

ANTI-INFLATION PROPOSALS

**HEARINGS
BEFORE THE
COMMITTEE ON
BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
NINETY-FIFTH CONGRESS
SECOND SESSION
ON
OVERSIGHT ON INFLATION POLICIES AND TAX-BASED
ANTI-INFLATION PROPOSALS**

MAY 22 AND 23, 1978

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(II)

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ANTI-INFLATION PROPOSALS

MONDAY, MAY 22, 1978

**U.S. SENATE,
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
*Washington, D.C.***

The committee met at 10:05 a.m. in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, Sparkman, and Schmitt.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

The CHAIRMAN. The committee will come to order.

Today we begin 2 days of oversight hearings on inflation and new ways to reduce inflation.

There is a growing consensus that inflation is our No. 1 economic problem. During the first 4 months of this year the rate of inflation accelerated to a 12-percent annual rate, and recent estimates of the underlying rate of inflation have been raised from 6 to 7 percent or more. There is no way to deny any longer that we are caught in a vicious inflationary spiral with wage and price inflation feeding on each other.

About 1 month ago President Carter announced his anti-inflation program which is based primarily on voluntary efforts to hold down prices and wages. There has been some support for the President's programs but there has also been clear and strong opposition to it by organized labor. About 2 weeks ago even though he was willing to recognize the inflation problem George Meany would not agree to support the President's request for restraint. Yet it is obvious that if the President's anti-inflation program is to work, everyone—the administration, the Congress, the Federal Reserve, business, and labor—must make a commitment to short-circuit the inflationary spiral.

It has become increasingly clear that the monetary and fiscal policies that could reduce inflation to an acceptable level are politically unachievable. I found that out 2 weeks ago when the Senate wouldn't reduce spending by \$25 or even \$5 billion as I recommended. Also, the Federal Reserve has repeatedly told this committee that it needs help in fighting inflation so that monetary policy does not have to create a situation where credit is excessively tight and interest rates skyrocket.

Everyone agrees that wage and price controls won't work and shouldn't be used. There is no interest at all in using wage and price controls in this committee and there shouldn't be.

So what are we left with to combat inflation beyond a hope that everyone will volunteer for the President's fight against inflation?

Well, the reason that these hearings are being held is that we have been told by some eminent economists that there is a new approach to reducing inflation that deserves to be given serious consideration. This approach would use the Federal tax system to provide incentives to business and labor to comply with disinflationary guideposts. No blame would be assigned to either business or labor for creating inflation by the proposed programs, and furthermore, compliance with the guideposts would be voluntary with the tax incentives providing the inducement to hold to the guidelines. These incentives would be similar to the incentives provided by the investment tax credit which is already part of the tax system.

OPENING STATEMENT OF SENATOR SCHMITT

Senator SCHMITT. The Carter administration's activities become more disturbing as time goes on, and there is a continuing impression that the President blames the country rather than Government for our economic problems.

The President's influence on economic monetary policy is through fiscal, and other policy recommendations to Congress, and through moral persuasion. Frankly, in the eyes of this Senator, both the policy recommendations and the moral persuasion are inadequate. One shot tax cuts without spending cuts and the magnitude of the recently imposed coal settlement are only the most recent examples of this administration's lack of fiscal leadership.

The Carter administration seems to have recognized that inflation must be reduced, but many of the policies supported by the administration will significantly increase the rate of inflation:

One: New social security taxes for 1978 will add \$6.8 billion to employers payroll costs. Over the next decade, the total increase in social security taxes will amount to \$113 billion for employers and the same amount for employees, according to the House Ways and Means Committee.

Two: Proposed energy taxes will mean higher fuel costs for utilities, industry, and consumers. According to testimony given by Treasury Secretary Blumenthal before the House Ways and Means Committee, under the Carter energy plan, if enacted as proposed, the American people would have faced almost \$177 billion in new taxes by 1985.

Three: For the businessman and consumer alike, the cost compliance with Federal regulations and their attendant paperwork represent purely inflationary costs. The cost of federally generated regulations and the attendant paperwork add \$102.7 billion in inflationary pressure according to a recent study by Murray Weidenbaum prepared for the Joint Economic Committee.

It is clear that the most critical economic problems facing us domestically and internationally are government created inflation, declining productivity, unemployment, and overregulation of the economy. Although the symptoms of these problems reinforce each other, there are gradual common sense solutions to each problem. If

we begin to solve these problems, and show some patience as solutions begin to take effect, the symptoms will begin to recede.

Let me once again suggest the following "common sense" approaches to these four problems. These approaches should be thought of as an interrelated package of scheduling goals rather than absolute goals.

INFLATION

Our 5-year fiscal policy should (1) Reduce the net Federal deficit by \$10 billion per year; (2) permanently reduce taxes on the productive portions of our economy by \$10 billion per year, and (3) reduce the rate of growth of the Federal budget by 2 percent per year.

The Federal funds rate should be held below 7 percent so that the credit market can stabilize and related pressures toward a recession can be reduced or eliminated.

