has an effect is when you have inflation.

We sort of had the worst of worlds in recent years—namely, we wouldn't index, and we kept saying stable prices were just around the corner. Yet, we pursued policies that make inflation worse. It has two major effects.

No. 1, as inflation accelerates, individuals, if they are lucky enough to keep up with inflation in terms of their income, move into higher brackets, and they pay a higher percentage of their total real income to Uncle Sam. Corporations do it the same way in the sense that original cost depreciation becomes less and less realistic.

And they also have profits from inventories which are transient, but reported as income. The inflation results in paying more tax.

The effect of revenues rising is to stimulate Federal spending. That is the way the political system works. I understand why it works that way.

For any one of us out there, any \$1 billion expenditure isn't going to make much difference in our taxes. And I don't want to come down here and tell you why it is a bad thing. But those who have vested in-

interest in that \$1 billion expenditure are down here lobbying the Congress. And it is sold as in the public interest.

So, No. 1, without an indexing tax system, Government spending is encouraged unnecessarily.

And, No. 2, it unduly restrains the incentive to save and invest.

We could well debate why we want more growth but the hearings imply you do because you are unhappy about slow growth. Then, you cannot continue to increase the disincentive to savings and investment. And that is exactly what happens in an unindexed tax system at a time of accelerating inflation.

I don't believe an indexed tax system causes inflation.

Mr. KRAUTHOFF. You don't believe it would lead to indexing across the board, maybe not all the way to the Brazilian example, but one index does lead to another in terms of equity.

Mr. SPRINKEL. The only indexing I would like to see is the tax system and savings bonds. It is unfortunate that savings bonds, which we encourage people to buy, have been a massive ripoff of the poor saver.

I am perfectly willing to let the marketplace take care of the rest of the indexing, and that is what happens.

In fact, when inflation accelerates, wage payments on average go up. This is why you can't stop wage increases at 7 percent with a 10-percent inflation. You find all kinds of ways to bend the rules and pay 10 percent or 11 percent.

Interest rates in the marketplace, not because of the law, begin to anticipate inflation. Now we have great corporations paying 9½, 10 percent for their money.

Most of the markets will automatically account for inflation. They index for inflation. There is no way the market can index a savings bond and the tax system. The Congress alone can do that.

Representative BOLLING. It has occurred to me that in the various statements, everybody seems to agree that at least we come very close to seeing to it that—and I know that this is not completely accurate—some people are saying that we are paying people not to work with Government funds in effect by taking away their incentive to work.

I hear that as an interpretation. So in effect, we are paying people not to work by taking away their incentive.

Now, why then would it be such a terrible step to take. I am not talking about the disabled because I know there are a great many people out there that are disabled who have to be supported because they can't work. So why wouldn't it be better for us to figure out some way—sort of by trading between the conservatives and the liberals—the business and the labor community—to go ahead and just pay them directly to do some work that may be at a slightly higher wage than we would have otherwise done it to do some work for Government projects or Government-developed joint projects?

You know the irrationality of what the private sector does with a great deal of Government subsidy is illustrated by transportation. It is no mystery that the public has paid for all transportation over time in one way or another, starting out with railroads and barges or barges and post roads, coming along with railroads, coming along with all the modern devices.

The public has paid for that, not the private sector. And if it hadn't been for the public paying for those things, we wouldn't have had an

opportunity for private sector to be anything like as effective as it has been. It is the entrepreneur.

I mean, when we were an underdeveloped country, we were in pretty bad shape. As we developed, we got the infrastructure. But why can't we anticipate that kind of a situation? If not with Ms. Nulty's—and I am not saying necessarily it should not be—solar and mass transit, with the whole range of different things, what would be wrong with that?

Why wouldn't that be to the advantage of everybody involved, including the free enterprise system?

Mr. SPRINKEL. Well, I personally have more confidence in the market system making the judgment as to where the payoff is going to be than I have in the political process in those kinds of activities.

Representative BOLLING. How about on transportation?

Mr. SPRINKEL. On transportation, we started out regulating the rates that railroads could charge. And it has been a disaster. Who is to say what would happen to mass transit under Government sponsorship?

Representative BOLLING. It didn't start out that way. What kind of disaster did we have in the railroads before we had any regulation?

Mr. SPRINKEL. Well, I know what the history books alleged. I was not there.

Representative BOLLING. OK, I won't push.

Mr. SPRINKEL. In fact, we had capital flowing in from foreign countries, especially the United Kingdom because the rate of return was very high. And they were willing to spend the money to try to improve our infrastructure.

I have great confidence in the American system allocating the resources where the rate of return is the highest. I have very little confidence of concluding today on the basis of present knowledge that solar energy is going to be our solution. It may be, but if so, it should support itself. We need not have massive Government outlays to arrive at that conclusion.

Representative BOLLING. Don't forget those alternate quarter sections we gave the railroads.

Mr. SPRINKEL. I read about that, too.

Mr. KRAUTHOFF. The United States defaulted on those first bonds about 110 years ago and it was a massive default.

Ms. NULTY. Mr. Sprinkel, could I just inform you that every other energy sector, all the other energy sectors combined—that is to say, fossil fuels, hydropower, nuclear power, and electricity generation and transmission, have received \$217 billion in public subsidies over the last 30 years.

Mr. SPRINKEL. I suspect your numbers are correct. I am also very well aware of the fact that we have had price controls on gas and oil, going back into the fifties on gas, on oil at the beginning of President Nixon's price controls. We have refused to create incentives to conserve. We have refused to create incentives to produce. And now we wake up with a shortfall, and the only way to relieve it is import it from abroad, which makes us vulnerable.

Representative BOLLING. I don't want to have to do this, but I am going to have to go. I am going to leave it to you if you want or Lou if you want. I will leave you in charge.

But I would like to say that I am more than ever convinced there is only one solution with this economic dilemma. And despite your reference to the private sector, I think it is a political solution. There has got to be a new treaty. It has got to be worked out because otherwise, we will spend the rest of our lives in this Congress and in the country, each interest fighting bitterly for its own 100 percent when it is unattainable, and when the best we will ever get is probably 75 percent for each interest.

And there will be some kind of a compromise. That is the way it worked for 20 years pretty well. And it hasn't been working very well in the last 10 or 12 years. Somehow or other, we are going to have to be able to arrive at that. And I think it is going to be sort of fun if we can get Ms. Nulty and Mr. Sprinkel to come up with a compromise.

With that, I thank you and leave it to Mr. Albertine.

Mr. ALBERTINE. Are there any policy prescriptions that would bring you two together? If you were an advisory board to the Joint Economic Committee and Chairman Bentsen and Vice Chairman Bolling asked you to come up with a convenient prescription for controlling longrun inflation, could you do it?

Ms. NULTY. Let me just say one thing. I am all in favor of using incentives where it can be unequivocally demonstrated that those incentives work efficiently and accomplish their aims.

The only question that I am raising is whether the kinds of incentives that have been used in the past are in fact efficient for the purposes we set ourselves at the present. I would just like to say, you know, any given program I suggest should be judged on its own merits by that standard. I do not come with any preconceived notion of whether there is possibility of compromise or not. I just think on any given issue, one has to look at its merits.

As long as we all agree that we have to judge the efficiency of a policy by its behavior in the past, I just feel there is a lot of controversy in some of these areas that certainly can't be resolved this morning, but at least should be discussed in those terms.

Mr. ALBERTINE. Mr. Sprinkel.

Mr. SPRINKEL. I listened very carefully to Ms. Nulty's testimony. I have not read her paper. There needs to be much more discussion as to why inflation was a bad thing. And I certainly agree the poor do get hurt worse than the rest of us. And that's why it is so critically important to get inflation under control.

And I listened very carefully for solutions from her testimony, but the only suggestion I heard was that inflation was caused by market power, and we have been through that argument.

I think there is no evidence supporting that point of view.

And second, she criticized the present control program, suggesting it should be more general. I know of no control program of inflation that has worked if officials arbitrarily set lids on prices and wages. And this one clearly isn't working.

And to make them more massive and mandatory will create additional problems. So I am not certain what her solution would be.

Ms. NULTY. No, I am sorry, I did not suggest a controls program, a massive general controls program. In my paper, I used the energy sector as an example of what some options were, and they involved operating on the supply side as well as on the demand side.

Now, on the demand side, I said that what consumers need is greater diversity of choice in the forms in which energy is consumed. Energy is an intermediate product for consumers. They are concerned with the final services energy provides—heating, cooling, transportation, et cetera.

What I suggested was that a massive public transportation program would reduce not only consumer, but national economic dependency on fossil fuels because it is demonstrably more energy efficient.

This would create some discipline on the market on the demand side. A similar point was made with respect to solar energy from the demand side. On the supply side, I suggested in my prepared statement, although I haven't presented it for formal discussion, a Federal fuels corporation which would not need to expropriate any existing private property, but would act as an intervenor in energy supply markets by developing resources on public lands which are quite significant in terms of total energy supply and probably could become more so under public aegis, undertake buffer stock operations again to exert market discipline on the supply side and be well positioned to negotiate bilateral trade agreements which would provide a mechanism for reducing the impact of energy price increases on the general balance-of-payments problems which has an inflationary effect in our country.

So that I have a number of programs that were not suggested to be comprehensive solutions to our inflation problem. Don't misunderstand me. I am not trying to oversimplify the issues. I am simply giving examples of the way in which public policies can intervene to break up existing market relationships and widen the option of choice on both sides of the market relationship.

Mr. ALBERTINE. I think we should give each of our staff people one shot, starting from my right, Mr. Bartel.

Mr. BARTEL. Three of our panelists seem to be concerned with the large issue revolving about the distribution of national income, in the short and long run, on the one hand, and on the other hand, the role of investment in the economy, and the necessity to increase the rate of investment and the share of investment in GNP, if we want to expand the economy in the future.

I would like to ask Ms. Nulty how, in her vision of the long-run future, she would stimulate investment and yet at the same time try to avoid a reduction in the share of national income that would go to the household sector and continue to sustain the growth in their economic well-being?

Is that too large a question?

Ms. NULTY. It is a rather large question, and I am sure you don't want an hour-long answer even if I could do it which I probably can't on short notice like that.

But I think that you basically have a problem of deficient markets.

I have been really quite surprised to hear that the inflation that we have just been through has been the result of excess demand when all the figures you can see, at least for 80 percent of the population, has been falling consumption levels. And there has got to be a way to resolve that paradox.

I feel that the private sector will invest as long as there is a market for its product.

Now, if the market system is not generating the correct demand signals to call forth the kind of investment that we think the economy needs, I see no reason why the public sector through its expenditure potential should not be in a position to create that demand. If we take my examples of mass transit and solar promotion, those are two avenues that would create tremendous market potential which at the moment is having a lid kept on it. And I can tell you why the lid is being kept on it.

Because the private companies that have started to undertake solar development don't want to see massive public subsidies that would let the little guys get a crack in before they can sew up the markets for themselves.

Now, General Electric, Mobil, Exxon—the list is endless—the top segment of the Fortune 500, have been buying up solar development companies as though there were no tomorrow. And yet, we do not see any outpouring.

We know from various scientific and technological studies that photovoltaic technology, which perhaps over the long term the most promising solar technology, is virtually at the point of commercialization. And what is holding it back is a lack of sufficient market demand.

Here is an excellent opportunity for the Federal Government to go in and create the market that would call forth the investment that would create a photovoltaic industry in this country which does not now exist even though the technology exists.

This is the line which I take.

Mr. ALBERTINE. George Krumbhaar.

Mr. KRUMBHAAR. I found these prepared statements extremely interesting. And I am trying to tie them together and find out where they differ and where they might coincide.

Let me first remark, Ms. Nulty, I am interested in your analysis of market power and at times observe it myself. When I pay much more for an automobile than I think it is worth, I grumble about the automobile companies, saying they have so much market power.

But it works the other way around. I notice, for example, that in the past 5 years, the cost of babysitters in Washington, D.C., has gone up by 100 percent. In 1974, I paid a sitter 75 cents an hour. And now they get \$1.50.

So there must be something more than market power at work. Therefore, I am attracted to what Mr. Sprinkel has drawn our attention to the fact that the average rate of inflation is going up, and this is what we should be worried about.

And I am also attracted to what Professor Cagan calls the basic momentum rate of inflation, how this changes very slowly, and that once you have it at a high rate, it is a very difficult thing to get rid of.

The problem with the questions raised, or the difficulty with the questions raised, by some of the testimony is that while acknowledging that there is a kind of basic momentum rate of inflation or high average rate of inflation, I see this as a profound change which has come about in the last few years.

Nevertheless, some of the testimony shows, I think, a "there has been no change" type analysis. For example, Mr. Sprinkel, you say inflation is and always has been primarily a monetary phenomenon. That, to me, reflects a "there has been no change" type analysis.

Mr. Sommers, on the other hand, says that such a statement is a partial truth and misleading.

So my question is this: I would like you to get behind your statement, Mr. Sprinkel, that inflation is and always has been a primarily monetary phenomenon, get behind that statement to tell me why, if it is just a monetary phenomenon, has it kind of cracked in the last decade as our control of monetary aggregates has gotten out of hand?

Is it a social phenomenon we are facing that forces the monetary authorities to lose sight of monetary targets? Is it a fault of policy that they have their eye on interest rate targets rather than monetary aggregates? Where is the change? Because there has been a change.

MR. SPRINKEL. Well, the reference to inflation being a monetary phenomenon relates to a lot of research that has been done. I published a book a year and a half ago which computed rates of growth in the money supply, per unit of output for a large number of countries over a long period of time.

In my prepared statement is a chart for the United States from 1915 to now. I know of no case where inflation sharply accelerated over a considerable period of time that was not preceded by accelerated monetary growth. I know of no case in which a country pulled its inflation down over a number of years that was not preceded by a slowdown in money growth.

Switzerland and Germany are two good examples of that. They typically have low rates of inflation except back in the sixties, their money supply got out of control, and so did their inflation. But they promptly brought it back down. That is what we haven't done. We just kept going until last November.

So I don't think that is new. We have got evidence back in Roman days, we have evidence during the height of the Spanish Empire when they were importing gold into Europe. In all cases, more money causes more inflation.

Now, there is a sense that Al mentioned in which too much money is a half truth, but not the whole truth. That is why did the money supply get out of control? And I suggested three reasons in recent times. And I said there may be more, and I'm sure there are.

In a highly technical sense, you can say that the Federal Reserve has the wrong operating technique. I can say that because the technique is ingeniously designed to create excessive monetary growth during periods of strong business and not enough during periods of weak business, monetary policy destabilizes the economy.

It need not be that way, but that is the way they do it. But more fundamentally, I think is the pressure to do things with Government spending and the unwillingness to tax to pay for it. We think more Government spending is a free ride.

It is not a free ride. We are going to pay, the American public is going to pay one way or the other. And we pay with deficits, and those deficits can have two kinds of costs. One of them will be inflation if we finance that deficit with new money. And we have done a lot of that.

But it also drags private capital formation if you finance it out of privately generated savings. So I don't think that is new.

The only thing that may be new is our unwillingness to pay or our belief that deficits are not bad things.

Keynesian economic texts have taught us for 40 some-odd years that deficits are good things. What I am saying is they are bad. They either create inflation if you finance with new money or they create a drag

on private capital formation if you absorb them, if you finance them by absorbing savings.

So I don't think that is new either. Just because Keynesian texts say something different doesn't mean it is true. I really don't believe that the laws of economics have been repealed. We have got a lot to learn from history, not only in our case, but in other countries. And I look at that evidence, and I still conclude that inflation is primarily a monetary phenomenon.

That is an oversimplification, but that is the one most important simple statement I can make about inflation.

Mr. SOMMERS. You know my protest to that from the copy, but I don't carry that dogmatic view about the consequences of budget deficits. The financing of those deficits is not necessarily at the expense of the capital formation sector by any means.

As a matter of fact, the past couple of years, there has been abundant supplies of funds available to the capital sector. The heaviest borrowers in the United States have been the private sector, and the heaviest among the private sector has been the household sector which is simply gobbling up American capital at a fantastic rate.

In West Germany, they run a budget deficit that is about double ours now. Japan is running a budget deficit that is four or five times ours. But they finance it with private saving.

And one of the reasons is that the credit extending sectors of those economies do not simply dump credit on consumers the way we do in the United States. We have had a lot of discussion today about the disappearance of the American living standard and the decline in real income and consumption. I disagree with most of that.

We are consuming at a simply enormous rate and saving in the household sector at a very low rate. And I don't believe the figures that suggest that on average, American families are worse off now than they were 10 years ago. That is certainly not true of the real personal consumption measured in the GNP.

A great deal depends on what you want. There is no sense having a lot of roads and no cars. And there is no sense having a lot of cars and no roads.

Ultimately, a public decision about what this society wants and needs ultimately dictates the spending rate of government. And if we run a deficit to produce more roads while consumers reduce their automobile outlay for a while and provide the saving to finance the deficit, I am not saying that is a good or bad tradeoff. It cannot be ruled out on logical grounds as being inefficient or uneconomic.

No sector of this system really pays its way as it goes. The aggregate debt rises a little faster than GNP. This is the long-term history.

The explosion of debt in the postwar years has not been public debt; it has been private debt. When we started the postwar years, public debt was 85 percent of total public and private debt. It is now about 15 or 20 percent. The massive growth has been in corporate debt and in individual debt.

I mentioned earlier that I don't see a prima facie case for simply ruling out additional powers available to the part of our credit system to deal with what would appear to be for the time being a starvation of private capital formation in the presence of an enormously high rate of private and particularly household debt.

Right now at this moment, the government sector in the United States, including State and local as well as Federal, is in balance. The debt in the household sector is rising at \$170 billion a year, and business debt at \$120 billion a year. Again, it is not a prima facie case that it is government debt that is doing all of it.