Monetary policy should reduce the gap between the quarterly averaged growth of M_1 and the quarterly averaged growth rate of real GNP by 0.5 percent per year until rough equality is reached.

Congress should allow for graduated mortgage rates to reduce any short-term adverse effects of possible increased interest rates as a consequence of tighter money growth.

Management and labor policy in the private sector must jointly bear the burdens of reducing demands for price and wage increases as a strong incentive for the Government to also show restraint.

UNEMPLOYMENT

Tax policy should establish annual permanent decreases in personal and business taxes which will (1) Encourage small business development and hiring; (2) create increased long-term demand, and (3) create investment in increased labor-intensive productions.

Congress should gradually increase the incentives for able-bodied persons on welfare to seek private sector employment or training for future private sector employment.

Monetary policy should be one of restraint so that business and investment confidence can contribute directly to the creation of private sector jobs.

Federal tax policy should be one of general reduction so that the bottom rungs of the economic ladder to success are restored for unemployed youth and for those with dreams of starting their own business.

ENERGY

Regulatory and tax policy should create incentives for production and efficient use of our vast domestic resources of oil, natural gas, coal, uranium, geothermal and solar energy so that energy costs can be driven down by competition and increased domestic supply.

The administration and the congressional majority do not understand that the high cost of energy is caused by Federal regulation that prevents the increases in domestic production that can break the back of the OPEC cartel.

It is not caused by too little energy regulation and taxation.

The guarantee of a free market price structure for new domestic oil and natural gas would rapidly begin the discovery and production of a resource base of at least 300 billion barrels of oil and 700 trillion cubic feet of natural gas. That would provide several decades of supply while we develop alternatives as fast as we can but without the threat to national security we now face.

REGULATION

Federal regulatory policy must be streamlined so that Congress can review major regulatory programs for their economic, judicial, and paperwork impacts on the economy. I have introduced the Regulation Reduction and Congressional Control Act of 1978, S. 2011, which would accomplish this aim.

I hope that during these hearings on anti-inflationary proposals, this committee will give its primary attention to the major source of inflationary pressure in our economy: The Federal Government.

It is a simple fact that every first-year student of economics learns, "As the supply of a commodity increases, its price, or value, declines." That is just what the Government has done with the dollar. By putting too many dollars into circulation, the value of each of them has been diminished. It is pointless to call upon the rest of the country to forego the pay increases that will allow them to keep up with the declining value of the dollar. We must address ourselves to ending inflation through changes in Federal policies instead.

The CHAIRMAN. We are honored today to have some of the economists who first recommended the new tax-based, anti-inflation policies here to give us their views on inflation and to explain how their proposals would work toward reducing inflation.

Our witnesses today will appear as a panel. They are the Honorable Henry Wallich, a member of the Board of Governors of the Federal Reserve System; Dr. Arthur Okun, a senior fellow at the Brookings Institution and former Chairman of the Council of Economic Advisors; Mr. David Lilly, who has recently been a member of the Federal Reserve Board and who will soon take on the responsibilities of dean of the business school at the University of Minnesota; and Mr. Emil Sunley, Deputy Assistant Secretary of the Treasury for Tax Analysis.

I would like to ask our witnesses to come forward if they would and I would like to ask our witnesses to limit their oral statements if they would to 10 minutes if possible. There will be a light—I hope you can see it—right in front of me here. The green light will go on for 9 minutes, then a yellow caution light for 1 minute, and then the red light suggests that your 10 minutes are up.

Governor Wallich, go right ahead, sir.

STATEMENT OF HENRY C. WALLICH, MEMBER, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. WALLICH. Thank you, Mr. Chairman.
[Complete statement follows:]

Statement by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

I am pleased to present before this distinguished Committee my personal views on the subject of tax-based incomes policies (TIP). Among the several versions of TIP that have been under discussion, my testimony will focus on the approach colloquially referred to as the "stick approach," on which Professor Sidney Weintraub of the University of Pennsylvania and I have collaborated since 1971. The stick version of TIP seeks to restrain inflation by imposing a tax on employers granting excessive wage increases. There is no interference with the forces of the market: employers who, for some reason, wish to raise wages substantially, can do so; TIP, therefore, in no way involves wage and price controls.

Various other forms of TIP have been proposed, especially the "carrot" approach, which rewards employers and employees for maintaining moderation in wage increases. A few comments on the differences between the two approaches will be made later in this testimony. I would like to stress, however, that what counts at this time is the general principle rather than the specifics. What needs to be examined now is whether any form of TIP can contribute to restraining inflation, rather than whether one or the other version may be preferable.

If other well-functioning weapons against inflation were readily available, there would be no need to discuss TIP. It is because the orthodox methods work slowly that leads me to believe that a device such as TIP, despite its obvious inconveniences, deserves consideration at this time.

Fiscal and monetary policy, the orthodox weapons against inflation, so far have not been successful in winding it down. This does not mean that they would be without effect in the long run. Nor do I believe that the cost of applying them, measured against realistic alternatives, would be as high as is sometimes believed. The alternative to successfully combating inflation is not a constant rate of inflation. We do not have the choice between doing something about inflation and leaving it alone. Left alone, it will accelerate. This tendency results from the fact that inflation increases the degree of uncertainty with which all participants in the market must cope. Thus business, labor, borrowers, lenders will all tend to inject mounting insurance premia into their wage, price, and interest rate behavior to guard against the contingency of higher inflation. Inflation itself tends to generate accelerating inflation unless effectively restrained. Accelerating inflation, however, means sure recession sooner or later. The cost of letting inflation run, therefore, is higher than even a costly form of restraining it.

TIP, moreover, should not be viewed as an outright alternative to monetary and fiscal restraint. In 1971, wage and price controls were viewed as such an alternative, and fiscal and monetary policy accordingly turned expansive. I do not believe that TIP could offset the consequences of excessively expansive monetary and fiscal policies. Some restraint by use of these traditional tools will continue to be needed.

Nevertheless, an appropriate combination of TIP and the standard tools of fiscal and monetary policy offers great promise for the longer run, once the present inflation has been wound down. TIP, continuously employed, would exert continuous restraint on wages and prices. This means that fiscal and monetary policies could be somewhat more expansionary once reasonable price stability has been restored. TIP would tend to reduce the "noninflationary rate of unemployment." Whatever the level of unemployment consistent with reasonable price stability (or a constant rate of inflation), the restraints imposed by TIP would tend to make it somewhat lower. Fuller utilization of resources and larger output would thus become possible. The payoff to a successful effort to wind down inflation would thus become very large over time.

Distinctive Features of Carrot and Stick Approach

Both approaches rest on the well documented fact that prices follow wages. Numerous researchers have arrived at that conclusion. At the same time, of course, prices influence wages, although the relationship is less close. There are other cost factors that often are claimed to be responsible for inflation - high profits, high interest rates, monopolistic practices, high prices of food, of oil, and the depreciation of the dollar. While at times each of these does exert an effect, the main factor governing

prices nevertheless is wages. With about 75 per cent of national income representing compensation of labor, it could not be otherwise. All other elements, although at times possibly significant, are bound to be small by comparison. Therefore, restraint of wages means restraint of prices. Labor does not lose from wage restraint. Whatever it gives up in the form of higher wage increases, it can expect to get back in the form of lower price increases.

Such unchanging real wage gains as wages and prices decelerate is all that the stick approach offers. The carrot approach offers that, plus the benefits from a tax bonus. The stick approach operates by shifting the balance of bargaining power between management and labor. The carrot approach breaks into the wage-price cycle by providing a tax bonus for wage earners -- and possibly price setters -- conditional on wage and price restraint.

There are further differences inherent in the two approaches. One difference is implicit in the fact that adherence to a carrot scheme can be made voluntary but also would probably have to be made universally accessible. The stick approach would have to be mandatory but could be limited to a group of the largest firms. Another difference would result if the carrot approach were so formulated as to require meeting a wage guideline accurately on penalty of losing the carrot. The stick approach proposes the penalty to be scaled to the degree of overshooting of the guideline.

Finally there is the fact that thanks to its voluntary character and availability of a reward the carrot approach should be more readily acceptable while the stick approach avoids a revenue loss and may even yield additional revenues.

Form of Tax Under Stick Approach ^{1/}

A penalty in the form of an increase in the corporate income tax rate, equal to some multiple of the excess of a wage increase over a guideline, is one of several options. It would have the advantage of relative difficulty of shifting the burden to consumers. It would have the disadvantage, on the other hand, of uneven impact as between capital intensive and labor intensive firms. Also, it would not be applicable to firms with losses, although such firms are perhaps less likely to grant excessive wage increases. The difficulty of applying an incomes tax penalty to unincorporated business, nonprofit institutions, and governments, would not weigh heavily if TIP is applied only to a limited group of large corporations.

Disallowance of an excess wage increase for corporate tax purposes would be a second option. It has the advantage of simplicity and of having been on the statute books on prior occasions. Its main disadvantage is greater shiftability.

A payroll tax offers a third option. Against the advantage of simplicity of administration stands the fact that it appears to penalize labor when the purpose of the tax is to exert pressure on management.

1/ These and many other technical aspects are examined by Richard E. Slitor in a report, "Tax-Based Incomes Policy: Technical and Administrative Aspects," prepared for the Board of Governors of the Federal Reserve System.