Ms. NULTY. I am not a monetary economist, and I would be interested, and this may not be the appropriate venue, but it strikes me there is some merit also in looking into the new credit instruments that the private banking system or new financial instruments that the banking system itself has created.

I have certainly got the impression from banking surveys I have read in the London Economist and Business Week that the influence of the Federal Reserve Board and Government expenditure must by its nature be reduced by this tremendous outpouring of private commercial paper, all kinds of new instruments that both the manufacturing corporate sector and banking sector have been able to create which are completely outside public control as far as I can determine.

Mr. CAGAN. May I briefly respond to the general nature of this discussion and the vice chairman's request that a consensus be developed?

I am concerned that in discussing inflation, because of the broad context of the committee's purview, all sorts of things are brought in at the same time. The question of slower growth in the economy, the effect of taxes on energy and public investment—these are important issues and should be discussed. But—I support Mr. Sprinkel here—these are not problems of inflation, through it probably exacerbates them. I would like to see a consensus develop around the point of view that, while we have a lot of problems, inflation is No. 1.

We should say that, no matter what else we do about everything else, we are going to do something about inflation; thus, while we will do something about unemployment, develop our manpower programs and do a lot of things, our No. 1 objective is still to subdue inflation. That, I think, is what is necessary to deal with inflation. If we did start making inroads against inflation, a lot of these other problems would appear to be much less important than they are now.

Mr. ALBERTINE. I think the final word should go to the new director of the special study whose responsibility is to pull all this together. And he has done an outstanding job of setting up these hearings.

I would say specifically to Professor Cagan, the 1975 annual report of the joint committee was endorsed by every member of the committee which did in fact say inflation was our No. 1 problem.

Mr. CAGAN. I'm sorry I missed seeing that statement.

Mr. ALBERTINE. Mr. Krauthoff.

Mr. KRAUTHOFF. All I want to say is thank you very much for a very interesting morning.

And we may not have solved the intractable problem, but I think we are getting it more into focus. And we certainly are going to keep working on it.

And we will be keeping in touch with you. And the next time we get together in our current endeavor will be on Wednesday morning.

We have a room change. We are going to be in room 5110 on Wednesday morning. And we will meet at 10 a.m.

The committee stands in recess.

[Whereupon, at 12:25 p.m. the committee recessed, to reconvene at 10 a.m., Wednesday, May 9, 1979.]

STAGFLATION

WEDNESDAY, MAY 9, 1979

CONGRESS OF THE UNITED STATES,
SPECIAL STUDY ON ECONOMIC CHANGE OF THE
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to recess, at 10:20 a.m., in room 5110, Dirksen Senate Office Building, Hon. John H. Rousselot (member of the committee) presiding.

Present: Representative Rousselot and Senator Javits.

Committee staff present: John M. Albertine, executive director; Louis C. Krauthoff II, assistant director-director (SSEC); Kent H. Hughes, Paul B. Manchester, and George R. Tyler, professional staff members; Mark Borchelt, administrative assistant; Charles H. Bradford, minority counsel; and Stephen J. Entin, Mark R. Policinski, and Peter Turza, minority professional staff members.

Special Study on Economic Change staff present: George D. Krumbhaar, Jr., counsel; Douglas N. Ross, senior economist; Richard D. Bartel, economist; Margaret Blaszak, Michael J. Lockerby, and Carolyn H. Crowley, research assistants.

OPENING STATEMENT OF REPRESENTATIVE ROUSSELOT, PRESIDING

Representative ROUSSELOT. I call the committee to order.

Senator Bentsen is indeed sorry that he can't be here. He suffers from the problem that all politicians fear the most. And that is laryngitis. We are sorry that he isn't here to participate and thank each of you for coming.

I have a fairly brief opening statement I would like to make on this topic of stagflation.

This morning is the final day of public panel discussions on stagflation as part of the Joint Economic Committee's Special Study on Economic Change. I might explain for those not familiar with the special study project that it grew out of discussions with the majority and minority members of the Joint Economic Committee and with the leadership in the House and Senate.

We prepared a prospectus about 2 years ago which called for a 3½-year study to identify the nature of major economic changes occurring in the United States and the world that may have rendered ineffective the traditional methods for achieving aims of the Employment Act of 1946. On the basis of this prospectus, House Concurrent Resolution 248 was introduced in the House and passed overwhelmingly, then was approved by the Senate by unanimous consent on July 18, 1977.

The underlying thesis of the study is that economic, social, political, international, and technical conditions have changed, and are still changing radically. While the basic principles of economics still remain to guide policymakers, the interrelationships between economic sectors have changed, and business firms and households have altered their market activities in significant ways. Thus, economic policy, if it is to be effective, must adopt to a new global environment.

Today, we continue our discussion of persistent inflation and unemployment, sluggish capital formation, and declining productivity growth which our study addresses under the heading stagflation. The recent statistics of both consumer and wholesale prices make us all acutely aware of accelerating, double-digit inflation.

On the other side of the coin, U.S. productivity growth, according to recent statistics, has not just slumped to zero, but has turned negative in the first quarter of this year. Poor productivity growth means the U.S. economy is not improving productive efficiency.

Higher wages are not being offset by higher output per worker. Consequently, this spells more price inflation and even slower real growth in output for the future.

How do we get that much-needed productivity growth? Investment in capital goods, more modern factories and improved labor skills all enhance our productive efficiency. Indeed, as indicated by the Council of Economic Advisors, the drop in our rate of capital investment may have shaved as much as half a percentage point from U.S. annual productivity growth.

The influx of unskilled and inexperienced workers into the labor force, the rapid rise in energy costs, and a slowdown in innovation have also cut into productivity growth. Overcoming these drags in our productive efficiency is not only a key to curbing inflation over the long term, but essential to the growth of national income.

The American people can expect continued improvements in our standard of living only with corresponding improvements in our productive efficiency.

I might add that the urgency of our stagflation problems this year led to an important consensus among Democrat and Republican Joint Economic Committee members and the first unanimous report in 20 years.

The committee's annual report pointed out that in order to correct deeply entrenched inflation and unsatisfactory levels of unemployment requires the Federal Government to put its financial house in order and to meet the major challenges confronting us on the supply side of the economy.

In seeking policy options, we look for measures to enhance the supply side of our economy that contribute to real growth in output and employment. We look for more efficient production processes, more effective management, higher investment, more skilled labor, and higher total productivity. It is our target to achieve price stability in an expanding economy, not a declining one. We cannot make our peace with either rising inflation or rising unemployment.

To join us in a dialog on the longer term outlook and solution to these stagflation problems, the Special Study has invited a number of preeminent economists, business leaders, and labor authorities. Our

first two distinguished panels, after debating the problems of our persistent inflation and unemployment in the 1970's, suggested no quick fix.

They, too, believed our current economic malaise to be caused by a complex set of forces, only some of which respond to macroeconomic policies. A general consensus emerged that stagflation must be attacked simultaneously on a number of policy fronts.

The emphasis on particular policies certainly varied. Fresh, new policy options, however, seemed as remote as ever.

One interesting theme, developed in Monday's discussion, highlighted the way in which Government policy on balance seems to encourage consumption at the expense of saving and investment. The choice of less investment today means slower growth in living standards tomorrow.

Indeed, in recent years, improvement in our standard of living has ground virtually to a halt. Meanwhile, U.S. investment as a component of GNP has fallen far short of the Japanese and German ratios. And this has contributed to our failure to compete effectively in world markets.

In today's panel discussions, we hope our experts will look beyond the immediate questions of monetary and budget policy and out into the 1980's and beyond. Certainly, our long-range prospects are colored by the short-run policy options we take in the Congress today.

But what do you envision for the long-range future? How do you expect the economy to shape up? What do you feel we should, as a nation, strive toward in the more distant future? Are our current policies carrying us toward those objectives, or do they lead us to quite unexpected and unintended scenarios for the American economy and society?

Now, my understanding is that Mr. Leontief is our first witness. All right, Mr. Leontief.

STATEMENT OF WASSILY LEONTIEF, DIRECTOR, INSTITUTE FOR ECONOMIC ANALYSIS, NEW YORK UNIVERSITY, NEW YORK, N.Y.

Mr. LEONTIEF. Do I have about 10 minutes?
Representative ROUSSELOT. Ten or fifteen.

Mr. LEONTIEF. Congressman, the effect of technological advance on employment has been debated for over 168 years since desperate workers in the textile town of Nottingham, England, led by a certain Ned Ludd wrecked newly invented knitting machines that threatened—so they thought—their livelihood. The mill owners of course disagreed and were supported by economists who proceeded to “prove” once and for all that unemployment caused by technology can be nothing but an illusion.

There were, however, notable exceptions, among them John Stuart Mill—the author of “On Liberty”—who, after arguing first that workers displaced by machines in one line of production would necessarily find equally good employment opportunities in some other, later changed his mind and admitted that both the introduction of machines and their increase in numbers and efficiency can, indeed, depress the aggregate demand for labor.

Thirty years ago, it took several thousand switchboard operators to handle 1 million long-distance telephone calls; 10 years later, it took several hundred operators; and now, with automatic switchboards, only a few dozen or so are required. The productivity of labor—that is, the number of calls completed per operator—is increasing by leaps and bounds; it will reach its highest level when only one operator remains, and become infinite on the day that operator is discharged.

The usual measure of the “productivity” of labor is the total output divided by the number of workers, or even better, by the number of hours of work required for its production. The peculiar nature of this conventional measure, used in many official publications and referred to in public policy discussion, becomes clear if one tries to apply it, say, to describe and to assess the effects of the progressive replacement of horses by tractors in agriculture. By dividing the successive annual harvest figures, first, by the corresponding gradually increasing number of tractors and then by the steadily falling number of horses, we arrive at the paradoxical conclusion that at the time of transition, the relative “productivity” of tractors tended to fall, while the “productivity” of horses replaced by them has steadily risen. In fact, the cost effectiveness of horses, of course, diminished steadily as compared to that of the more and more efficient tractors.

Technological advance is uneven. Some sectors of the economy are more affected by it than others; some types of labor are replaced faster than others. Less-skilled workers, in many instances but not always, go first; skilled workers, later. Computers taking on the jobs of white-collar employees perform first simple, then increasingly complex, mental tasks.

From the time that the steam engine was invented, successive waves of technological innovation have brought about an explosive growth of total output accompanied by rising per capita consumption and, up until the middle 1940's, a progressive shortening of the normal working day, working week, and working year. Although increased leisure (and for that matter cleaner air and purer water) is not included in the official count of goods and services used to measure the gross national product, it has certainly contributed greatly to the well-being of blue-collar workers and salaried employees. Moreover, the reduction of the average workweek in manufacturing, from 67 hours in 1870 to 42 hours in the middle 1940's, combined with longer schooling amounted to a large-scale withdrawal from the labor market of many millions of working hours. At the end of World War II, the situation changed. Successive waves of technological innovation continued to overtake each other as before and the real-wage rate continued to go up, but the length of the normal workweek today is practically the same as it was 35 years ago. In 1977, the normal workweek—adjusted for growth in vacations and holidays—was still 41.8 hours.

This means that we have to face the prospect of technological unemployment's turning from its past benign “voluntary” state into a virulent involuntary phase. With this would come an inevitable increase in the social tensions resulting from the slowly but steadily increasing pressure of structural, as contrasted with passing cyclical, unemployment.

In complex systems like the modern economy, there is no such thing as a single cause of a problem. While without technological change there could, of course, be no technologically caused unemployment, neither would such unemployment exist if the total population, instead of growing slowly, began suddenly to shrink, or if workers agreed to accept lower and lower wages. Those who want the current population trends reversed are likely to proclaim that population growth is the actual cause of unemployment; those who would like to see profits rise and wages go down can be expected to declare that high wages are its real cause. The remedy favored by the "keep your hands off the free market" libertarians is wage cuts brought about by systematic reduction of the power of trade unions as well as a curtailment of unemployment payments and welfare benefits.

While in many operations even dirt-cheap labor could not compete effectively with very powerful or very sophisticated machines, a drastic general wage cut would temporarily arrest the adoption of labor-saving technology. But unless the introduction of the cut was interdicted by specially erected barriers, the old trend would be bound to recur. Even a most principled libertarian might hesitate to have the wage question settled by cutthroat competition among workers under continued pressure of steadily improving labor-saving machines.

Some advocates of full-employment policies have proposed that labor-intensive processes be given preference over labor-saving technologies. If administered persistently, such Luddite medicine would slow down technical progress and bring about difficulties even more menacing to the health of our economic and social system than the disease it is intended to cure.

Stepped-up investment can certainly provide additional jobs for people who otherwise would be unemployed. However, under conditions of labor-saving technological advance, creation of one additional job 20 years ago might have required \$10,000; today, \$20,000; and 20 years from now easily \$50,000, or more, even if inflation is controlled. A high rate of investment is indispensable to satisfy the expanding needs of a growing society. But it can make only a limited contribution to solution of the problem of involuntary technological unemployment particularly since the greater the rate of capital investment, the higher the rate of introduction of new labor-saving technology.

In connection with the work in which we are presently engaged, a member of my research team had to visit recently a modern recently constructed copper smelter. What he saw was a gigantic plant, the construction of which cost \$450 million; the total labor force required to operate it consists of less than 50 men per shift.

One must conclude that it would be sensible to explore the possibility of resuming the interrupted process of the gradual reduction of the length of the labor day, labor week, and labor year—or even labor life.

Once, voluntary sharing of technological unemployment—that is, progressive shortening of worktime—was accompanied by a steady rise not only of hourly wage rates and monthly salaries but also of total annual, and even lifetime, take-home income. It appears that because of the greatly expanded opportunities to replace labor by increasingly sophisticated machinery, the impersonal forces of the

market will not favor this solution any more. But humans are not horses—they can reason, and in our democratic society they can vote.

Up to the middle 1940's, American families chose, as their real income rose, to enjoy it not only through increased consumption but in the form of a shorter workweek and more leisure. Without the increase in leisure time, the educational and cultural advances that have marked the first 40 years of the 20th century would not have been possible. Americans probably would have continued to absorb potential technological unemployment in this voluntary way had real wages risen during the next 40 years even faster than they have.

Government policies designed to bring about a steady rise in real wages sufficiently large to induce workers and employers to resume continuous voluntary reduction in the length of the normal work week once could have been considered. Under present conditions, such policies would require so large an increase in labor's share of the total national income that there would be a decline in productive investment, and this would result in an unacceptable slowdown of economic growth. The other alternative policy consists of a two-pronged approach combining direct action toward progressive reduction in the length of the normal workweek with income policies designed to maintain and steadily increase the real family income of wage earners and salaried employees.

We are already practicing such income policies by gradual changes in the structure of our tax system and through social security, medical insurance, welfare payments, and unemployment benefits. The system should be redesigned and expanded so as to reduce the contrast between those who are fully employed and those who are out of work. Let us remember the widespread European practice of paying supplemental benefits to wage earners who work less than the normal number of hours per week.

A reasonable and effective response to the incipient threat of involuntary technological unemployment should aim at bringing about an equitable distribution of jobs and income without, however, obstructing, even indirectly, technological advance.

But, would not the admittedly far-reaching measures proposed above contribute to inflation? Such a question is being asked nowadays whenever one speaks of better environmental protection, improved transportation, or simply of advancing the clock to summertime on June 1 instead of May 15.

In anticipation of such a question, I take the liberty of concluding my testimony with a few words on the subject of inflation.

Inflation that has been plaguing for some time this and several—but notably not all—other advanced free market economies is, in my opinion, not primarily a technical economic, but essentially a deep-seated social problem. While an effective combination of fiscal and monetary policies is indispensable for effective management of a modern economy, their success is predicated not only on tacit mutual understanding, but institutionalized day-by-day cooperation between business and labor.

West Germany—a country whose successful stabilization policies we envy—is usually thought of as an example of ideal unregulated free enterprise economy. In fact, the success of Chancellor Schmidt's

anti-inflation policies is built on the firm foundation of institutionalized joint labor-capital participation in the management of German industry. The bylaw requires that one-half of a board of directors of large corporations represent the shareholders while the other half are elected by labor. Among the latter, most are elected by that corporation's own labor force; but some—the outside labor directors—represent essentially the national trade union. In Germany, as in the United States, wage and employment questions constitute only a small part of management problems which the corporate board of directors has to decide. That means that employers and employees maintain a working contact at the very grassroots of German industry. That cannot be but of crucial importance from the point of view of determining the nature and implementation of agreements reached in national wage negotiations; across-the-board wage negotiations between the employee organizations and unions are conducted in Germany essentially on a national level.

In Austria, another country that successfully resists inflationary pressures, the institutional set-up is very similar to that described above except that the Government plays a greater role in across-the-board negotiations between trade unions and employers' organizations. It does so by contributing rather detailed input-output type projections of economic outlook for some years ahead.

The economic, social, and political situation and historical tradition in labor management relationships in the United States is obviously so different from that which exists in Europe that the institutional arrangements that will have to be devised to bring about a closer day-to-day cooperation between—organized—labor and management are bound to be very different from those described above. But I have no doubt that without such cooperation, all attempt to contain inflationary pressures, through monetary and fiscal measures, by suasion or by legislation, even if they might succeed temporarily, are bound to fail in the long run.

Thank you.

Representative ROUSSELOT. Thank you very much.

Mr. LEONTIEF. I'm sorry to take so much time.

Representative ROUSSELOT. Well, I don't serve in this body; I serve in the other. We have a problem over there with time also, we have a 5-minute rule. But, we gave you an extra 5 minutes.

Mr. LEONTIEF. Thank you.

Representative ROUSSELOT. Mr. Wachter, will you proceed. We would appreciate having your comments.

And thank you, all of you, for joining us. We appreciate your doing it.

STATEMENT OF MICHAEL L. WACHTER, PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA, PHILADELPHIA, PA.