The Guideline

The setting of a guideline for nonexcessive wage increases is not as critical a decision within the TIP framework as is sometimes argued. The consequences of a relatively high guideline can be compensated by more severe penalties for overshooting. The likelihood that a relatively low guideline will be frequently over-shot can be compensated by a more moderate penalty. The concern that a guideline will become the minimum rather than the maximum should be largely allayed by the favorable effects of a guideline on wage setting in smaller firms, unincorporated businesses, and other employers that probably would not be covered. The guideline should embody the well-known principle that nationwide rather than industry or firm-wide productivity gains are the proper standard for wage increases. The guideline would be the sum of this long-term nationwide productivity trend and an amount, such as perhaps one-half of the going rate of inflation, that would allow for the fact that inflation must be wound down gradually rather than overnight. At the present time, this sum might be 5.5 per cent, reflecting 2 per cent for productivity and 3.5 per cent for inflation. The guideline would have to be reset periodically, perhaps annually, at lower levels ideally, until wage increases equal productivity gains.

If prices follow wages, as can be expected, labor would not suffer from accepting a moderate guideline even if, at the original rate of inflation, this guideline seemed to leave no room for real wage increases. As inflation decelerates, real wage gains will

be restored to their normal level, i.e., on average equal to average productivity gains.

Costing the Wage Increase

To establish the tax consequences of overshooting the wage guideline, exact costing of a bargaining agreement including all types of fringes, is necessary. This requires measuring the total increase in compensation, including pensions, medical benefits, cost-of-living adjustments, improvements in working conditions, and others. It also becomes necessary to determine the increase per employee, or per hour worked, or per hour worked in each differently paid employee category. In all probability, the best approach would be an index of increases covering all employee categories, weighted by hours worked.

For both types of calculation -- total increase in compensation, and the per cent increase for a given firm -- there are well established precedents. The Internal Revenue Service continually has to deal with the question of what constitutes compensation and what does not. From the experience of the Council on Wage and Price Stability and before it that of the Pay Board, which administered wage controls during Phase Two, the problems involved in costing out a percentage increase are familiar. They are not simple, but they would yield to careful writing of regulations. The task would be made easier

if the number of firms to be covered is limited. It would be eased also by the fact that small differences between taxpayers and the IRS would have only small consequences in terms of the penalty to be assessed under a graduated penalty scheme.

If a surcharge on the corporate income tax is employed as the tax "stick," the unit for which the wage increase must be computed clearly must be the parent corporation, rather than particular subsidiaries or plants. This means that a number of bargaining units may be involved, with different wage settlements. The fact that in such a situation management would be impelled by TIP to resist all wage increase demands, both high and low, is not a disadvantage, however. Wage restraint, to the extent possible, should be applied with equal strength at all margins.

Coverage

Conceptually, TIP can be applied to all employers, including unincorporated business, nonprofit institutions, and governments. Penalties other than the corporate income tax would, of course, have to be employed for some of these. In practice, limiting applicability to the largest thousand or two thousand firms seems preferable from an administrative point of view. The largest one thousand firms alone cover about 26 per cent of all nongovernmental payroll employees. These firms also are the pattern setters for wages so long as the economy is not overheating. The existence of a guideline should help uncovered employers restrain the demands confronting them.

Narrow coverage would reduce a number of troublesome administrative problems. Among these are problems of new firms, and of merging or splitting firms.

One possible defect is inherent in narrower coverage. The closeness of the relation of prices and wages may diminish if coverage is incomplete. A loosening of this linkage could, of course, occur in special circumstances. A manner of dealing with it is outlined in the next section.

Restraining an Increase in Profits

In terms of nationwide averages, prices move with wages. Under some circumstances, the link may loosen. Some of these instances are not capable of being remedied. For instance, a decline in productivity, a rise in oil prices, and the consequences of a drop in the dollar, are "real" phenomena which affect the availability of goods. They are bound to affect real wages. This is not the case, however, of a loosening of the linkage of wages and prices that is reflected in a change in profit margins. In the unlikely event that deceleration of wages should fail to be followed by deceleration of prices without any of the above noted factors being present, profit margins would widen. The share of profits in GNP, in that event, would rise as a consequence of wage restraint.

This contingency could be guarded against by changing the corporate profits tax rate in such a way as to restore the after-tax

share of profits to its previous level. In order to eliminate the influence of purely cyclical factors, some benchmark for the profit share based on historical relationships might be established. A tax designed to hold profits down to this share could be regarded as an "excess profits tax" on the profits of the entire corporate sector. It would fall on corporations with high and low earnings. It would probably have a very moderate impact, thereby avoiding the familiar drawbacks of an excess profits tax geared to the profits of particular enterprises. Given the close historical link between wages and prices, this "corporate sector excess profits tax" probably would rarely, if ever, be triggered. But its existence would serve as a protection against an adverse shift in the distribution of income.

Revenues

Neither the penalty tax on excess wage increases nor the "corporate sector excess profits tax" are intended to raise revenue although they may do so. Any revenue that does accrue could be employed to reduce income taxes. The amounts raised by the penalty tax depend, of course, on the level at which the guideline would be set and on the penalty rate on overshooting these guidelines. The objectives in setting rates should be not the raising of revenue, but the optimal functioning of TIP.

That completes my testimony.

The CHAIRMAN. Thank you very much, Dr. Wallich.
Dr. Okun.