Mr. WACHTER. Thank you for the invitation to appear today.

I see the stagflation problem as essentially having three components—high unemployment, high inflation, and slow real growth. I believe that in many respects, these are distinct problems. In the short run, they may be closely related, with periods of declining unemploy-

ment being associated with rising inflation and more rapid real growth. In the long run, the relationships among unemployment, inflation, and real growth are more complex and are likely to be different than they are in the short run. Hence today, we have high unemployment and inflation and low real growth.

A major point of emphasis, in my discussion, is that traditional Keynesian monetary and fiscal policies deal essentially with only the demand side of the economy. In the short run, Keynesian solutions allow policymakers to expand the economy, reduce unemployment, and increase real GNP growth. The only cost appears to be a higher rate of inflation. The problem is that in the long run, the economy is only left with the legacy of higher rates of inflation. Keynesian policies cannot permanently lower the unemployment rate below the equilibrium or sustainable level, not permanently increase the real rate of growth of the economy.

The political problem is that Keynesian solutions are very attractive because they do improve the shortrun economic outlook. But will the political process accept longer run solutions even though they don't have the quick benefits that you get from highly stimulative monetary and fiscal policy? This issue is of critical importance because shortrun Keynesian solutions worsen the longrun problems. Let me deal first with the issue of high rates of unemployment.

I believe that the unemployment problem today is largely a non-cyclical one. It is primarily related to demographics. In part, this is an indication of how successful Keynesian policies have been. The use of Keynesian policies have enabled us to bring the cyclical unemployment rate essentially down to zero. The major deviations from zero cyclical unemployment have been associated with conscious attempts to reduce the inflation rate.

In today's terms, my own research indicates that the full employment-unemployment rate or the noncyclical unemployment rate is somewhere between 5½ and 6½ percent for the U.S. economy. In my prepared statement, I show that the equilibrium unemployment rate has increased from around 4 percent in the early fifties to the area of 5.5 to 6.5 today. The U*1 series, which is my lower estimate, is based on the demographic shift related to the great influx of younger workers as well as the impact of Government labor market programs. The U*2 series, which provides an upper bound, is, by construction, that unemployment rate which would be required to stop inflation from accelerating.

To deal with noncyclical unemployment, Keynesian policies are simply not successful. If they have an impact, it is likely to be adverse. By increasing inflation without improving real growth, pressures are created to battle inflation through recessionary policies. The result is an increase in uncertainty which is likely to worsen the longrun economic climate.

To deal with these problems, we need to adopt structural policies. In particular, we need to deal with the demographic adjustments associated with the great influx of younger and less skilled workers. I believe that manpower training and employment tax credits have considerable potential. Although manpower training is generally viewed as an old, unsuccessful policy, that is not the case. Training is

always included in manpower legislation, but receives relatively little attention in practice.

Most of the funding is for direct job creation, work experience programs, and summer youth programs for employing young people. Few serious attempts at manpower training have been made.

For example, the young person in the structural unemployment pool is frequently someone who has dropped out of high school at the age of 16 or 17, and has been kicking around the labor market for 3 or 4 years. The traditional Government manpower program hires that person for 3 or 4 months and attempts to retrain him in that period. I would argue that this type of labor market problem is not going to be improved by a 3- to 6-month program or direct job creation effort. It certainly will not be improved by "make work" summer jobs. Training programs that might be successful would have to last at least 1 year and perhaps as long as 2 years. My own view is that the employment tax credit measures that have been suggested recently are also promising in terms of programs to reduce U^* .

Taking a somewhat longer run view of the equilibrium unemployment rate, I think there is a fair chance that we are going to get substantial improvement even if Government programs are otherwise neutral. The demographic forces, after working toward higher unemployment rates over the last 15 years, are about to shift. The percentage of younger workers will begin to decrease as the baby boom generation moves from the youth to the nonyouth age category. This should result in a reduction in youth unemployment and in the overall equilibrium unemployment rate.

As the youth unemployment picture improves, however, the economy will face the new problems created by the baby boom generation age 20 to 40.

With respect to the second issue, high inflation rates, the initial problem is the diagnosis. I believe that too much time is devoted to blaming unions and oligopolies for the inflation problem. In my research over the last 10 years and my reading of the literature, I have found very little evidence that either unions or oligopolies contribute in any significant amount to the inflation problem.

I think OPEC is a factor in the short run, but there again, it cannot explain how we have moved from a 1-percent inflation rate in the early sixties to the 9- or 10-percent inflation rate today. I believe that the answer to the secular increase from 1 percent to 10 percent has to do with overexpansionary monetary and fiscal policy. These policies have reduced unemployment too low relative to the equilibrium unemployment rate and GNP too high relative to potential output.

Table 2, of my prepared statement, presents the old potential output series that was used as a target by the Council of Economic Advisers in the 1960's. Table 3 shows the current Council of Economic Advisers' potential output series. Presumably, this series is now being used as a target for monetary and fiscal policy. If you were to believe these measures of potential output, it would be the case that the economy has rarely experienced overheating. Indeed, according to the old CEA series, the United States has always been below potential output.

On the new CEA numbers, there are 2 or 3 years where the economy has exceeded potential output. But by and large, both the old and

new CEA measures of potential output are simply too high. By the time that the economy reaches or even approaches those measures of potential output, the inflation rate is accelerating. These measures of potential output cannot be used as targets for a policy that wants to avoid accelerating inflation.

My own research efforts as well as others' have been directed at finding a measure of potential output which is compatible with a stable inflation rate. My upper bound series, POT₁ is shown in table 3 and my pessimistic series, POT₂ is shown in table 5.

Those series suggest that the U.S. economy essentially reached potential output some time in 1978. That is, cyclically unemployment is now zero or negative. These numbers can help to explain why the economy has had accelerating inflation during 1978 and 1979.

Personally, I am somewhat amused at the image of a Democratic administration blaming labor unions for accelerating inflation in 1978-79 when I see almost no evidence that labor unions are at all the source of the problem.

For the long run, the solution to the inflation problem has to be geared to reasonable targets on unemployment and potential output. I believe that if my measures of unemployment and potential output are correct, we overestimate the costs of unemployment rates of 6 percent and overestimate the benefits of unemployment rates of 4 to 5 percent.

Using my calculations, the output loss when the unemployment rate is 6 percent is essentially zero. At 6 percent unemployment, the pool of unemployed workers is heavily weighted toward the frictionally unemployed and those who want to work part time or have a low attachment to the labor market. Creating permanent jobs for these workers, in an attempt to reduce the unemployment rate to 4 percent, will only yield increasing inflation. That is, the apparent labor surplus disappears if one tries to maintain too low an unemployment rate.

One of the major policy questions today is whether policymakers should induce a recession in order to lower the inflation rate. My own view is that we should not run a recession. Although recessions do reduce the inflation rate, I think it does so at a cost. Once unemployment rises above 6 percent, there is an output loss. The cost of a recession is thus reduced investment and hence reduced availability of capital goods and trained labor. Given the concern with secular low real growth rates, this is a serious cost. I would argue that the appropriate policy over the long run is not the continuation of stop-go measures. Policymakers avoid running recessions for a couple of years and then bouncing back from them by overstimulating the economy.

The appropriate policy is to stay as close to potential over the long run as possible. While remaining close to potential, the growth rate of the money supply should be reduced slowly over time and the budget deficit should be reduced to zero.

There is no doubt in my mind that the budget deficit is currently too high. If full employment is 6 percent, then the budget should be in balance today. It is not in balance. But I would not favor moving in 1 year from a \$30 billion deficit to a balanced budget because that would

most likely result in a recession. On the other hand, it would be beneficial to have a commitment to a balanced budget over the business cycle.

The third part of the secular stagnation problem is longrun real growth. This is perhaps the major part of the problem. In terms of popular perceptions of economic problems, inflation receives the most attention. But inflation itself does not prevent standards of living from improving. I believe that people are really most unhappy with the slowdown in real growth which has meant unchanging and even declining per capita, after tax, real standards of living.

In the Japanese economy, where occasionally high growth is combined with high inflation, there are fewer complaints about the impact of inflation. There is a recognition that high real growth rates allow individuals to keep ahead of inflation.

In our economy today, the problem that is probably causing the most unease is slow real growth. Living standards, as currently measured, have stopped increasing. Although many see inflation as the cause of the problem, the immediate issue is a slow real growth rate.

If we are going to deal with the underlying economic problem of slow growth, Government policy has no alternative but to shift from encouraging consumption to encouraging investment.

I believe that policies over the last 20 years have not been neutral. Even if neutral policies with respect to consumption and investment were adopted, policymakers would have taken important steps to solving the stagflation problem.

The question, as always, is how do you get from the short run to the long run given the fact that the shortrun solutions seem so attractive and the longrun solutions seem so unattractive.

Two very different examples of currently popular policies that can cause longrun problems are the work registration program and national health insurance. The major impact of the work registration program is likely to be an increase in the measured unemployment and equilibrium unemployment rates. It does very little for the potential output of the economy because the affected welfare population is a relatively low-skilled group. More important, you cannot make people work. You can only make them register for work. The result is to reclassify individuals who are actually not in the labor force into the unemployment category.

Another policy, which represents a prototype policy of the investment consumption tradeoff, is national health insurance. Certainly, the less ambitious national health insurance policies do not pose a problem. The more ambitious measures that have been suggested, however, although popular, must be viewed as alternative to high growth, high investment policies.

The Government cannot do all things in the short run and this is where the tradeoff occurs. In the short run, it may seem more attractive to adopt national health insurance than a high investment policy. In the long run, however, I believe that the low-income population will benefit more from the high investment policies than from the comprehensive national health insurance programs that have been suggested.

Let me conclude with a few general points.

First, a high-investment strategy need not hurt the poor. It need not redistribute income from the poor to the wealthy. It is possible to devise a high-investment policy that will be relatively neutral with respect to the income distribution.

Second, although the types of policies I am discussing are occasionally referred to as the new conservatism, that is a misleading label. It is not clear to me why progrowth policies should be viewed as conservative. In addressing the problems of the poor and the disadvantaged, overexpansionary monetary and fiscal policies have not worked. Although the poor are better off than they were 20 years ago, the improvement is not the result of overexpansion and Keynesian policies.

Hence, I believe that the old liberalism is no more liberal than is the new conservatism. Indeed, I would question whether the old liberalism is not in some ways more destructive for the groups that it means to help than is the so-called new conservatism.

My argument is that the policies that will best aid the poor and the disadvantaged, over the next one or two decades, are high-growth policies.

Thank you.

Representative ROUSSELOT. Thank you, Mr. Wachter. I appreciate your very thorough testimony. And I assume you want your prepared statement submitted for the record with all your graphs and charts?

Mr. WACHTER. Yes, sir.

[The prepared statement of Mr. Wachter follows:]

PREPARED STATEMENT OF MICHAEL L. WACHTER

The Nature of the Stagflation Problem

I. INTRODUCTION

The problem of stagflation encompasses a broad range of interrelated economic topics. The three crucial ingredients are low real economic growth, high unemployment and high rates of inflation. The problem of unemployment is only indirectly related to the stagflation issue. Current high levels of unemployment are due to changes in the equilibrium rates and are not due to inadequate demand. Policies to deal with this type of unemployment need not have any effect on the rate of real growth of the economy or on the rate of inflation.

The problem of secularly rising inflation rates is due largely to failures of government policy. With respect to long-run inflation issues, short-run shocks such as OPEC oil and food price increases are not important. The central problem is the tendency of policymakers to underestimate the sustainable unemployment rate and to overestimate the potential output of the economy. These policy mistakes are due to a lack of recognition, both of the rise in the sustainable (or equilibrium) unemployment rate and of the slowdown in the rate of growth of potential output.

The problem of slow real growth is a major concern and may be the core of the three issues. The factors that account for the increase in the equilibrium unemployment rate and the increased inflation rate are both explanatory elements in the slowdown in real growth. A related causal factor is the gradual, almost unperceived shift in government policy toward encouraging consumption at the cost of investment. These policies are generally adopted to deal with short-run problems of inadequate demand. Their side effects, however, appear over the longer-run in the form of reduced real growth. The U.S. economy is currently growing at approximately 3 percent per year, and most of this growth is attributable to the increase in the size of the labor force. Standards of living have virtually stopped improving. The solution to this problem involves shifting

away from demand oriented and toward supply oriented stimulus policies. In general, the solution to the overall stagflation problem requires the recognition of the pivotal importance of stimulating productivity, investment (in both capital and people) and hence real economic growth.

II. UNEMPLOYMENT

Although unemployment is often viewed as the largest problem of stagflation this is not the case. To an important extent the high unemployment in the United States over the past decade is largely unrelated, except indirectly, to stagflation.

As I have argued elsewhere, the current unemployment rate and level of GNP indicate that the United States has fully recovered from the 1974-75 recession. The high level of unemployment which persists in our economy is approximately equal to that unemployment rate which can be maintained without accelerating inflation (for ease of exposition, I hereafter refer to that as the equilibrium unemployment rate or U^*).

The equilibrium rate of unemployment, which I estimate to be between 5.5 and 6 percent, is the lowest unemployment rate that monetary and fiscal policy can achieve without rekindling inflation. At that level, the pool of job seekers is heavily unbalanced toward unskilled workers. The unemployment rate of skilled workers (broadly defined) is commensurate with our notion of frictional unemployment. Therefore, any overall expansion of labor market demand is inflationary because it increases the demand for skilled workers and capital and these inputs are not available at current money wage and price levels.

An indication that U^* may be above 5.5 percent is the shifting relationship between capacity utilization and the unemployment rate. It appears that for any given unemployment rate today, capacity utilization is much higher than it was in the 1960's. Whereas the availability of labor was the constraining factor in the 1960's, the availability of capital is the constraining factor today. Inflation in the Wharton model tends to accelerate when capacity utilization is around 93 percent. In the current Wharton forecast, capacity utilization in 1979 will be just above 93 percent and unemployment will be approximately 6.2 percent. That is, we will reach the inflation point on the capacity utilization rate when the unemployment rate is still 6.2 percent.

The evidence suggests that several factors have been operating since the early 1960's to increase the equilibrium rate of unemployment. Of particular importance is the demographic shift toward younger and female workers. Young workers, both male and female have been increasing as a percentage of the labor force as a direct consequence of the baby boom of the late 1950's.

As a consequence of the baby boom and the changes in government labor market programs, a pattern of high frequency-low duration bouts of structural unemployment has become the norm. The low-skilled worker is unemployed frequently, but for short periods. For example, over the past year, the average duration of unemployment was slightly over two months, but approximately half the unemployed were out of work for less than five weeks.

In the current pattern of structural unemployment, there are two main reasons for being unemployed. First, if workers' potential earnings, based on their skill, are below the minimum wage, they may have difficulty finding stable employment. The minimum wage law reduces the demand for low-wage workers in the covered sector.

Second, because of the increase in the level of transfer payments, some low-skilled people may not want to work full time. It is sometimes argued that these unemployed are malingering and that the work ethic should be strong enough to force them to work all the time. For the most part, low-wage workers do not have opportunities to work at enriching, pleasurable, creative jobs. They might want to work part of the time in order to remain eligible for public assistance or unemployment compensation, and to retain their skills. But to work all of the time, when society is willing to provide the present level of support, is not "rational" in the economic sense of the term.

Furthermore, many of the structurally unemployed will "outgrow" their unemployment problems. The low work attachment of this group is often associated with the fact that they are teenagers, who do not have family responsibilities, or females that are heads of households who have too much family responsibility. Both groups will alter their working behavior as they age.

TABLE 1.—ACTUAL AND ESTIMATED EQUILIBRIUM UNEMPLOYMENT RATES

	U (Actual unemployment rate)	U_1^*	U_2^*
1955	4.37	4.01	4.19
1956	4.13	4.04	4.22
1957	4.30	4.05	4.24
1958	6.84	4.08	4.28
1959	5.45	4.15	4.35
1960	5.54	4.23	4.55
1961	6.69	4.27	5.14
1962	5.57	4.28	5.29
1963	5.64	4.39	5.41
1964	5.16	4.52	5.56
1965	4.51	4.65	5.73
1966	3.79	4.78	5.89
1967	3.84	4.83	5.95
1968	3.56	4.87	5.94
1969	3.49	4.97	5.75
1970	4.98	5.09	5.83
1971	5.95	5.22	5.98
1972	5.58	5.35	6.12
1973	4.85	5.45	6.23
1974	5.58	5.49	6.28
1975	8.47	5.50	6.31
1976	7.68	5.53	6.34
1977	7.03	5.55	6.36
1978	6.00	5.55	6.40

U_1^* is the equilibrium rate adjusted for demographic factors and Government labor market policies.

U_2^* is the equilibrium rate that satisfies the condition of nonaccelerating inflation in a wage equation.

Source: Jeffrey M. Perloff and Michael L. Wachter, Carnegie-Rochester Conference on Public Policy (supplement to Journal of Monetary Economics), 1979. "A Production Function-Nonaccelerating Inflation Approach to Potential Output: Is Measured Potential Output Too High?"

Two alternative estimates of the equilibrium unemployment rate are shown in Table 1. The first U_1^* , assume that the equilibrium rate in the mid-1950's was 4.0 percent and then adjusts for changes in the demographic composition of the unemployment rate. It indicates that the current level of U_1^* is 5.5 percent. The second estimate U_2^* is obtained by solving a wage equation for the U^* that satisfies the condition of nonaccelerating inflation. The U_2^* series is consistently above U_1^* and is currently 6.4 percent.

The labor market policies stressed by Congress and the Administration, however, are those geared to problems of aggregate demand. There is little attempt to attack the structural problems. Aggregate demand policies have successfully dealt with the cyclical unemployment from the 1974-75 recession, but there has been no dent in the non-cyclical component of unemployment—that is, the remaining 6 percent.

To solve the structural unemployment problem, the skill level and hence the market wage of less skilled workers must be increased relative to the level of transfer payments; that is, the cost of being unemployed must be increased. I am not recommending that public assistance and minimum wages be lowered. The economy can afford a relatively high guaranteed income floor for people who have very low skills or who cannot work. Society is wealthy enough and the social product of low-skilled people is small enough to afford a high level of public assistance as well as high market wage.

Public policy should focus on increasing the skill levels of the group of workers who have suffered on account of the baby boom. That includes not only the young workers, but also disadvantaged workers who were caught in the secondary labor market when the baby boom arrived.

The indirect relationship between stagflation and the high current levels of unemployment is due to the slow growth of productivity, potential output and real wages. That is, government policy has been oriented toward the short-run problem of propping-up aggregate demand. These policies have tended to encourage consumption over investment. That is, the short-run policies to increase demand have served to slow the long-run real growth rate of the economy. As a result of the slower real income and wage growth, given the growth rate of transfer payments, the equilibrium unemployment rate has increased.

The intermediate-term outlook for unemployment, however, is favorable, even if government policy is hereafter neutral. As the baby boom ages and the baby bust cohort enters into younger age groups, the equilibrium unemployment rate will decline. My calculations suggest a decline of between .75 and 1.00 percent in the equilibrium unemployment rate over the next decade. This gain will be due solely to the demographic factor. Government policy and external events can operate to either offset or further this projected decline in the equilibrium unemployment rate.

The relatively distinct nature of the unemployment and stagflation problems are indicated by this projected decline in the equilibrium unemployment rates over the 1980's. Slow growth and high inflation can remain as problems even as the demographic factors operate to lower the unemployment rate.

III. INFLATION

The current level of inflation is largely due to overexpansionary monetary and fiscal policies. Exogenous shocks such as the food and fuel price increase during the 1970's can only lead to ongoing inflation if they are validated by aggregate demand policies. For example, although the large OPEC price increase in 1973-74 and again in 1978 can cause a short-run increase in the inflation rate, the price level should eventually settle down at the new high level dictated by higher energy prices. If the increase in OPEC prices, however, leads to a higher rate of monetary growth and a large full-employment deficit, inflationary expectations will increase. The result is that a short-run spike in the inflation rate becomes a long-run increase in the level of inflation.

The inflationary bias of government policy can be seen by evaluating the GNP and unemployment targets of policymakers relative to attainable levels of potential GNP and equilibrium unemployment. For example, the government's own unemployment rate target is below the 5.5 percent figure. In the late 1960's the government target was 4 percent and the equilibrium rate was between 4.9 and 5.4 percent. By the mid-1970's, when the government target was lifted to 4.9 percent, U^* had increased to between 5.5 and 6.0 percent. This is a key ingredient in the increase of the inflation rate, from an average of 1.5 percent in the early 1960's to approximately 9 percent today. Moreover, the "full-employment" budget surplus is seriously overstated by calculating that figure on the basis of a 4 or even 5 percent equilibrium or full-employment, unemployment rate. The result is a tendency to believe the fiscal policy is more restrictive than actually is the case.

The same factors are relevant to potential output. Table 2 shows the Government's measure of potential output that was utilized during the 1960's. That series is denoted Old CEA. (Where CEA refers to the Council of Economic Advisors) According to this table, potential output was always greater than actual output or GNP. But if the economy always had economic slack, what explains the increase in the inflation rate over the past fifteen years?

More recently, the Government has reduced its measure of potential output. This new variable (denoted, New CEA) is shown relative to GNP in Table 3. Although GNP is now occasionally above potential, this is still rarely the case. An increase in the ongoing or built-in inflation rate cannot occur if the economy is constantly operating with the kind of slack indicated by NEW CEA. However, if the Government uses monetary and fiscal policy to achieve a potential output target which is too optimistic, the result will be accelerating inflation. In addition, the economy will still rarely have a GNP which reaches the target level of potential. If the correct measure of potential is below the target level, the expansionary policies will lead first to accelerating inflation and overheating and second to recession as the government moves to slow the inflation rate.

My optimistic estimate of potential output is shown in Table 3 and denoted POT₁. It is well below the Government's current measure of potential and it indicates that GNP was close to potential by the end of 1978. This is shown in Table 4. According to my pessimistic potential output estimate, the economy was overheating early in 1978. This pessimistic estimate of potential differs from POT₁, in part by using the U^* series instead of U^* , to construct the potential labor series. This series, denoted POT₂, is shown in Table 5.

TABLE 2.—GNP AND THE ORIGINAL COUNCIL OF ECONOMIC ADVISERS MEASURE OF POTENTIAL OUTPUT

	GNP	Old CEA
1955	654.80	653.63
1956	668.80	676.60
1957	680.90	700.38
1958	679.52	725.00
1959	720.45	750.49
1960	736.80	776.87
1961	755.30	804.17
1962	799.12	832.51
1963	830.72	863.07
1964	874.37	895.59
1965	925.92	929.33
1966	981.02	964.34
1967	1,007.70	1,000.69
1968	1,051.80	1,038.35
1969	1,078.80	1,079.13
1970	1,075.30	1,122.53
1971	1,107.50	1,167.63
1972	1,171.10	1,214.58
1973	1,234.90	1,263.40
1974	1,217.80	1,314.18
1975	1,202.30	1,367.03
1976	1,271.00	1,421.95
1977	1,332.60	1,497.10

TABLE 3.—GNP AND ALTERNATIVE MEASURES OF POTENTIAL OUTPUT

	GNP	POT ₁	New CEA*
1955	654.80	651.20	651.41
1956	688.80	667.07	673.91
1957	680.90	687.52	697.18
1958	679.52	712.70	721.26
1959	720.45	732.12	746.16
1960	736.80	757.75	771.93
1961	755.30	786.86	798.59
1962	799.12	815.17	826.43
1963	830.72	842.01	857.08
1964	874.37	872.86	890.34
1965	925.92	901.79	925.00
1966	981.02	941.96	960.77
1967	1,007.70	928.48	996.25
1968	1,051.80	1,014.90	1,031.70
1969	1,078.80	1,047.30	1,068.30
1970	1,075.30	1,082.70	1,106.20
1971	1,107.50	1,122.90	1,145.40
1972	1,171.10	1,160.90	1,186.10
1973	1,234.90	1,202.30	1,223.20
1974	1,217.80	1,240.40	1,271.70
1975	1,202.30	1,280.40	1,316.90
1976	1,271.00	1,324.30	1,363.60
1977	1,332.60	1,368.20	1,412.00
		‡3 percent	‡3.3 percent
1978	1,385.70	1,409.20	1,413.40
1979		1,451.50	1,460.00
1980		1,495.10	1,508.20

Key: POT₁ is the potential output series derived in Jeffrey M. Perloff and Michael L. Wachter, Carnegie-Rochester Conference on Public Policy (supplement to Journal of Monetary Economics), 1979, "A Production Function-Nonaccelerating Inflation Approach to Potential Output: Is Measured Potential Output Too High?"

*New CEA is the current potential series used by the Council of Economic Advisers.

†The series was extrapolated by assuming 3 percent growth rates per annum.

‡The series was extrapolated by assuming 3.3 percent growth rates per annum.

TABLE 4.—QUARTERLY GNP AND POTENTIAL

	GNP	POT ₁	
1976:			
1st quarter.....	1,255.5	1,307.4	
2d quarter.....	1,268.0	1,316.0	
3d quarter.....	1,276.5	1,332.6	
4th quarter.....	1,284.0	1,341.3	
1977:			
1st quarter.....	1,306.7	1,352.6	
2d quarter.....	1,325.5	1,362.2	
3d quarter.....	1,343.9	1,375.2	
4th quarter.....	1,354.5	1,382.9	
		* 3	† 3.3
		percent	percent
1978:			
1st quarter.....	1,354.2	1,393.2	1,397.2
2d quarter.....	1,382.6	1,403.1	1,407.2
3d quarter.....	1,391.4	1,416.5	1,420.6
4th quarter.....	1,414.7	1,424.4	1,428.5
1979:			
1st quarter.....	1,417.3	1,435.0	1,443.3

* The series was extrapolated by assuming 3 percent growth rates per annum.

† The series was extrapolated by assuming 3.3 percent growth rates per annum.

TABLE 5.—GNP AND A "PESSIMISTIC" POTENTIAL OUTPUT MEASURE

	GNP	POT ₂	
1955.....	654.80	650.36	
1956.....	668.80	663.14	
1957.....	680.90	681.60	
1958.....	679.52	706.22	
1959.....	720.45	723.54	
1960.....	736.80	747.77	
1961.....	755.30	775.64	
1962.....	799.12	802.33	
1963.....	830.72	827.85	
1964.....	874.37	857.24	
1965.....	925.92	835.24	
1966.....	981.02	924.22	
1967.....	1,007.70	963.53	
1968.....	1,051.80	995.09	
1969.....	1,078.80	1,026.70	
1970.....	1,075.30	1,061.50	
1971.....	1,107.50	1,102.20	
1972.....	1,171.10	1,139.20	
1973.....	1,234.90	1,180.60	
1974.....	1,217.80	1,218.70	
1975.....	1,202.30	1,258.40	
1976.....	1,271.00	1,299.40	
1977.....	1,332.60	1,340.60	
		* 3 per-	† 3.3 per-
		cent	cent
1978.....	1,380.82	1,384.84	
1979.....	1,422.24	1,430.54	
1980.....	1,464.91	1,477.75	

* The series was extrapolated by assuming a 3-percent growth rate.

† The series was extrapolated by assuming a 3.3-percent growth rate.

Source: See the reference in table 3. The POT₂ was constructed in Perloff and Wachter, op. cit.

Given this view of inflation, what is the intermediate run outlook for this variable and what are the costs of ongoing inflation? The outlook is simply impossible to predict because it rests squarely with the future decisions of the monetary and fiscal authorities.

One of the major problems in the anti-inflation battle is that the appropriate unemployment rate target for stabilization policy is not known with certainty. How far can the monetary and fiscal authorities push down the unemployment rate without causing accelerating inflation? In the 1960's it was argued that uncertainty about the length of the lagged response of economic activity to aggregate demand policies was the key problem in fine tuning the economy. The problem still exists, but I would argue that it is small compared with the issues raised by the uncertainty over the level of the sustainable unemployment rate. My equilibrium unemployment rate of 5.5 percent is a point estimate with a large standard deviation. The unemployment constraint could easily be over 6 percent.

A commitment to fighting inflation suggests that the government avoid using monetary and fiscal policy to push the unemployment rate below 6 percent. The 6 percent unemployment rate target, however, is only the target for monetary and fiscal policies. The goal should be to achieve a lower unemployment rate and a faster GNP growth rate by adopting structural measures aimed at improving the supply side of the labor and capital markets.

In order to reduce the inflation rate, the evidence suggests the need for a long-run commitment to avoid overheating the economy. Within this context, however, it is not necessary to run a recession. Rather, the evidence suggests the adoption of a policy which maintains unemployment close to 6 percent while the money supply growth rate slowly decelerates and the full-employment surplus, properly defined on a 6 percent unemployment rate, is brought into balance. This policy will require several years before the inflation rate is significantly lowered, but the alternative seems to be a continuation of accelerating inflation combined with occasional recessions that are precipitated in abortive and short-lived attempts to reduce the inflation rate.

One problem with using recessions to cure inflation, is that they reduce the rate of capital accumulation and investment. The optimal monetary and fiscal policy to encourage maximum supply side growth is a policy which minimizes the variance in GNP growth rates. The adoption of this approach also requires using reasonable targets for potential output and equilibrium unemployment.

IV. INCREASING THE RATE OF GROWTH OF REAL OUTPUT

The major element in the stagflation picture is the slowdown in real economic growth. The current inflation and unemployment rates would be considerably less painful if the rate of real economic growth were increased. At present the rate of growth of potential output (using POT₁ or POT₂) is approximately three percent. In per capita terms, after adjusting for the growth in the labor force, this is a dismal record.

The general shape of policies to increase real GNP growth rates are well known. The basic requirement is a shift away from policies which encourage consumption toward those which encourage investment. This would require a major overhaul in the tax structure as well as a change in priorities for government expenditure programs. Contrary to conventional wisdom, such policies need not increase the gap between high and low income families. Incentives for increased savings rates can be targeted at the middle class and government expenditure programs can be aimed at increasing the "human capital" of our lowest skilled workers. Obviously, even outlining the details of a high growth rate policy is beyond the scope of my testimony.

Over the long-run the success of a high growth rate policy is improved if the inflation rate is reduced. A reduction in the level of inflation, given our economic institutions, also means a reduction in the variance of the inflation rate. Business and individuals can best make long-run investment decisions in a noninflationary, stable environment. The experience of some western European countries and Japan, however, indicate that high inflation does not rule out high long-run growth rates for real income.

More important to improving the real growth rate is a commitment to ending the unending budget deficits. Keynesian economics, properly applied, argues for a deficit during recessions and a surplus during expansions. Given the inappropriate use of too low an unemployment target, the U.S. economy has consistently run budget deficits during expansions as well as during recessions. The U.S. budget

should be in balance when the unemployment rate reaches 6 percent. The current policy results in "crowding-out" of business investment by government consumption.

A decision to adopt a high growth rate policy, if made at all, will be politically difficult. Popular expenditure programs may have to be cut back. A test case over the next few years will be the congressional decision on national health insurance. In its current form, this is the prototype program that is popular, consumption oriented, but at the margin will crowd out high growth policies. Given scarce resources, and a current low growth rate of potential output, the economy faces a clear trade-off between new expenditure programs such as national health insurance and pro-growth policies.

V. THE RELATIONSHIP BETWEEN WELFARE PROGRAMS AND HIGH GROWTH RATES POLICIES

An important issue is whether a high level of welfare payments is a barrier to a supply side policy of increased capital accumulation, productivity growth and lower equilibrium unemployment rates. Do increasing Federal Government outlays or welfare program exert an inflationary bias by suppressing incentives to work and by shifting funds from relatively high savers to high consumers? This is a complex question with considerable merit. It can, however, be pushed too far.

As discussed above, the increase in transfer payments (such as AFDC, food stamps and unemployment compensation) as a percentage of market wages should lead to an increase in the equilibrium unemployment rate. This cannot be shown unambiguously because of the poor quality of the data on transfer payments, but the debate in the economics literature is over the magnitude rather than the sign of the effect. The decline in the cost of being unemployed is one of the factors that is partially captured in the U_1^* measure presented above.

In addition, almost all income transfer programs reduce the aggregate savings and investment rate since they presumably are designed to transfer income from wealthier to poorer families and individuals. Although there is little data on the issue, it is safe to assume that families on AFDC or other transfer programs are not saving significant amounts out of their transfer income. These programs are specifically designed to support the nonproductive members of society by providing a minimum income floor.

The income transfer programs affect two groups of individuals. The first group, those serviced by welfare programs, are among the lowest skilled individuals in society. The cost to society of having these individuals not working is measured by the income transfers they receive. The level of transfer payments in the U.S. are not out of alignment with those paid by Western European countries. Wealthy societies can afford to maintain a relatively high guaranteed income floor. Bringing these individuals back into the labor market will contribute little to GNP because of their low skill levels.

For example, I would argue that the work registration programs, aimed at forcing welfare mothers back to work, is misplaced. The Government can force someone to register to work, but cannot force them to work. The result will be an increase in the labor force and a resulting increase in the equilibrium unemployment rate. Moreover, since welfare mothers tend to have low skill levels—which is why some are on welfare rather than working—the lost GNP is extremely small. As a result, this type of program is likely to be counter-productive; its main effect will be to increase the equilibrium unemployment rates even further above the target levels of U^* used by monetary and fiscal authorities.

The unemployment insurance system deals with the second group of individuals. Since unemployment compensation is a percentage of the market wage, high as well as low wage individuals may be receiving benefits. The economic evidence suggests that unemployment insurance does tend to increase the duration of unemployment. A component of this increase in duration may improve productivity. It may allow young workers to search for a job in which they are likely to be most productive. In addition, it allows cyclically displaced workers to await recall to their old jobs. Where specific training is important, productivity over the cycle will be improved by encouraging workers to await recall rather than to take a new permanent job.

On the other hand, the unemployment compensation system encourages firms to layoff workers during a recession and it subsidizes seasonal industries. These distortions reduce productivity and increase the equilibrium unemployment rate.

The appropriate policy is to adjust the unemployment compensation tax schedules so that virtually all firms face additional taxes (somewhat in relationship to the cost of the benefits) if they layoff workers. Too many firms, especially seasonal firms, are at the maximum tax rate so that there is no additional tax charge for an additional layoff.

The unemployment insurance system also encourages those who have lost their jobs but do not want another job to stay unemployed so as to maintain eligibility for unemployment compensation. That is, individuals who want to work part-of-the-time are encouraged to report themselves as unemployed than out of the labor force. This again serves to increase the equilibrium unemployment rate but has little impact of productivity.

Since the benefits for unemployment insurance usually extend for 26 weeks (when the economy is not in a recession), it is unlikely that relatively skilled workers who want full-time jobs would use the system as a way of avoiding work. Indeed, for workers on temporary layoff the option of turning down a recall almost always results in the termination of benefits.

A potential cost of the transfer programs is the work disincentives to the tax payers. That is, welfare programs not only reduce the work incentives of the payees of the transfer system, but also of the tax payers. For both groups, the marginal tax rates on the wage income are increased. The negative impact on work incentives would yield a reduction in potential output. But the work disincentive effect is general to the overall income tax system and the variety of programs it supports. It is unlikely that the taxes collected to pay for the welfare program have different work disincentive affects for the taxpayers than other government programs.