STATEMENT OF ARTHUR M. OKUN, BROOKINGS INSTITUTION

Mr. OKUN. Thank you, Mr. Chairman.
[Complete statement follows:]

Statement by Arthur M. Okun*
Senior Fellow, Brookings Institution

before the

Committee on Banking, Housing,
and Urban Affairs
U.S. Senate

May 22, 1978

I am a proponent of a tax-based incomes policy, not because that policy is beautiful, but because it is a lot less ugly than alternative policy strategies. Under present policies, inflation is proceeding at a pace that is unacceptable to the American people; it is not unwinding but rather tending to step up; it is not susceptible to any efficient cure from either fiscal-monetary restraint or price-wage controls.

The Preamble to TIP

Despite persistent excess supplies for more than three years, our economy is suffering from an entrenched price-wage spiral with a 6-percent rate of price increase and an 8-percent rate of pay increase. And although the rate of price increase has been reasonably steady and well-predicted, inflation remains public enemy #1 in the eyes of the overwhelming majority of the American public. Currently inflation seems to be moving a bit above the 6-percent plateau, reflecting an inevitable catch-up of nonunion wages

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

and the consequences of several cost-raising measures taken by the government.

Inflation could be slowed down once more by recession, as it was during 1974-75. But fighting inflation by curbing demand at a time when it is not being caused by excess demand is absurdly inefficient. It is like burning down the house to roast the pig. A wide variety of statistical estimates that I know agree that, under current conditions, a reduction of 1 percent in nominal GNP for 1979 would cost between 0.85 and 0.95 of a percentage point of production and save only between .05 and .15 of a percentage point in inflation. In their discussions on fiscal policy, the Administration and Congress show that they are not willing to pay that price; while in its decisions on monetary policy, the Federal Reserve apparently considers it essential to pay that price. Hence, the nation is facing the serious risk that fiscal policy and monetary policy may be on a collision course. In light of all these unfavorable circumstances, I simply cannot see a realistic happy ending to the present scenario of policy.

The momentum of inflation must be stopped -- without another bloodletting of jobs and investment like that of 1974-75 and without a return to the brittle and distorting controls of 1971-72. The same opinion surveys that record the American people's antipathy toward inflation also reveal their basic support for a mutual deescalation of wages and prices. But because this is a decentralized economy, no single group of private decisionmakers can stop the spiral on its own. On the contrary, firms and unions must run ever faster to protect themselves from higher costs being imposed on them. The spiral can be broken only with the help of a collective, social decision.

Tax-based incomes policy (TIP) is a way of pursuing mutual deescalation. It is not tried and true; but the present scenario has been tried and found sadly wanting. It is not a substitute for lower rates of monetary growth and lower federal deficits as a remedy for inflation, but it is a way to make possible the necessary slowdown of money growth and turnaround of fiscal stimulus without the enormous economic and social costs of recession.

An Outline of a Reward Tip on Wages

I speak as the inventor of the reward TIP; the original, basic-model TIP produced by Henry Wallich and Sidney Weintraub relies on a stick, and I sought to convert it to a carrot. I see some distinct advantages and disadvantages in each of the two approaches. But, most of all, I believe that either of them could work effectively, and that both belong among the options from which the Congress might ultimately select an efficient cure for stagflation.

My thinking about how a reward TIP might best be implemented has evolved during the past six months in light of constructive criticisms and probing inquiries that I have received; and I expect it to change some more. But let me outline my current thoughts on the main features of that program. To begin with, I would like the legislation implementing a reward-TIP for wages to be enacted for a three-year period, with the understanding that the ceiling on the wage increase that qualifies for the reward and the size of the tax credit would be determined annually by the Congress. I would hope to be able to declare victory and let TIP expire after the three-year period, but I would like to hold open the possibility of renewal.

As I envision it, forms would be sent to all employers in the

nation on October 1 in the year prior to the initiation of TIP, asking them to enlist in the program. To participate at that time, the firm would have to pledge to limit the average pay increase for its workers in the next year to no more than 6 percent. Pay would be defined as wages plus private fringe benefits, and the definition of fringes would be spelled out in detail. The pledge would leave the firm free to grant promotions and merit raises of any size to individual workers so long as its overall average increase in pay was within the limit.

By participating, the firm would qualify all its employees for a tax reduction during the year ahead equal to 1½ percent of their wage and salary income up to some level, say \$20,000. For most workers, that tax credit would be the equivalent of a raise a little bigger than 2 percent (before-tax). In other words, the worker would be better off with a 6-percent raise and the tax credit in combination, than with an 8-percent raise and no tax cut. The credit would then be subtracted in calculating the worker's withholding tax, in effect offsetting a portion of the present payroll tax.

The firm would also be asked to state in the initial form how it intended to measure its units of employment for the two consecutive years -- for example, as total person-hours or as full-time equivalent employees. It would also be asked to specify how it planned to calculate its average wage increase -- for example, simply by using the totality of all pay and all workers, or by weighting increases for distinct occupational groups, plants, subsidiaries, or the like. Once the firm made these decisions, it would be required to stick with them for the

next tax year.