The Nation's welfare and unemployment compensation systems, although reasonably liberal, need not be viewed as having an inflationary bias. If the government were to recognize that its transfer policies have the effect of increasing U^* and possibly reducing potential output, there would be no additional inflationary pressures. Of course, this means that the Government would have to allow the unemployment rate to increase to the level of the new higher equilibrium rate.

To summarize, the existence of relatively generous welfare and unemployment insurance systems increases the equilibrium unemployment rate and it shifts resources from more to less productive members of society. The increases in the equilibrium unemployment rate is a problem, however, largely because its changes are not easily monitored and the Government tends to ignore increases in U^* . If the Government were to recognize the effects of its policies on U^* and potential output, the welfare system could be characterized as inflation neutral.

The recent reduction in the growth rates of potential output and productivity and the increase in the equilibrium unemployment rate, could be offset by a switch from high consumption to a high investment economy. Investment tax credits, accelerated depreciation, manpower training, employment tax credits, and a reduction in marginal income tax rates, could all be part of a pro-investment package. Moreover, the transfer system, excluding social security, is sufficiently small so that these policy changes could be made without reducing the relative level of welfare payments. Over the long-run a high investment policy would yield higher wage rates, lower equilibrium unemployment rates, and consequently a reduction in the welfare population.

Representative ROUSSELOT. Mr. Meltzer, I guess you are next on the totem pole.

STATEMENT OF ALLAN H. MELTZER, MAURICE FALK PROFESSOR OF ECONOMICS AND SOCIAL SCIENCE, CARNEGIE-MELLON UNIVERSITY, PITTSBURGH, PA.

Mr. MELTZER. Thank you, Congressman Rousselot. I appreciate the opportunity to present my views on the topics of the special study.

I will read parts of my prepared statement and shorten my remarks.

We are deep into the era of relatively high measured unemployment rates and high rates of inflation that is described by that inelegant term "stagflation." Growth rates of real output fell in Western

Europe and the United States just at the time that the growth rates of the labor forces increased.

The rate of increase in productivity has fallen, so real incomes have either fallen or risen more slowly than in the sixties. Inflation and progressive tax rates financed further increases in the relative size of the public sector with the result that current and prospective taxes have grown more than incomes.

The combined effect of rising prices, higher unemployment, higher taxes, and slower growth in real income produced the dissatisfaction and malaise that makes "stagflation" a widely discussed problem. Governments appear unable to reduce inflation without increasing unemployment or to reduce unemployment without, sooner or later, increasing inflation.

Nowhere does this outcome seem more apparent than in the United States where the rates of inflation and unemployment rise with each succeeding round of expansion and recession, and where measured productivity growth in the private sector has remained close to zero, on average, for the past 2 years.

The appearance of a positive relation between the cyclical average rate of unemployment and the cyclical average rate of price change is misleading. There is no necessary relation between the two, and any existing long-term relation between the two in the United States could be eliminated by a decision to index the tax system.

Stagflation appears to have two distinct meanings. One is the apparent longer term relation between the average unemployment rate and the average rate of inflation just mentioned. The other is the very limited reduction in inflation—and relatively large increase in unemployment—that occurs in the first year or two following a shift in political priorities from reducing unemployment to reducing inflation.

The reason that unemployment responds to policy change more quickly than prices is very different from the reason that average unemployment and inflation are higher than in the past.

I discuss the lessons to be learned from long-term experience in Britain and the United States, and draw some conclusions.

Although stagflation is a relatively new problem, some of its principal features can be found in earlier periods. Two periods are of special interest. The interwar experience of Britain helped to shape many of the beliefs now commonly held about unemployment.

The depression of the 1930's seemed to show that the interwar experience of Britain was a general phenomenon, applicable to many countries. Countercyclical fiscal and monetary policies were used on a much larger scale than ever before, and the groundwork for postwar economic policies was laid in that era.

The lesson from the experience of Britain in the 1920's and in the United States during the thirties is that high rates of unemployment coexist with rising prices, falling prices and stable prices. There is no reason to expect an association between the average unemployment rate and the average rate of price change, and none is found.

This does not mean that nothing can be done. There are policies that lower the rate of unemployment, but if we understand the reasons for unemployment, we may not want to adopt some of those policies.

Reducing real tax burdens, slowing the growth of Government spending to the rate of growth of output or lower, reducing the size of transfer payments or their rate of increase, and lowering the minimum wage relative to the average wage rate are all means of reducing the average rate of measured unemployment and the number of discouraged workers. The decision to take these steps is the responsibility of the Congress. If they are taken, the average rate of measured unemployment will decline.

Failure to reduce the relative size of the government sector by permanently lowering tax rates, or to reduce unemployment benefits relative to wages, or to take other steps that increase the after-tax returns to labor and capital raises unemployment rates.

If we can remember that the higher average unemployment rates and slower growth of output are, in part, a result of our tax and transfer policies, we will avoid one of the major mistakes of economic policy in this decade—using fiscal and monetary policies to pump up spending with the aim of reducing the average unemployment rate or eliminating some arbitrary measure of the output gap.

Professor Wachter has spoken and written about the arbitrariness of these measures of the output gap, and he has produced numbers which in my judgment are far more meaningful than the numbers used as a guide to policy.

I believe one of the more interesting phenomena of the last 2 years has been the fact that much of the apparent output gap, about which the committee heard a great deal, vanished without being eliminated. It was simply erased from the books when the Council of Economic Advisers decided that their previous measures were inappropriate.

Yet, policies were geared to the elimination of that output gap. And much of our current inflation is due to the fact that we persisted in policies to close an output gap which has now vanished from the books.

To raise standards of living, we must have increasing capital for workers and increased productivity. Since 1973, both of these traditional sources of growth and living standards have been modest. Productivity growth has averaged less than 1 percent a year since the previous peak in 1973.

I believe that the most effective programs that the Congress can enact to increase long-term productivity growth are these:

One, permanent tax reductions for individual and corporate taxpayers, accompanied by

Two, permanent reduction in the growth of public spending and transfer payments and a combination of

Three, deregulation; and

Four, the establishment of rules for regulatory agencies that are as clear, definite, and long lasting as the Congress can provide.

The Congress has made enormous grants of authority to the regulatory agencies who provide an enormous amount of variability in the expected returns to capital and the opportunity for labor.

We have built a system in which very high rewards go to those who find ways to circumvent regulation or to reduce its burden on firms or groups. Firms often have a greater opportunity to reduce costs by reducing the burden of regulation than by improving production techniques.

Skilled personnel, our most talented individuals, are attracted to fields or endeavors that are much more valuable to firms or groups than to society as a whole. One step in a program to restore productivity growth is to reduce the social cost of regulation. The other main step is to slow the relative growth of government and the anticipated growth of taxes.

Let me now turn to the problem of cyclical stagflation.

Whenever political priorities change from stimulus to restraint, the size of the budget deficit, or the public sector borrowing requirement, and the growth rate of money change. The first effect of the shift toward less expansive economic policies is on employment. Inflation starts to fall only after restraint has been maintained for some time.

Sometimes, a year or more passes before the policy of restraint has any noticeable effect on the rate of inflation. The converse is also true. A policy shift toward greater stimulus first affects output, then employment, and later prices.

The problem with the types of policies on which we have relied is that they have not worked as promised. Whatever confidence people may have had about the ability of fiscal and monetary authorities to keep the economy near full employment without inflation eroded long ago. The policies failed because they were based on incorrect beliefs about the way in which the economy works.

There are two principals, and I believe, fundamental errors in the theory of inflation and employment or unemployment that guide policymakers. One is the failure to recognize that workers in cyclically sensitive industries expect periods of unemployment.

The other is that workers, on average, choose to accept unemployment in preference to wage cuts as long as they believe that unemployment is temporary.

Workers in cyclically sensitive industries know that fluctuations in employment have occurred in the past and will occur in the future. They are uncertain about the timing and duration of recessions, but not about their occurrence. No one knows precisely when a recession will start, how long it will last or how severe it will be.

However, few of us are unaware that there have been recessions, and few doubt that there will be future recessions.

At the start of a recession, workers who are "laid off" regard the experience as consistent with their belief that the layoff is temporary. They do not, in most cases, search for new jobs at lower wages, but instead use their time to take a vacation, to fix up their houses, to do odd jobs. They wait to be recalled.

If, on average, a worker experienced layoffs or unemployment of this kind for periods of 6 or 8 weeks every 3 or 4 years, he is not surprised to be laid off when recession occurs. He does not start to look for permanent employment elsewhere at lower real wages. He waits.

It is true, as many economists have noted, that workers could offer to reduce their real wages in periods of low demand for their services to maintain their jobs. Workers agree to reduce real wages, as many examples show, when they believe that the alternatives are a permanent loss of employment or search for a different job at lower pay.

The response to a permanent loss of employment resulting from changes in tastes, technology, or international competition is very different from the response to the temporary changes in employment that occur during recessions. Employees most readily agree to cut wages when the alternative is a plant closing.

Unfortunately, changes in employment do not come with neatly typed labels indicating that they are permanent changes. Workers and employers—people in general—must repeatedly solve a complex inference problem to decide on the proper course of action. Offering to supply labor at lower real wages represents a loss of lifetime income if the education in demand is temporary.

Failing to cut real wages when the reduction in demand is permanent also means a loss of lifetime income. The proper choice is not always clear at the time, sometimes not immediately obvious afterwards. This is one reason that workers and firms are slow to adjust prices and money wages up or down.

Suppose that a government of good intentions responds to every recession by pushing up spending to stimulate the economy. Each time this is done, output recovers, employment rises, but the rate of inflation is higher at each trough than at the previous trough and higher at each peak than at the previous peak.

Experience of this kind, and it is our experience, teaches the public two lessons. First, whether the decline is temporary or permanent, the average rate of price and wage changes rise from cycle to cycle. Resistance to relative wage and price reduction increases in recessions.

The other side of the coin is that anticipated inflation increases and the demand for higher wages rises.

Second, all temporary recessions are expected to be offset by stimulative Government policies, and the costs of unemployment are expected to be reduced by unemployment compensation benefits. There are fewer reasons to look for employment at lower real wages and more reasons to wait for stimulative policies to restore employment at the old job once these policies are anticipated.

The use of variable monetary and fiscal policies adds an additional dimension to the already complex inference problem. Uncertainty about the future course of monetary and fiscal policies add to uncertainty about present and future tax rates and uncertainty about inflation.

People who want to know whether tax rates will rise or fall in the future must guess, or infer, whether the bulge in Government spending during a recession is a portent of permanently higher spending and tax rates or temporary higher spending. Past experience gives some guidance, but it is very imperfect guidance.

Yet, differences in anticipated tax rates often are the deciding factor in decisions to invest in durable capital, to invest in land or other tax-sheltered capital or to consume.

With hindsight, it is easy to identify the sustained change in money growth that lead to higher or lower inflation. I assure you that there is much less certainty when the turning points occur. Our current uncertainty about the rate of monetary growth is an extreme, but nevertheless useful, example.

We have been through four or five cycles in which governments have made explicit commitments to end inflation. Is it unwise for the public to treat such commitments skeptically? I believe not. After four or five cycles in which promises to end inflation were followed by higher average rates of inflation, credibility is strained.

The experience of 1966-67 is informative. The 6-month average rate of change of wholesale prices fell from 4 percent to minus 2 percent in 1 year, and a similar average for consumer prices fell from 3.8 percent to 1.8 percent. People believed the anti-inflationary policy that had been announced and implemented would be maintained.

The retardation of the economy was so brief that the episode is not recorded as a recession. The anti-inflation policy worked quickly because inflation was a relatively new phenomenon, and the Government had not reduced its credibility by promising to end inflation while acting to increase it or by abandoning policies that slow inflation when unemployment increases.

The rest of my remarks suggest some policy to reduce cyclical stagflation. These policies are policies I have advocated on several occasions before.

The principal recommendation is, by now, familiar. My colleagues on the Shadow Open Market Committee and I have asked repeatedly for a commitment from government to a preannounced policy of sustained, gradual reductions in the growth of money by 1 percent per year until a noninflationary rate of money growth is achieved.

A similar recommendation has now been made, unanimously, by the House Committee on Banking, Currency, and Urban Affairs. Chairman Miller has recognized on many occasions that inflation cannot be ended in less than 3 to 5 years.

Recognition of the problem is not enough. The Congress should require the Federal Reserve to adopt a policy of this kind, and the Congress should endorse the policy. If a commitment to an anti-inflationary policy is made by the Federal Reserve, the Congress, and the administration is followed by implementation, beliefs about future inflation will erode more rapidly and the cost of ending inflation will decline.

To supplement monetary policy and make it credible, other steps must be taken. A commitment by Congress and the administration to hold the growth of public spending below the growth of output implies that the average tax rate will fall in the future.

But the commitment also implies that the Federal Reserve will not be called upon to finance larger Government deficits by raising money growth. A commitment to slower growth of government reinforces and complements the commitment to maintain a monetary policy that ends inflation.

There are many policy changes that can help to reduce the problem of cyclical stagflation. I would like to conclude, however, by pointing to two current risks that cannot be avoided without congressional action. I refer to the risks of a major error in monetary policy and the risk of a financial panic following a run on one of the noninsured financial intermediaries that now hold assets that formerly were held in insured commercial banks and thrift institutions.

The risk of a major error in monetary policy arises because the numbers now added together to form M_1 , M_2 or any other M do not have the same meaning that they had before the development of automatic transfer systems, NOW accounts, overnight repurchase agreements, money market funds, and many other assets.

Currently, money growth may be pushing the economy toward substantially higher inflation or deeper recession than we know or believe.

The risk of an error in interpretation cannot be reduced, at current rates of inflation, unless Congress agrees to repeal regulation Q, to repeal the prohibition against interest payments on demand deposits and to permit interest payments on required reserves.

The Congress has heard testimony on these proposals for more than a decade, but it has not acted. The failure to act now to lower the risk of a potential crisis is inexcusable and costly, in my opinion.

Suppose some larger seller of commercial paper, Eurodollars or other financial instrument defaults. These instruments are held indirectly by individuals and small firms through their participation in some of the substitutes for demand and time deposits that are now held by many people. The substitutes are not insured.

Here, we have the ingredients for the type of financial panic that we have not experienced since deposit insurance started more than 40 years ago. This risk can be reduced by removing controls on interest rates at banks and thrift institutions and by a clear statement from the Federal Reserve that it will serve as lender of last resort to the entire financial system.

The probability of a panic is small, but it is larger than it need be. And the probability is increased by the failure of Congress to remove regulations and restrictions.

Thank you.

Representative ROUSSELOT. Thank you very much, Mr. Meltzer.

[The prepared statement of Mr. Meltzer follows:]

PREPARED STATEMENT OF ALLAN H. MELTZER

The Problem of Stagflation

We are deep into the era of relatively high measured unemployment rates and high rates of inflation that is described by that inelegant term "stagflation." Growth rates of real output fell in Western Europe and the United States just at the time that the growth rates of the labor forces increased. The rate of increase in productivity has fallen, so real incomes have either fallen or risen more slowly than in the sixties. Inflation and progressive tax rates financed further increases in the relative size of the public sector with the result that current and prospective taxes have grown more than incomes.

The combined effect of rising prices, higher unemployment, higher taxes and slower growth in real income produced the dissatisfaction and malaise that make "stagflation" a widely discussed problem. Governments appear unable to reduce inflation without increasing unemployment or to reduce unemployment without, sooner or later, increasing inflation. Nowhere does this outcome seem more apparent than in the United States where the rates of inflation and unemployment rise with each succeeding round of expansion and recession and where measured productivity growth in the private sector has remained close to zero, on average, for the past two years. The appearance of a positive relation between the cyclical average rate of unemployment and the cyclical average rate of price change is misleading. There is no necessary relation between the two, and any existing long-term relation between the two in the United States could be eliminated by a decision to index the tax system.

Stagflation appears to have two distinct meanings. One is the apparent longer-term relation between the average unemployment rate and the average rate of inflation, just mentioned. The other is the very limited reduction in inflation—and relatively large increase in unemployment—that occurs in the first year or two following a shift in political priorities from reducing unemployment to reducing inflation. The reason that unemployment responds to policy change more quickly than prices is very different from the reason that average unemployment and inflation are higher than in the past. One concerns the level of the averages, the other their rates of change. I discuss the two separately.

LONG-TERM STAGFLATION

Although stagflation is a relatively new problem, some of its principal features can be found in earlier periods. Two periods are of special interest. The interwar experience of Britain helped to shape many of the beliefs now commonly held about unemployment. The depression of the 1930's seemed to show that the interwar experience of Britain was a general phenomenon applicable to many countries. Counter cyclical fiscal and monetary policies were used on a much larger scale than ever before, and the groundwork for postwar economic policies was laid.

In Britain during the years 1925 to 1929, measured unemployment rates remained remarkably stable at about 10 percent. Prices were stable also; the relatively high rate of unemployment leaves no imprint on either the rate of change of prices or the rate of change of money wages. The failure of real wages to fall in the face of persistent unemployment was puzzling. Recent work by two economists at the University of Washington, Levis Kochin and Daniel Benjamin, helps to resolve the puzzle. Kochin and Benjamin present evidence suggesting strongly that the introduction of unemployment compensation in the 1920's raised the rate of measured unemployment. Unemployment compensation, and other benefits to the unemployed, were low by current standards but high relative to the wages at which many of the idle would have been paid for work. The evidence suggests that much of the increase in unemployment that occurred in Britain during the twenties can be explained in this way.

In the 1930's, budget deficits and monetary expansion were used as part of a policy designed to move the economy from recession to prosperity. The economy recovered from 1933 to 1937 but did not surpass the previous peak in real output despite four years of Federal budget deficits that were rarely less, and often more, than total Federal government spending at the 1929 peak. After the recession of 1937-38, the economy moved forward sluggishly, even though the budget remained between 17 percent and 35 percent of Federal spending. As is well-known, the unemployment rate remained above 15 percent through much of the decade and did not decline until wartime increases in production and in the armed forces absorbed large numbers of persons into the military and civilian labor force.

The lesson from the experiences of Britain in the 1920's and in the U.S. during the thirties is that high rates of unemployment coexist with rising prices, falling prices and stable prices. There is no reason to expect an association between the average unemployment rate and the average rate of price change, and none is found.

The average rate of measured unemployment during a decade depends on a large number of factors. Demographic factors—as reflected in age, marital status or the like—affect the supply of labor and the rate at which the labor force turns over. Political and social decisions reinforce or offset the demographic factors by changing the real wages at which workers choose between labor and idleness and the prices at which potential investors choose between consumption and the accumulation of capital. Spending and transfers by government have increased relative to output in all Western countries during the past quarter century.

Taxes, whether paid directly or through inflation, must rise faster than output to pay for the increased spending, so after-tax returns from work and after-tax returns from investment are held down. Transfer payments to welfare recipients, food stamps, medical programs, and higher unemployment compensation lower the cost of unemployment to the worker. Together higher taxes and increased transfers lower the return from work and the cost of idleness. Many of the idle are counted as unemployed. Clarkson and Meiners have noted that, under the food stamp program, some recipients must register for employment to main-

tain their benefits. Legislation of this kind increases the average rate of measured unemployment, so we could expect some of the unemployment to vanish if the law were repealed.

Reducing real tax burdens, slowing the growth of government spending to the rate of growth of output or lower, reducing the size of transfer payments or their rate of increase, and lowering the minimum wage relative to the average wage rate are all means of reducing the average rate of measured unemployment and the number of discouraged workers. The decision to take these steps is the responsibility of the Congress. If they are taken, the average rate of measured unemployment will decline.

Failure to reduce the relative size of the government sector by permanently lowering tax rates, or to reduce unemployment benefits relative to wages, or to take other steps that increase the after-tax returns to labor and capital raises unemployment rates. If we can remember that the higher average unemployment rates and slower growth of output are, in part, a result of our tax and transfer policies, we will avoid one of the major mistakes of economic policy in this decade—using fiscal and monetary policies to pump up spending with the aim of reducing the average unemployment rate or eliminating some arbitrary measure of the output gap.

This committee heard testimony in 1977 and 1978 about idle resources and output gaps that were to be removed by expansive economic policy. The amount of idle capacity was overestimated because of an error in assessing the effects on the economy of the 1974 oil shock and the effect of tax and transfer policies on unemployment and potential output. The gap between actual and potential output vanished without being filled, but the attempt to close the gap by using expansive policies left us with high inflation, a devalued dollar, a large budget deficit and a high rate of inflation. I believe that the rate of inflation would be lower, the dollar would not have been devalued in foreign exchange markets in 1977 and 1978 and the unemployment rate would be little different if we had avoided the excessively expansive policies of 1976, 1977 and 1978.

Let me restate a previous conclusion in a different way. One reason we now have high inflation is that we used excessive fiscal and monetary expansion to reduce the average rate of unemployment and increase the growth of output. Moderate policies throughout the decade would have left us with about the same average rate of unemployment for the decade, possibly less, and less inflation. The average rate of unemployment and the average rate of inflation are best regarded as unrelated. The failure of policymakers to accept this conclusion is one of the principal reasons we have long-term stagflation.

A brief comparison of changes in prices and in industrial production in major countries for the current decade shows, as expected, that there is little relation between the two. Percentage increases in industrial production are listed in descending order and are compared to percentage increases in consumer prices. Rankings are shown in parentheses. A cursory examination shows that high or low rates of increase in industrial production, used to measure the growth of employment opportunities, occur with relatively high and relatively low rates of increase in consumer prices.

TABLE 1.—RATES OF INCREASE IN INDUSTRIAL PRODUCTION AND PRICES, 1969 TO AUTUMN 1978

Country:	Percentage increase, industrial production	Percentage increase, consumer prices
Japan.....	54 (1)	131 (3)
Canada.....	44 (2)	89 (5)
France.....	38 (3)	114 (4)
United States.....	33 (4)	81 (6)
Italy.....	32 (5)	181 (2)
Germany.....	29 (6)	55 (7)
United Kingdom.....	14 (7)	191 (1)

The longer-term problem of stagflation for the United States is that the relatively modest average growth of industrial production occurred during a period in which the growth of the labor force increased. Increases in output provided mainly by growth of the labor force leave little room for rising standards of living. To raise standards of living, we must have increases in capital per

worker and increased productivity. Since 1973, both of these traditional sources of growth in living standards have been modest. Productivity growth has averaged less than 1 percent a year since the previous peak in 1973.

I believe that the most effective programs that the Congress can enact to increase long-term productivity growth are: (1) permanent tax reductions for individual and corporate taxpayers, accompanied by (2) permanent reduction in the growth of public spending and transfer payments and a combination of (3) deregulation and (4) the establishment of rules for regulatory agencies that are as clear, definite and long-lasting as the Congress can provide.

We have built a system in which very high rewards go to those who find ways to circumvent regulation or to reduce its burden on firms or groups. Firms often have a greater opportunity to reduce costs by reducing the burden of regulation than by improving production techniques. Skilled personnel, our most talented individuals, are attracted to fields or endeavors that are much more valuable to firms or groups than to society as a whole. One step in a program to restore productivity growth is to reduce the social cost of regulation. The other main step is to slow the relative growth of government and the anticipated growth of taxes.

CYCLICAL STAGFLATION

Whenever political priorities change from stimulus to restraint, the size of the budget deficit, or the public sector borrowing requirement, and the growth rate of money change. The first effect of the shift toward less expansive economic policies is on employment. Inflation starts to fall only after restraint has been maintained for some time. Sometimes, a year or more passes before the policy of restraint has any noticeable effect on the rate of inflation. The converse is also true. A policy shift toward greater stimulus first affects output, then employment and later prices.

Were it not for this pattern of delayed response in prices, cyclical fluctuations would not have their well-known pattern. If the price level, interest rates and wage rates adjusted instantly to changes in tastes, productivity and government policy, we would not have the fluctuations in output and employment known as business cycles. Instantaneous adjustment of prices to changes in the demand for or supply of output would eliminate the effectiveness of economic policies but would also eliminate any need for stabilization policies.

Contemporary economic policies are based on a Keynesian view of fluctuations. Money wages and prices are assumed to be rigid, or slow to change, so policies that increase spending raise output first and the rate of change of prices and money wages later. Policies to slow an inflating economy work through the same mechanism. Output falls and, later, the rate of change of prices and wages falls.

Policymakers who follow this approach, as many have, regard most cyclical changes in employment as "involuntary," the result of insufficient spending by the private sector. Even if the unemployed receive compensation equal to their real incomes, it is believed that society loses all of the output that the unemployed do not produce. Hence government policies to eliminate unemployment are regarded as policies that have low cost and large social benefits. Because the rate of inflation is regarded as slow to adjust, policymakers believe, or are advised, that there is no reason to expect inflation to increase until full employment is reached.

Repeated attempts to use fiscal and monetary policies to stimulate output first and slow inflation later have left a residue of higher inflation. Widespread public dislike of inflation forces policymakers to respond and often to overreact, thereby creating another recession, another attempt at stimulus and another round of stop and go. We may be, once again, in the process of shifting from excessive expansion to excessive contraction.

The problem with the types of policies on which we have relied is that they have not worked as promised. Whatever confidence people may have had about the ability of fiscal and monetary authorities to keep the economy near full employment without inflation eroded long ago. The policies failed because they were based on incorrect beliefs about the way in which the economy works.

There are two principal, and I believe, fundamental errors in the theory of inflation and employment or unemployment that guides policymakers. One is the failure to recognize that workers in cyclically sensitive industries expect periods of unemployment. The other is that workers, on average, choose to accept unemployment in preference to wage cuts as long as they believe that unemployment

is temporary. Recent work with my collaborators, Karl Brunner and Alex Cukierman, has explored these issues in detail, but the basic idea can be summarized readily.

Workers in cyclically sensitive industries know that fluctuations in employment have occurred in the past and will occur in the future. They are uncertain about the timing and duration of recessions but not about their occurrence. No one knows precisely when a recession will start, how long it will last or how severe it will be. However, few of us are unaware that there have been recessions, and few doubt that there will be future recessions. At the start of a recession, workers who are "laid off" regard the experience as consistent with their belief that the layoff is temporary. They do not, in most cases, search for new jobs at lower wages but instead use their time to take a vacation, to fix up their houses, to do odd jobs. They wait to be recalled. If, on average, a worker experienced layoffs or unemployment of this kind for periods of six or eight weeks every three or four years, he is not surprised to be laid off when recession occurs. He does not start to look for permanent employment elsewhere at lower real wages. He waits.

It is true, as many economists have noted, that workers could offer to reduce their real wages in periods of low demand to maintain their jobs. Workers agree to reduce real wages, as many examples show, when they believe that the alternatives are a permanent loss of employment or search for a different job at lower pay. The response to a permanent loss of employment resulting from changes in tastes, technology, or international competition is very different from the response to the temporary changes in employment that occur during recessions. Employees more readily agree to cut wages when the alternative is a plant closing.

Unfortunately, changes in employment do not come with neatly typed labels indicating that they are permanent changes. Workers and employers—people in general—must repeatedly solve a complex inference problem to decide on the proper course of action. Offering to supply labor at lower real wages represents a loss of lifetime income if the reduction in demand is temporary. Failing to cut real wages when the reduction in demand is permanent also means a loss of lifetime income. The proper choice is not always clear at the time. This is one reason that workers and firms are slow to adjust prices and money wages up or down.

Suppose that a government of good intentions responds to every recession by pushing up spending to stimulate the economy. Each time this is done, output recovers, employment rises, but the rate of inflation is higher at each trough than at the previous trough and higher at each peak than at the previous peak.

Experience of this kind, and it is our experience, teaches the public two lessons. First, whether the decline is temporary or permanent, the average rate of price and wage change rises from cycle to cycle. Resistance to relative wage and price reduction increases in recessions. The other side of the coin is that anticipated inflation increases and the demand for higher wages rises. Second, all temporary recessions are expected to be offset by stimulative government policies, and the costs of unemployment are expected to be reduced by unemployment compensation benefits. There are fewer reasons to look for employment at lower real wages and more reasons to wait for stimulative policies to restore employment at the old job once these policies are anticipated.

The use of variable monetary and fiscal policies adds an additional dimension to the already complex inference problem. Uncertainty about the future course of monetary and fiscal policies adds to uncertainty about present and future tax rates and inflation. People who want to know whether tax rates will rise or fall in the future must guess, or infer, whether the bulge in government spending during a recession is a portent of permanently higher spending and tax rates or temporarily higher spending. Past experience gives some guidance, but it is very imperfect guidance. Yet, differences in anticipated tax rates often are the deciding factor in decisions to invest in durable capital, to invest in land or other tax-sheltered capital or to consume.

With hindsight, it is easy to identify the sustained change in money growth that lead to higher or lower inflation. I assure you that there is much less certainty when the turning points occur. Our current uncertainty about the rate of monetary growth is an extreme but nevertheless useful, example.

We have been through four or five cycles in which governments have made explicit commitments to end inflation. It is unwise for the public to treat such

commitments skeptically? I believe not. After four or five cycles in which promises to end inflation were followed by higher average rates of inflation, credibility is strained.

The experience of 1966-67 is informative. The six-month average rate of change of wholesale prices fell from 4 percent to minus 2 percent in one year and a similar average for consumer prices fell from 3.8 percent to 1.8 percent. The retardation of the economy was so brief that the episode is not recorded as a recession. The anti-inflation policy worked quickly because inflation was a relatively new phenomenon, and government had not reduced its credibility by promising to end inflation while acting to increase it or by abandoning policies that slow inflation when unemployment increases.

SOME SUGGESTIONS FOR CHANGE

I have suggested some explanations of long-term and cyclical stagflation. Earlier, I proposed some policies to increase long-term growth and stability. I will conclude with recommendations to lower the cost of ending inflation.

The principal recommendation is, by now, familiar. My colleagues on the Shadow Open Market Committee and I have asked repeatedly for a commitment from government to a pre-announced policy of sustained, gradual reductions in the growth of money by 1 percent per year until a non-inflationary rate of money growth is achieved. A similar recommendation has now been made, unanimously, by the House Committee on Banking, Currency and Urban Affairs. Chairman Miller has recognized on many occasions that inflation cannot be ended in less than three to five years.

Recognition of the problem is not enough. The Congress should require the Federal Reserve to adopt a policy of this kind, and the Congress should endorse the policy. If a commitment of this kind by the Federal Reserve, the Congress, and the administration is followed by implementation, beliefs about future inflation will erode more rapidly and the cost of ending inflation will decline.

To supplement monetary policy and make it credible, other steps must be taken. A commitment by Congress and the administration to hold the growth of public spending below the growth of output implies that the average tax rate will fall in the future. But the commitment also implies that the Federal Reserve will not be called upon to finance larger government deficits by raising money growth. A commitment to slower growth of government reinforces and complements the commitment to maintain a monetary policy that ends inflation.

There are many policy changes that can help to reduce the problem of cyclical stagflation. I would like to conclude, however, by pointing to two current risks that cannot be avoided without congressional action. I refer to the risks of a major error in monetary policy and the risk of a financial panic following a run on one of the non-insured financial intermediaries that now hold assets that formerly were held in insured commercial banks and thrift institutions.

The risk of a major error in monetary policy arises because the numbers now added together to form M1, M2 or any other M do not have the same meaning that they had before the development of ATS, NOW accounts, overnight repurchase agreements, money market funds and many other assets. Currently, money growth may be pushing the economy toward substantially higher inflation or deeper recession than we know or believe.

The risk of an error in interpretation cannot be reduced, at current rate of inflation, unless Congress agrees to repeal regulation Q, to repeal the prohibition against interest payments on demand deposits and to permit interest payments on required reserves. The Congress has heard testimony on these proposals for more than a decade, but it has not acted. The failure to act now to lower the risk of a potential crisis is inexcusable and costly.

Suppose some large seller of commercial paper, Euro-dollars or other financial instrument defaults. These instruments are held indirectly by individuals and small firms through their participation in some of the substitutes for demand and time deposits that are now held by many people. The substitutes are not insured. Here we have the ingredients for the type of financial panic that we have not experienced since deposit insurance started more than 40 years ago. This risk can be reduced by removing controls on interest rates at banks and thrift institutions or by a clear statement from the Federal Reserve that it will serve as lender of last resort to the entire financial system.

The probability of a panic is small, but it is larger than it need be. And the probability is increased by the failure of Congress to remove regulations and restrictions.

Representative ROUSSELOT. Our final witness is Mr. Alfred S. Eichner.

STATEMENT OF ALFRED S. EICHNER, PROFESSOR OF ECONOMICS, STATE UNIVERSITY OF NEW YORK, PURCHASE, N.Y.

Mr. EICHNER. Thank you, Congressman Roussetot.

I want to thank you and the rest of the committee for the opportunity to appear here today.

I also want to commend the committee for its willingness to look beyond the public concerns of the moment and focus on the problems likely to dominate policy discussions in the 1980's.

As will become clear from my remarks, I believe this is precisely the shift in time perspective that is needed.

The feeling is widespread today, just as it was in the 1930's, that economics as an academic discipline no longer offers a solution to the Nation's economic problems. Only among economists themselves does the faith in the standard textbook arguments and conventional policy prescriptions still run strong.

I come before you this morning as one of a small, but growing, number of economists who believes that economics took a fateful wrong turn in the years immediately following World War II. Rather than carry out the fundamental reformulation of economic theory which a true Keynesian revolution would have required, economists preferred to seize upon only a few ideas which could easily be incorporated into the old analytical framework and to reject the rest.

The debate between the so-called Keynesians and the monetarists is largely over how few of Keynes' ideas need to be taken seriously. This patched-up analytical framework has served well enough as a guide for avoiding the widespread unemployment which occurred in the 1930's, but it has proven increasingly inadequate as the basis for coping with the problems of an expanding economy which fluctuates more or less short of full employment.

The post-Keynesian group to which I belong takes issue with the dominant fraction within the economics profession on almost every important theoretical point. These conceptual differences have been spelled out, not only in the paper prepared for this committee on the problem of stagflation, but also in the series of articles currently appearing in Challenge magazine.

In my brief remarks this morning, I want to emphasize primarily the policy differences.

Macroeconomic policy in the United States since the end of World War II, guided by the dominant view among economists, has focused almost entirely on shortrun demand management. And I underline the words "shortrun demand management."

At certain times, the diagnosis has been that aggregate demand is too low, this by way of explanation for the rise in unemployment.

At other times, the explanation has been that aggregate demand is too high, this by way of explanation for the rise in prices. And I might

add parenthetically that today's suggestion we redefine "full employment" is merely a way of saying that there is exists no problem at all.

But whichever the malady, the cure is always seen to lie in altering the level of aggregate demand. What controversy has arisen among economists—and it has certainly been considerable—has centered on one, what is the optimum balance between unemployment and inflation; and two, whether fiscal or monetary policies can better achieve that balance.

The efficacy of shortrun demand management as the policy focus has seldom been questioned.

Post-Keynesian economists like myself reject this framework for macroeconomic policy on several grounds.

First, we would deny that inflation is due solely or even primarily to the economy becoming "overheated"—the result of well-intentioned, but misguided, efforts to reduce unemployment.

We therefore question on both theoretical and empirical grounds the validity of the Phillips curve and the supposed tradeoff between unemployment and inflation implicit in that putative relationship. We would instead assert that the processes determining the expansion of employment and output are separate and distinct from those determining the rise in prices, and that it is a fundamental error in economic analysis to view the two as being one and the same.