I believe that workers would strongly prefer getting the bonus right from the beginning of the year in their take-home paychecks, and that is why I emphasize advance commitments by firms to participate. But some firms may be unable to predict their wage increases in advance or might become unable to keep wages on target under some contingencies they might encounter during the calendar year.

Hence, I think that firms should be given an option to fill out the form, displaying an interest in the program without making a commitment; they would hold open the possibility of qualifying their workers for refunds after the year ends, if they meet the wage limit. In contrast to those firms that delay their decision, any firm that makes an advance commitment must take the responsibility of fulfilling its pledge and must assume the full liability for any subsequent determination that the reduction in withholding taxes from workers was unjustified. For carrying those responsibilities, the firms that sign up in advance (not those that only qualify ex post) should receive some reward for themselves -- perhaps one-fourth of the amount that is rebated to their workers through withholding.

Thus, the key features of the plan can be summarized as follows:

1. A qualified worker receives an anti-inflationary tax credit equal to 1½ percent of his wage or salary income up to \$20,000 -- equivalent to an extra raise of 2+ percent (before-tax).
2. A worker becomes qualified when his employer either:
 - A. Pledges in advance that the overall average pay increase for the year will not exceed 6 percent (and then the worker gets the credit in take-home pay through reduced withholding); or

B. Reports on its tax return, ex post, that its average pay increase for the year in fact did not exceed 6 percent (and then the worker gets a tax refund).

3. A firm that enlists in advance (as in 2A above) receives for itself a tax credit equal to one-fourth the total reduction in withholding taxes granted to its workers.

Under present circumstances, I would expect the overwhelming majority of nonunion employers to enlist in the program, with virtually all governmental units and nonprofit institutions leading the parade. Employees would be informed that they would receive tax credits, and, I would expect, most would be assured by the firms that, if their relative wage position should fall behind during the course of the program, it would be subsequently restored. I would expect a significant fraction -- though probably only a minority -- of unionized firms to participate during the initial year of the program. In fact, the size of the pay increases scheduled for the second year and third year of many existing three-year contracts would make participation worthwhile to the workers. Indeed, a substantial fraction of union contracts average less than 8 percent over the life of the contract, even though the average is apparently above 9 percent. As a rough guess, I would expect that about two-thirds of all workers would be enrolled in the program. If the Congress could afford to make the rebate 2 or 2½ percent rather than 1½, that figure might be raised to 80 or 90 percent.

Firms will want to participate in a reward TIP because -- and only because -- the tax credit to their workers would help them to slow down wages; and that is the basic guarantee that the program would be

effectively anti-inflationary. I would expect -- and, indeed, I would want -- the average wage slowdown to be somewhat smaller than the tax credit so that labor is initially made better off, as well as gaining additional benefits from the subsequent slowdown of prices. I would also expect generally favorable effects from the recognition and the expectation of the deceleration of inflation.

Surely, the slowdown of wages in general will affect union contracts; the influence of relative wages works both ways -- from nonunion to union sectors as well as the reverse. Moreover, the deceleration in consumer prices stemming from the slowdown in wages would automatically have further favorable anti-inflationary effects through cost-of-living escalator clauses.

During the second and third years of the program, I would expect an increasing fraction of union workers to be enrolled in it. All participation requires an implicit understanding with employers that, at the end of the program, any group that has fallen behind in relative wages would require some compensatory catch-up. But with broad participation, such adjustments would largely serve to restrain those who did not join up, rather than to compensate those who did.

At the end of each year, employers who qualified their workers for the credit (either by advance pledge or by ex post action) would fill out a supplemental form on their income taxes, totalling wages and all other deducted expenses that are classified as pay, and then dividing that total pay by the number of employment units (say, full-time equivalent workers or total manhours). The calculation would be made for the latest year and for the base year, to show that the 6-percent standard had been met.

There would be no monitoring, investigating, or approval or notification of any wage change during the course of the year. The auditing of tax returns would be the sole technique of enforcement, just as it is now for all provisions of the income tax. In these respects, all types of TIP contrast sharply with controls: no private behavior is prohibited, and no advance approval from the government is required.

If a firm has an acute labor shortage and really needs to raise wages by 12 percent to get the added workers it can profitably use, clearly it should and would stay out of the program. That firm and its workers should then recognize that, in all fairness, they are not entitled to an anti-inflationary tax credit. Analogously, in the case of the investment tax credit, a firm that does not need more equipment is not obliged to invest; but neither does it have any justified complaint about not receiving a tax reward.

Some Features of Alternative Proposals

The advantages and disadvantages of various approaches form an interesting balance sheet:

Revenue costs. The most obvious disadvantage of the reward-TIP relative to the penalty TIP is that the reward costs federal revenue, and that is a significant matter.

Scope. Secondly, the reward approach must be universal; the tax reductions must be available to employees of the corner grocer and the county sheriff's office as well as to those of major corporations. The penalty approach, on the other hand, can be confined to large firms which may be viewed as the pacesetters in the determination of wages. At a Brookings conference last month that covered this range of subjects, many participants viewed the opportunity for selectivity as a major

advantage of the penalty approach, particularly because it avoided the problems of record-keeping, informing, and auditing for very small firms.

In my personal judgment, however, that is not a decisive matter. Small firms are now offered the opportunity of qualifying for the investment tax credit, the employment tax credit, capital gains advantages, deductible travel and entertainment expenses, and all of the other complex tax-minimizing provisions of the income tax. And all of these provisions are enforced solely through the low probability of subsequent audit of returns. But if the Congress should feel that an onerous burden would be placed on tiny firms, then enterprises with, say, less than twenty employees (as well as brand new firms operating in their initial year) could be given a special exemption, enabling them to qualify their workers for the tax credit simply by signing a pledge to adhere to the anti-inflationary spirit of the program. Any sensible employer would convert that into some slowdown of wages.

Special situations. Like any tax incentive program, any newly enacted TIP will run into some special situations that can reasonably be regarded as "inequities." For example, some firm may have granted no pay increases at all in the preceding year, and its workers might well feel that they deserve the elbow room to catch up. Alternatively, another firm might have raised pay by 10 percent on September 1 of the preceding year; that alone would push up the calendar-year average increase of the next year above the 6 percent hurdle, even if no further pay increases were awarded during that calendar year. No manageable set of provisions can "fix up" such special problems. If these are inequities,

they are surely far less serious than the inequities imposed by stagflation. The Congress would have to accept some imperfections to ensure an administratively feasible and economically effective program. I suspect that such a course would be more acceptable if the victims of "special situations" are merely deprived of rewards rather than subjected to penalties. In the history of tax legislation, "grandfather clauses" have been typical for newly stiffened rules, but not for new benefits, like the investment or employment tax credits. So this difference is another advantage of the reward approach.

In a somewhat related manner, the reward approach builds in a better incentive for compliance by making employers liable for any unwarranted rebates of taxation to their workers. Firms are much less likely to risk IRS punishment for unjustified claims that benefit workers directly than for minimization or avoidance to shave their own liability for penalties.

Pass-through. In the penalty approach, firms that pay higher taxes because of large wage increases may conceivably pass on the tax penalty to their customers in the form of even higher prices. I do not view the pass-through as an overwhelming problem, but it is avoided by the reward approach.

Fairness to workers. Both the reward and the penalty TIP apply leverage directly to wages rather than to prices. That aspect of TIP needs to be clearly understood. Every TIP proponent knows that labor has not been the villain in the present inflation and that wages are not out of line on the high side. The reason for focusing on wages is quite different. According to a vast body of statistical evidence, a slowdown in wages is fully and reliably translated, after a reasonably short lag,

into a slowdown of prices. The evidence on the conversion of price slowdowns into wage slowdowns is much less clear. Some studies suggest that a 1 percentage point slowdown in prices will slow wages by only 0.2 percentage point, while others give answers as high as 0.9. Mainly, the problem is that economists just don't know. If we were sure that a price slowdown would generate a prompt and substantial wage slowdown, we could break the spiral by a direct attack on consumer prices -- for example, a federal program to "buy out" state sales taxes (or to slash federal payroll taxes on employers). I think those steps are well worth taking, but I do not have the faith in their effectiveness to rely entirely on them.

At least in part, wage inflation must be the direct target of any effective TIP. With a reward TIP, I do not see a substantive equity problem: the average take-home pay of workers would probably be increased a little initially, even before they benefit from a slowdown of price inflation.

With the penalty approach, there is a problem of ensuring fairness to workers. They would be better off before long, and would be far better off than they would be if inflation speeds up or if it is curbed by recession. But they are not immediately indemnified for the initial slowdown of wages that is being induced by the tax penalty. As some see a penalty TIP, it requires workers (and only workers) to ante up for the deal, so to speak. Henry Wallich and Sidney Weintraub have been sensitive to such criticisms and have suggested added provisions to achieve equity -- like a contingent tax on any shift of income to profits.

Problems of this sort are most relevant in the first year of a penalty TIP, since the statistical evidence warns that it takes a little while for a wage slowdown to be translated fully into a price slowdown. It could help to combine the stick on excessive wage increases with a general carrot for all wage earners in that year -- e.g. by enacting an income-tax cut for low and middle income families or, even better, a cut in federal payroll taxes on workers, or, best of all, a federal grant program to induce cuts in state sales taxes.

A Price Restraint Credit?

In the search for still greater evenhandedness, I suggested last fall that a tax reward (perhaps a discount on income taxes) might be offered to those businesses that limited to 4 percent their price increases on a value-added basis (that is, above and beyond increased costs of purchased materials, energy, and supplies). On this proposal, the criticisms that I have received from my professional colleagues have generally been more adverse and, to me, more persuasive than those on the wage reward TIP. I was searching for symmetry, but the economy has a basic asymmetry: it is much harder to measure increases in product prices than increases in wages. New products, quality changes, and widely varied types of output complicate the calculation. I now believe that a price reward can be incorporated into the program if the Congress insists that the burden of proof rests on any claimant for such a tax credit -- that the firm is responsible to develop the kind of systematic price indexes that would justify its deduction. But my critics would emphasize that such an accounting task would be inherently less difficult for large manufacturing firms, airlines, communications companies, and utilities than for small enterprises.