There is thus no inherent economic reason that we can see—there may, of course, be political and social reasons—why employment cannot be expanded, along with the output of goods and services, without this leading to inflation. Indeed, the Nation's experience during the first half of the 1960's attests to this very possibility.

Second, we would argue that the key to employment expansion lies in a set of policies which focus on long-term supply enhancement—and again, I underline the words "long-term supply enhancement"—relegating shortrun demand management policies to a secondary and supportive role.

It is through additions to the economy's production capacity that not just the demand for labor, but also the output of goods and services, can be increased over time. These additions to capacity require investment, both private and public.

Thus, it is the level and composition of investment which is critical to the ability of the economy to expand over time, and it is the level and composition of investment which should be the focus of public policy.

Shortrun demand management policies, to the extent they discourage capital outlays on the downswing and favor other types of expenditures in generating the upswing, work against the long-term enhancement of supply capacity.

What is needed in my judgment, to reverse the undue emphasis on shortrun demand management policies, is a quasi-governmental body to serve as a clearinghouse for capital spending plans, both private and public. The function of this new entity would be to see what the various plans, when examined altogether, add up to.

Will the aggregate level of investment be sufficient to assure the desired long-term expansion of the economy? Are bottlenecks likely to arise because of the inconsistency of the different plans? Are important

areas for investment, vital to the future direction the economy is likely to take, being ignored?

It is a serious deficiency in the existing structure for economic policymaking that there is now no body, official or otherwise, responsible for answering these questions. Certainly, if the problem of inflation is one of excess demand—and there may indeed be times when this is part of the story—then clearly the better solution is to assure an adequate supply beforehand rather than to curtail demand as a belated response.

The Employment Act of 1946 needs to be reinterpreted as placing on Government the responsibility for overseeing the adequate expansion of the economy's supply capacity over time, and not just an obligation to intervene with demand management policies on a crisis basis.

If every large corporation and nonprofit organization which prides itself on good management has a unit charged with the responsibility for long-term forward planning, no less can be expected of the institution—and here, I am referring to Government—responsible for the economy as a whole.

Third, post-Keynesian economists like myself would argue that the problem of inflation needs to be disentangled from issues of shortrun demand management. Inflation needs to be viewed as a problem of excessive money claims against real output, with prices rising to bring the money claims into line with the available real resources.

The United States, ever since its formal commitment to full employment goals, has relied on either market forces or the bludgeoning effect of deliberately induced recessions to hold down the growth of money claims. But it should now be clear, after three decades of experience, that neither device can be counted on to bring a wage-price inflationary spiral to a halt once it has been initiated.

Trade unions have more than sufficient collective bargaining strength to obtain higher money wages, this as a way of protecting the real income of their members and assuring them and other workers a fair share of any gains in real output. Trade unions are not dissuaded from this course by the stick of higher unemployment.

Industrial enterprises, meanwhile, have more than sufficient market power to obtain higher prices, this as a way of protecting their profit margins in the face of rising costs. They are not dissuaded from this course by the stick of reduced sales and lower operating rates.

Both market forces and deliberately induced recessions being incapable of bringing a wage-price inflationary spiral to a halt, it is now time to try a different approach.

Like other post-Keynesians, I believe that different approach involves some form of incomes policy. But not an income policy which simply attempts to hold down money wages, leaving business profits and other forms of household income unchecked.

And not an incomes policy which is simply imposed by Executive order, giving business, organized labor, and the other groups that must support the policy little or no voice in its formulation.

And finally, not an incomes policy which precedes, rather than follows from, certain new institutional arrangements.

Just as monetary policy cannot be effectively implemented without a central bank and fiscal policy without congressional budget committees, so an incomes policy cannot be expected to succeed in an institutional vacuum.

One of the institutions that an incomes policy requires is the clearinghouse for capital spending plans already mentioned. As post-Keynesian theory makes clear, not only are the rate and composition of investment critical to the long-term enhancement of supply capacity, they also have important consequences for the distribution of income. These consequences, along with the other considerations outlined in my paper for the committee, need to be taken into account before an incomes policy can be formulated that will enable the economy to proceed along a noninflationary growth path.

However, the technical analysis which the professional staff of the clearinghouse would be able to provide would not be enough to assure the success of an incomes policy. There must also be some means of arranging for a dialog to take place among the various private interest groups which have to lend their support to an incomes policy, together with key public officials.

For while the technical experts from the clearinghouse would be able to indicate what margin exists for increasing money claims without precipitating a wage-price inflationary spiral, there are still important choices to be made within those limits. These choices require that a bargain be struck at the top among all the affected interest groups, with that bargain then ratified as part of a "social contract," through the subsequent actions by public officials.

Agreement must be reached, not just on the tradeoff between current and future consumption levels, but also on the tradeoff between work and leisure which Professor Leontief mentioned today, and between public and private consumption which I think some of the other panelists mentioned.

Thus, the long-term solution to the problem of stagflation lies in the creation of a new set of political-economic institutions.

One of these institutions should be a social and economic council on which would sit representatives of all the private interest groups significantly affected by an incomes policy, together with key public officials.

Another of the institutions should be a professionally staffed quasi-government body which could provide technical backup support to the social and economic council while serving as a clearinghouse for all capital spending plans.

To function most effectively, both the social and economic council and the technical support unit and clearinghouse linked to the council should be formed with the support and encouragement of public officials, but outside the formal structure of government. In that way, questions of representation and other matters could be resolved on a gradual and pragmatic basis.

Not until these two prerequisite institutions are in place can an incomes policy be successfully implemented, and not until then will the economy be able to proceed along a noninflationary growth path. This country presently finds itself unable to cope with the problem of stagflation, not just because of the bad advice it receives from economists, based on a faulty understanding of the economy, but also because of the institutional vacuum which makes it impossible to formulate effective supply enhancement and incomes policies.

My principal recommendation to the committee this morning, therefore, is that it see what steps can be taken to fill that vacuum. And I would just add parenthetically, since this is a committee concerned with long-term problems, it needs to be concerned, not with what can solve the problems in the next year or so, but what can lead to a permanent solution to the problem of stagflation.

Congressman, I thank you and the committee for your attention, and I invite any questions you may have.

Representative ROUSSELOT. Gentlemen, thank you for your very thorough statements. This has been a fascinating group of witnesses.

And Mr. Eichner, I agree with your closing comment that we here in Congress are sometimes confused by all the advice we get from economists.

Mr. EICHNER. So are economists.

Representative ROUSSELOT. I am just delighted. And I am afraid we have followed some of it too long as some of you have suggested.

And I want to thank each of you because this has been a fascinating panel. I have a couple of questions, and then I will turn it over to Jack Albertine who can allow the staff to ask some questions.

I do have to go back to the House for some meetings that I had committed myself to before I realized I was going to be chairing. Otherwise, I would have canceled the whole day and been here.

But thank you, each of you, for your participation, especially your emphasis on the supply side of our economic equation.

You each know that our Joint Economic Committee annual report this year gave greater emphasis to that than we have ever given. Each of you has placed a certain amount of emphasis on it. And I hope that this Special Study will have a followup with more participants like each of you who have given a new emphasis to this.

Mr. Eichner, I am fascinated by your comment that the Employment Act of 1946 needs to be reinterpreted, placing on Government the responsibility for overseeing the adequate expansion of the economy supply capacity over time and not just an obligation to intervene with demand management.

You are right, but we can't get everybody here in the Congress to listen to that. We are kind of in a fixation on that subject.

Let me see if I can suggest a couple of thoughts here. I really would like to ask an awful lot of questions on all this fine testimony. Mr. Meltzer and Mr. Wachter, you seem to favor raising rates of return for business, while savers and investors prefer lowering tax rates. We have a problem every time we suggest that in Congress. They say that we are going to cause huge reductions in revenues, and this will be a catastrophe all through the economy.

Would you like to comment on that a little further? You have already done it, each of you, in your testimony, but how do we get our colleagues who fear that, seem to fear that, reducing tax rates, how can we assure them that this is not going to be another 1930 depression?

You know the usual word we get. Would either of you or any of you like to comment?

Mr. WACHTER. I would suggest that, first of all, it needs to be done slowly. I think one of the things——

Representative ROUSSELOT. We aren't even doing it very slowly.

Mr. WACHTER. We are moving in the wrong direction. As income goes up, we have increasing tax rates, rather than decreasing.

Representative ROUSSELOT. The spender seizes upon that as a wonderful chance to spend more money.

Mr. WACHTER. The consensus I see emerging is one that favors stable Government policies rather than rapid shifts.

In terms of reducing tax rates, the stress should be on across-the-board decreases. The changes should be neutral with respect to the income distribution, but should increase the taxes on consumption relative to savings. I see no evidence that supply side policies need to hurt the poor.

Representative ROUSSELOT. Let me interrupt at that point. That isn't the information we always get from economists, especially in the administration.

Mr. WACHTER. I think by and large, some of the measures that are introduced can have that effect, but certainly we can encourage relatively more saving by the middle class than we do now. For example, the tax exemption on dividends and interest can be increased to \$2,000 or \$3,000. Further, the capital gains tax can be reduced to zero for those with incomes below \$15,000 or \$20,000. That would directly encourage the middle class to save.

At the same time, I think that spending cuts should not be oriented toward transfer programs for the poor. By and large, we can afford the transfer levels we have today. What is needed, is to get the Government out of subsidizing middle-class and upper-class expenditure programs.

Representative ROUSSELOT. Some of us don't even talk about expanding. We just talk about restraining the increases. And we can't even get that done.

Mr. WACHTER. I believe that national health insurance will be the next test case. It has great public appeal. But some of the current suggested policies will lead to an unending drain on the budget and a continuing shift of resources into the consumption of medical care and away from investment.

Representative ROUSSELOT. Thank you.

Mr. MELTZER. I would like to add to that. There are some things that should be considered. I know the chairman has introduced an amendment to balance the budget. What we need is certainty. And we need long-range policies to deal with long-range problems.

Supply side problems are not going to be solved by a series of gimmicks which patch up the framework. The kind of policies we need are policies of the kind that have been recommended in the national tax limitation amendment. These say, "Let's put a ceiling on the growth of Government spending." That would be a way of making sure that, eventually, we get the budget into balance.

I have suggested other steps that could be taken. Without endorsing a particular amendment, I would say that a reduction in the size of Government is a first step.

The important things to emphasize about these proposals is not the specific details. It is the nature of the change. If we can agree on a

restriction so that people will know what the long-range tax climate is going to be, what it is going to be like when that electric powerplant is producing energy 20 years from now or when the steel mill or aluminum mill is producing 10 or 20 years from now, and get some better ideas of what the after-tax return is going to be in that climate, we will be taking a major step toward stability.

Many of our problems arise because we don't have that climate. We have a series of very quick responses with no clear indication as to what the general direction of the growth of Government will be relative to the private sector. We know it has risen.

Representative ROUSSELOT. Rather substantially.

Mr. MELTZER. Yes.

Mr. EICHNER. I wonder if I might just interrupt there.

I think from what I have read of the testimony before this group that there seems to be fairly general agreement that one can't achieve higher rates of growth of productivity without the higher rates of investment. There is substantial agreement on that.

I think the problem arises as to how one can obtain higher rates of investment. A number of the panels have suggested that lowering tax rates might achieve that goal.

My reading of the empirical evidence would indicate that skepticism is required before one goes down that path very far. But I don't believe that we ought to sit and talk about that question here because I think the fundamental issue is what is the appropriate mechanism for getting a resolution of that type of question.

That is, it seems to me—and I go back to my notion of the clearing-house for investment—that we have to see what the levels of investment currently are. Are they in the right sectors? Are they in the sectors where we want investment to give us growth in the future? Where, in fact, is investment inadequate?

Then, we ought to be able to take up the question of how.

Representative ROUSSELOT. Who would make that judgment, then? Say the Federal Reserve Board?

Mr. EICHNER. I am trying to indicate I don't think right now we have the mechanisms. We are operating on the assumption there is a machine out there to press the lever, and that is going to solve the economic problems we have. I am trying to suggest we don't have the lever yet. We haven't built the machine.

We have two levers we can pull—the monetary lever or the fiscal lever. And we have two parts of that fiscal lever. We can raise taxes or lower taxes, raise Government spending or lower Government spending. Those are the only levers we have.

And I am saying those levers are not enough to give us the types of growth rates that we want to achieve. That is why I think we have to move toward some new mechanism, whereby we can coordinate investment planning, coordinate a whole series of policies on the supply side.

There is continual criticism about Government policies deterring investment in given areas. We don't have any single forum within which all of those different types of arguments are put together so they can be considered in toto rather than each one being considered individually on its own merit.

That is the point I am trying to make. We really can't intelligently decide these questions in this forum.

Representative ROUSSELOT. In your testimony, you suggest some kind of a commission or something; isn't that correct?

Mr. EICHNER. I am suggesting—

Representative ROUSSELOT. Government appointed or what?

Mr. EICHNER. It is elaborated in my prepared statement for the committee, but my recommendation would be to try to bring together all the different groups which are currently feeling the effects of inflation and low-growth rates, not just labor and industry, but farmers and the whole spectrum of private interest groups.

Representative ROUSSELOT. Who would appoint all those people that would make the final decisions?

Mr. EICHNER. I am not suggesting they make final decisions; I am suggesting they go through an exercise—it could be a foundation or some group outside Government.

Representative ROUSSELOT. This would be outside?

Mr. EICHNER. I would suggest we do it once or twice on the outside of government as an exercise to see whether or not this leads to any productive results.

Representative ROUSSELOT. What is wrong with the marketplace?

Mr. EICHNER. The marketplace does an outstanding job in many areas. But we need to focus on the areas where it doesn't do a good job because those are the things that hurt. I am suggesting that this is one of the areas in which we cannot rely on the marketplace.

The market does a fine job of telling a company if it should invest in a given area because either its sales go up in that area or not. But when you have to coordinate investment between different branches of industry, the market doesn't always give us the appropriate signals until too late to take the next corrective action.

Representative ROUSSELOT. I am glad Senator Javits is here. I appreciate your comment.

I was trying to understand. I did follow your testimony about your suggestion for some kind of an indication. Your first idea is that it would be outside of government?

Mr. EICHNER. As an exercise because we have efforts to do this sort of thing, and they fail. And we are stuck with the remnants of that organizational structure. I am suggesting we try to do this on a non-governmental basis with strong governmental support, but on a non-governmental basis.

Let's see, it may be a crackpot idea, who knows? Let's see if it works. It may not have any payoff. If it works once or twice outside government, then we can decide how best to incorporate it into the governmental structure.

But what we have is a tremendous amount of knowledge and expertise which never gets brought to bear on these problems because there is no institutional mechanism whereby these types of issues can be discussed calmly and in an environment where we can make these decisions in the same manner they are made in, say, a corporation.

When corporations decide what their long-term expansion plan is, they don't do it by having the accounting department and the other departments fight it out politically. They try to reach some calm and sane judgments based on an assessment of the facts.

Representative ROUSSELOT. Their decisions are pretty much made—let me give the analogy of the corporation—on the basis of the marketplace that they serve, aren't they?

Mr. EICHNER. No, they get eventual feedback from the market. They know 5, 10 years later they have made a mistake, but they are forced to go ahead and make judgments without—

Representative ROUSSELOT. If they are losing money, they learn pretty quickly.

Mr. EICHNER. After a while.

Representative ROUSSELOT. Yes, Mr. Meltzer.

Mr. MELTZER. I would like to make two comments.

One, I would not like Mr. Eichner's comments on tax cuts and the stimulative effects on investment to pass. I think it is very important to distinguish between permanent and temporary tax cuts. People know countercyclical tax cuts will be eroded in a very short time because on average, Government spending is rising. And people recognize that rising Government spending means business and consumers are going to be paying higher taxes in the future.

People may not know the timing of these events, but they understand that is a temporary tax cut. I think the effects are quite different for permanent tax cuts.

After all, we do know there is a positive association between rates of return and investment.

The second comment that I would like to make in respect to Mr. Eichner's experiment is that his experiment has been tried and has failed in a large number of countries. We have a vast number of countries with socialism ranging from India and countries with that type of planning to countries like the Soviet Union where investment is all planned.

We certainly don't want to emulate those countries. We would, I think, generally have to conclude the results of those experiments have been poor.

Our problems may be immense, but they are not so serious that we should throw away the advantages we currently have.

Representative ROUSSELOT. Thank you.

Mr. Leontief, did you want to comment on the general discussion?

Mr. LEONTIEF. I would suggest that before following Professor Meltzer's advice, we should see what will be the results of Mrs. Thatcher's radical policies in England.

Mr. MELTZER. We don't have to wait for Mrs. Thatcher. We do have some experience in the first 155 years in this country.

Mr. LEONTIEF. Let me say—

Representative ROUSSELOT. We certainly couldn't.

Mr. LEONTIEF. West Germany—which succeeded in mastering inflationary pressure more effectively than any other advanced Western country except Austria—is anything but a land of unhampered competition and free rugged enterprise.

Representative ROUSSELOT. Of course, Germany hasn't been increasing their supply of money as rapidly as we.

Mr. LEONTIEF. Contrary to what the readers of our financial press are lead to believe, the relationships between capital and labor—far from being settled through the operation of impersonal market forces

of supply and demand—are in fact governed in West Germany by special institutional arrangements established by law.

One-half of the members of the board of directors of every large West German corporation is elected by the shareholders—while the other half is elected by the workers. Moreover, 7 out of 10 of the labor members are chosen by workers employed in that enterprise, while the other 3 represent the national labor unions. In other words, these are the “outside labor” directors who are the counterparts of the “outside directors” elected by the shareholders. And mind you, the labor representatives take active part in the determination of all corporate policies—not just those pertaining to employment conditions and labor relations.

These legal arrangements provide a firm institutional basis for effective day-to-day implementation of national wage, price, and income policies. It is my considered opinion that without formal cooperation between capital and labor—not only on the national and industrial, but also on the individual corporation level—monetary and fiscal stabilization policies would, in the long run, be as ineffective in West Germany as they proved to be in the United States.

Mr. MELTZER. Since this was a comment on my remarks, I will take the opportunity to reply.

Mr. LEONTIEF. Excuse me; I didn't finish.

In Austria, similar, but somewhat more formal arrangements seem to work even better. Mr. Kreisky was reelected recently on the basis of an enviable economic record characterized by the maintenance of a high rate of economic growth, practically full employment and an upward price drift of not more than 2 or 3 percent per annum.

Here, in the course of annual top level negotiations between the central employers' organization and equally well organized labor—without formal participation, but with a technical, essentially fact finding assistance on the part of the Government—the past performance and the future prospects of the economy are surveyed, and after a hard bargaining process, a general agreement is reached on next year's rise in real wages. In the process of these negotiations, due attention is paid to assessment of the needs for additional productive investment. Being able to negotiate the level of the real—rather than only nominal money—wages, the unions have neither the need nor a justification to press for an unreasonable rise in money wages. Businesses, on the other hand, assured of the necessary investment, find that they have no reason to initiate inflationary price increases.

Monetary and fiscal management can, under such conditions, play effectively its indispensable supporting role.

I join Professor Eichner in his observation that to secure for our economy and our society a safe passage through the shoals that this country will have to navigate in the coming years, we cannot and should not rely exclusively on the operation of the blind market mechanism. The contest of the conflicting interests should be settled at the negotiating table and institutional legal provisions should be made for implementation of the agreement reached through informed, well coordinated public action.

Representative ROUSSELOT. I thank you for your comment, but maybe we ought to wait until Mrs. Thatcher has been in a while because you

certainly weren't implying by that that we have had a good example to follow in England for the last several years?

Mr. LEONTIEF. Let's see, how to——

Representative ROUSSELOT. By saying to wait and to watch what happens in Mrs. Thatcher's government, you are not saying what has preceded has been bad?

Mr. LEONTIEF. No, no; not at all.

Representative ROUSSELOT. I wanted to be sure.

You wanted to comment on that?

Mr. MELTZER. I just wanted to make two points to correct perhaps some of the impression given by Professor Leontief.

First, the experiment in union and management participation on boards of directors of Germany is relatively recent. It is interesting to observe that the growth rate of output during this period has been relatively low, not high. The rate of investment in Germany is probably lower than it is in the United States; a large capital outflow partially stimulated by the fears of this experience in social control of the corporations by union and management jointly will lead to low rates of return in the future. Therefore, investment opportunities are more attractive in places like the United States, Canada, Brazil, and some other parts of the world.

If we are waiting for the outcome of Mrs. Thatcher's experiment, we might also await the outcome of the German experiment which is of relatively recent vintage and has contributed very little to the growth rates of output in Germany.

Second, I would say in response to the statements about union/management cooperation that I place primary emphasis on the fact there are clear, announced, and definite programs on the Government's part which are carried out. These programs are about ending inflation and about the budget and so on. If we are going to copy something from Germany, we ought to copy the idea that when the Government makes statements about its policies, it carries them out. It doesn't change its policies like a will-o'-the-wisp in a few weeks or months.

Representative ROUSSELOT. Thank you.

I regret I have to move on and turn the chair over to Senator Javits who, had he been here, would have been chairing. And I thank you all for your comments and testimony. And I do hope that this committee can act again as a catalyst to give better economic advice to our colleagues on both sides of the aisle.

Senator, I will turn this over to you now. You get to be chairman now.

I regret I have to leave.

Senator JAVITS [presiding]. Thank you. Gentlemen, I apologize for not having been here, but as usual I have four committee meetings this morning, and I have something else in 10 minutes. But I would like to engage you in this question, and I hope you will please be perfectly free to tell me whether what I ask has already been covered.

We have now, in place, the German experiment which began immediately after the war, so that Germany has had about 30 years of these joint boards in the iron and steel industry.

I notice you shake your head, Mr. Meltzer, but I was there in 1947 so I know what I am talking about.

The other thing that interests me which I would greatly appreciate comment on is this: We have now incorporated in a number of States a provision for labor/management committees to deal with the value of work life problems. And we have some very extraordinary examples of that in my own State of New York. That is why I have been so very interested in this matter.

One example relates to the States that have the CETA law, at least that part of the law which relates to private enterprise and training of the structurally unemployed, for which we are going to put on \$400 million. And the other one is in an effort to keep kids in school by applying the work/study technique at lower than the college and university level.

Both of these examples have provisions for labor/management committees.

In addition, we have a very extraordinary example in the State of New York. The city of Jamestown was one of the worst economically hit cities in the early 1970's, and it was a very bad labor town, so people avoided it.

Through the enterprise of the mayor who, by the way, was a Democrat, and with my cooperation, a labor/management public committee was formed. And the town completely turned around. It is now one of the best labor towns in New York.

That doesn't mean nonunion. It is simply one of the best labor towns in New York. It has attracted a major manufacturing industry from the Middle West to set up a new plant and put countless new workers into Jamestown which is not a terribly large city.

This example has since been emulated by Elmira and other cities in New York.

Now, that is a practical application of what Mr. Leontief was talking about. One of the laws which we have now provides that the Federal Mediation Service will stimulate the promotion of these committees through the country. I am hopeful. We have appropriated some \$10 million for them to get started.

It is in the pipeline right now. There is an application of the idea which is possible. It is a small application, and I am for a much bigger one. But I just lay that before you because it is an experimental idea.

Yes, Professor.

Mr. EICHNER. I think that is pretty much the gist of what I was trying to suggest about the problems of inflation, stagflation, economic growth. These problems cannot be resolved except through the coming together of labor, management, and other groups.

And I think it is not helpful to label this as some form of socialism or the like; that this is really true throughout the entire OECD community of nations.

There was a conference on inflation sponsored by the American Council of Life Insurance, I believe, where one of the key recommendations to come out of that group was an endorsement for this very idea of tripartite attempts to solve the problem of inflation.

I think they have sent this committee a copy of their recommendations. It turned out that one of the members of that council had himself served on a similar committee during World War II and recalled that experience as perhaps being helpful in the present context.

I understand that others have recognized the need to bring different groups together to focus on economic growth. And I think we can't wear ideological blinders on this any longer. You think about Japan, Germany—all the countries that have been most successful. It is because they have found one way or another to achieve better cooperation among different groups in their society; and to reject that idea on ideological grounds seems to me to be counterproductive.

Senator JAVITS. Is it being rejected on ideological grounds, Mr. Meltzer?

Mr. MELTZER. I did not reject anything on ideological grounds. I think we are falling into the fallacy of composition. It is very possible for Jamestown to improve its labor relations climate and improve its investment. What we were talking about is how the United States as a whole can improve its labor productivity and investment.

To increase investment we have to either grow at a more rapid rate or we have to shift resources from private consumption and government into investment. And we have to find ways to improve productivity.

I believe that the level of cooperation between union and management can make a difference for the rate of productivity growth and, therefore, it is a useful thing. To the extent that individuals are able to cooperate, it is useful.

To freeze such schemes into law or to believe that the experiments have a lesson for national planning or teach something we should try to do on the national level is a wholly different matter. I believe the schemes would not succeed.

Now, in the case of the steel industry in Germany, that is a good example. For a while, the steel industry in Germany was very productive and did very well. At the present time, the German steel industry is certainly anything but an inspiration. It is certainly not the result of national planning we would want to have. It doesn't seem to be able to solve its present problems. It seems to have certain tendencies that are common in steel industries in other countries, and particularly the countries where there is a large amount of public participation in the steel industry—namely, to demand large subsidies and sell a lot of steel on the market and produce certain number of problems, not only for the steel industry, or for Germany, but also steel industries in the large part of the rest of the world, including the United States.

Senator JAVITS. Mr. Leontief.

Mr. LEONTIEF. As I see the problem of the steel industry, I think the problem is worldwide. And the basis of it is that 60 years ago, textile industry had similar problems where 60 years ago textile industry was a flourishing industry of advanced countries. But slowly, the less advanced countries learned how to make cloth. And slowly, this industry developed, not the most advanced country, but catching up slowly.

The same thing, I think happening now with steel industry. Steel industry is not any more the premier industry, the honorary steel industry. It still grows in Brazil, India—all over the world. And the response to it, if we do it in a concerned, intelligent way, is slowly go down on the brakes, but the economy is very inflexible.

Nobody wants to give up. And there are two ways of introducing flexibility.

One, abolish laws. All regulations, let bankruptcy take off adjustment. This is one old-fashioned way of adjusting if an industry suddenly goes bankrupt. Stockholders lose their money, workers lose their jobs.

Other way, more humane way, which is smarter, I think, on concept of model social conscience, try to help a transition. And this, only Government can do.

So to say let's reduce Government and let market take care of everything is, I think, a very risky business. We are only the way when I don't get excited about it because I am sure we won't abolish government. The Government will grow, and people will complain about it. And what we should do is try to improve cooperation of Government.

This, I think, applies to inflation and to economic development and technology.

Senator JAVITS. Professor Wachter.

Mr. WACHTER. Senator Javits, I think that you gave two of the examples where I believe the Government can be most effective in dealing with market problems.

One is in structural unemployment areas and manpower training.

And the other is in location problems where there are considerable market failure problems.

I believe, however, that Government policy dealing with the incentive mechanisms for plant location should be differentiated from Professor Eichner's suggestion of meetings where people would decide how much investment might be made by different industries.

If one gathers people together to make investment decisions by industry, the investment monies will flow into steel and into textiles. Those industries have the labor-management constituency to dominate newer, high potential industries such as semiconductors and computers.

In fact, most of the investment needs to be done precisely in those areas that will be least popular because they will have the smallest constituency.

Let me finish, by saying as a resident of the State of Pennsylvania, where we have a great deal of investment in older industry, I only wish that someone would bring Texas Instruments or new industries into Pennsylvania rather than subsidizing inefficient steel mills. If the Pennsylvania economy is going to grow over time, it will have to attract growing industries, not declining industries.

Senator JAVITS. Gentlemen, if I may raise just one other question, then I am sorry, I must leave you.

Senator Hubert Humphrey, of revered memory, and I developed an indicative plan with a rather interesting mechanism to divorce it from the problem which Professor Wachter just mentioned.

Is there any sentiment here for anything like that as a way in which indicative planning—you all understand, I'm sure, that means non-mandatory planning—is there any comment on that in terms of using this mechanism for the purposes we discussed?

I would like to mention to you that I was the author of the plan originally, and I will tell you what got me interested in it.

In the fifties, we had a Commission called the Paley Commission which analyzed our potential for the future, in terms of natural resources. That Commission anticipated the oil crunch, but it was in Eisenhower's time. The report was a very good report, but it was written, filed, and gathered dust on the shelf. No one paid any attention to it, obviously because there was no mechanism in the country which could give any indication of what we needed.

I am reminded also of a comment made to me by a state planner in a Communist country—I think you all realize I have been in this field a long time—very long time—he said, “Suppose that it becomes most profitable to run gambling casinos. If that is the most profitable thing to do, in your capitalist society, are you going to allow all of your investment to go into gambling casinos to the exclusion of food, clothing, shelter, steel and everything else?”

It is a very, very provocative question.

So I just would like to momentarily lay that on the table.

Mr. EICHNER. Senator, I think the burden of my argument is in support of some form of indicative planning. I don't think it is a good solution. I think it has all sorts of problems. But I don't know of any other solution.

And I think that the entire postwar experience has shown that it is a necessary solution. We have tried every other possible way of dealing with these problems. We have been the last to even think about some form of indicative planning.

And, while we may not make a decision this year or next year in favor of this approach, I am absolutely convinced, as someone who has studied these problems for at least a decade, there really is no alternative.

Senator JAVITS. We will come to you, Mr. Meltzer. I assume you will be opposed, but I want to get the pros first.

Mr. LEONTIEF. Anything new is very difficult. And if you start razing the houses down, it is particularly difficult.

My feeling is it would be possible very quietly, very thoughtfully, to begin to put together some, to say a mechanism, particularly where analysis mechanism, because at the present time, our Government knows very little is happening. It just is chasing up to it by a couple of indexes moving up and down. There is very little understanding what happens in the country.

And that, I think, I know I am on an executive board of a science advisor council of the EPA, \$20 million operation. I see what is happening. Very few people know what is happening because we don't have enough analysis putting it together, not just to kind of an indices, not every way, but actual analysis of the situation.

And I think this type of thing should be undertaken. It will cost \$100 million. All right, it costs \$100 million. It is less than an airplane, a good one.

And ultimately, I am convinced it will come to it as a result of Mrs. Thatcher's experience. English socialists didn't have anything like that. English socialism is consisting of nationalizing industries. What is the difference, nationalized or not? Usually, you cannot nationalize because business does not resist nationalization which makes very large losses.

The reason I socialize my losses, nationalize my losses, it is always good. But you think this is the way in which slowly—I didn't talk about it for a long time because I saw what the climate was not like that so why? That is all we can do.

Thank you.

Senator JAVITS. Professor Wachter.

Mr. WACHTER. The Government can influence the overall level of investment in society by determining the incentives to invest, the rate of return and by altering the consumption/investment ratio.

An overall policy group could determine what sort of public policies could be used to alter the incentives to invest so as to bring the level of investment, as a percentage of GNP, up to desired levels.

My concern, though, is that any attempt to deal with investment decisions at a micro or industry level, would certainly be counter-productive to the future growth rate of the United States. It will introduce tremendous uncertainty for firms making investment decisions.

If I am in the computer industry, I would have to decide if the Government, 5 years from now, is going to make a decision to double the investment level and subsidize that investment in a competing industry. The result would make any current investment in computers much more risky.

If the Government goes into the business, even if it threatens to go into the business, of determining investment at an industry level, the effect would be to substantially increase the uncertainty for every industry. I believe that the result would be to significantly reduce the investment level and the productivity of the U.S. economy.

Senator JAVITS. Professor, by way of correction, I would say the machinery was Government/private machinery. Of course, you can say private would be overwhelming. But it was Government/private machinery.

Mr. Meltzer.

Mr. MELTZER. Certainly what we know about productivity growth is very limited. But we do know this: We know that the success of this country has been achieved with steady, slow, average rate of progress amounting to 2 to 3 percent a year more than 120 years. That has been the history of our progress.

And that progress has been achieved with the leadership of vastly different industries from one period to another.

We also know that the experiences with planning have not been uniformly good. We have the experience of Britain which Professor Wachter referred to when he talked about the steel industry. There has been a large amount of indicative planning and direction of resources and investment. And most of the resources have gone into industries which would have failed otherwise.

Perhaps it was humane to do that, but it certainly has come out of the growth in income of the British public. And that is a major reason why we now have Mrs. Thatcher instead of Mr. Callaghan.

We have greater apparent success for some kind of indicative planning in France. People didn't follow the indicative plans, but the growth rate in France where indicative planning has been talked about, has been relatively high.

We have the example of a large amount of government policy involvement in the investment and consumption decisions in Sweden. At one time, Sweden was held up as an example of the good things a state can do, but it is no longer so.

We have, I think, in the developing economies a very rich experience with Government involvement in the economy. We have Brazil, for example, where the Government controls about 50 percent of the investment with very, very good success in terms of a high rate of growth but little planning. We have Korea where the Government is involved heavily in the decisions about resources in the economy, and there is a very high growth rate.

But we also have large numbers of examples where the exact opposite is the case. Hong Kong is one example. So it isn't just a matter of whether the government is involved or whether the government is not involved. The simple answer is, we do not know how to measure the gains and losses of Government involvement in planning, and doesn't seem to me, to be a very useful experiment for us to perform.

We do know that individuals respond to personal incentives about aftertax rates of return in deciding whether they want to work more or work less or whether they want to invest more or invest less. It seems to me that is a process which we know something about, which works in many countries independent of political structures.

If we are going to make an experiment, let's think of an experiment that provides a certain tax climate, that restores some of the mechanisms of the market which produced some of our past growth. That isn't to say we should not try to improve labor-management relations and do other things, but to suggest that the Government has the wisdom to decide where the next computer industry is going to be and to do it better than the market, that is incorrect.

I would like to emphasize that particular aspect. You know, it isn't difficult to get the Government to decide to invest more money in steel or in another industry that is developing or even failing. The difficult problem is to choose the industry that is going to be a great growth industry of the eighties and nineties; to have the wisdom and foresight and the willingness to accept risk by investing in that industry now.

That is something at which governments generally have not been successful. The record of the United States is that 200 years of market determination has worked tolerably well, and we ought to be careful about replacing the market.

Mr. EICHNER. May I make one quick comment?

Again, I think we have sort of gone off on a tangent here. I don't think the suggestion was that the Government attempt to control or regulate investment in individual industries, although we do a fair amount of that, certainly, in the regulated industries. That now happens.

But if one thinks ahead about the major supply bottlenecks of the next decade, it seems clear that both energy and to some extent transportation are going to be critical.

I can envision a substantial amount of direction, to investment, in both the energy and transportation fields, which would in turn create the needed climate for private investment. I think if one reads the his-

tory correctly, one will see that it was because of judicial strategic investments in transportation and other areas that this country has been able to provide a favorable climate to private investment.

I think, again, we should not be ideological about this.

Senator JAVITS. Gentlemen, I have to leave. I would just like to conclude by saying that indicative planning would have to be an agreed-upon mixture of private and public input. And beyond that, what does puzzle me is why it is good for A.T. & T. and IBM and not good for the United States of America.

Thank you all very much.

Mr. ALBERTINE. Thank you all for coming.

[Whereupon, at 12:30 p.m., the committee adjourned, subject to the call of the Chair.]