Frankly, I never expected much additional benefit in slowing inflation from the price reward, but felt that the forging of a social compact would be enhanced by treating wages and prices symmetrically. Now, however, I am concerned that a provision that was intended to reassure workers might turn out to bestow tax cuts arbitrarily on big business. At this point, I would not advocate a tax credit for price restraint.

* * * * *

In summary, TIP requires much more discussion and a major educational effort; and this committee deserves our gratitude for promoting that discussion. Clearly, the basic current controversy is not among alternative forms of TIP. Rather, it is between slowing the wage-price spiral by some form of TIP or other innovative cost-reducing strategy, on the one hand, and the hideous alternatives of letting inflation rip, fighting it by recession, or suppressing it by wage-price controls, on the other. The need to lick stagflation cooperatively and sensibly is the biggest economic challenge facing our nation, and also one of the biggest challenges to our democratic political process.

The CHAIRMAN. Thank you very much, Dr. Okun.
Governor Lilly.

**STATEMENT OF DAVID M. LILLY, FORMER MEMBER, BOARD
OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM**

Mr. LILLY. Senators, I have submitted a statement in writing and—

The CHAIRMAN. Without objection, all these statements will be printed in full in the record and if you would like to summarize it would be appreciated.

Mr. LILLY. All right. I will abstract the important parts.
[Complete statement follows:]

Testimony by David L. Lilly
before Senate Banking Committee
May 22, 1978

It is a pleasure to be here to testify before this distinguished committee on the problem of controlling inflation in our economy. I am speaking today as a private citizen who is concerned about this problem. As a private citizen, I have been simultaneously amazed and dismayed by the new anti-inflation proposals. I am amazed by the ingenuity of the designers of new policies like TIP, but I am dismayed because I believe most of the new policies are directed at the wrong sector of the economy. My experience as a businessman and as a member of the Federal Reserve Board has persuaded me that the federal government plays a major role in determining the price level and its rate of change.

It is this view--that the government plays a primary role in creating inflation--that I wish to emphasize today. The importance of determining the cause of inflation is, of course, obvious in designing a solution to our inflation problem. For if inflation is indeed caused mainly by the federal government, and if our policies designed to contain inflation are directed mainly at the private sector, these programs will have little chance of success and may even be counterproductive.

There are two ways principally that the government has contributed to our inflation problem: through stimulative fiscal policies and their accompanying large federal deficits; and through impediments to market performance resulting from overzealous use of the regulatory apparatus.

I. Fiscal Policy and Inflation

The tendency for the government to run large budget deficits has increased dramatically in the last decade. As you can see from

Chart 1, the federal government actually ran a small surplus on an average in the 1950s. In the 1960s the average deficit was about 3/10 of 1 percent of GNP, or in 1970 dollars, about \$5 billion per year. The deficit has averaged little over 2 percent of GNP, or about \$40 billion per year, in the current decade.

Not surprisingly the rate of inflation in the U.S. has ratcheted upward during the last three decades as shown in the next chart. The average rate of inflation in the 1950s was 2.3 percent. In the 1960s the average inflation rate moved up to 3.1 percent. In the current decade the inflation rate has averaged 5.6 percent.

Another way of looking at the same relationship is through the correspondence between the level of outstanding U.S. government debt and the price level. Shown in the next chart is the consumer price index and the outstanding stock of interest bearing U.S. government debt. The outstanding stock of narrowly defined money, M1, is also shown. As you can see, the relationship between the price level and the outstanding stock of U.S. government debt is amazingly close, particularly over the last ten years. Over this period the rate of growth of consumer prices as accelerated rather dramatically from its trend growth of the 1950s and the first half of the 60s; and the same time, the level of U.S. government debt has increased at about the same rate. In fact, the relationship between the consumer price level and the stock of outstanding U.S. government debt is much closer than the relationship between the price level and the narrowly defined money stock.

I don't have a very precise theory of how the government deficit--or what is essentially the same thing, changes in the outstanding stock of the U.S. government securities--contributes to the rate of

inflation. However, I think we all understand that a larger deficit means greater aggregate demand in the economy. And greater aggregate demand tends to push up prices as businessmen are forced to utilize plant and equipment more intensively or to hire less cost-efficient resources in order to meet the enlarged demand. Even without a precise theory linking government deficits with the price level, I think the evidence shown in Chart 2 is so clear and so striking that we must take very seriously the possibility that large government deficits contribute significantly to inflation.

If large deficits cause inflation, then the solution to our inflation problem seems clear, though it may be painful. In order to reduce the rate of inflation we need to shrink the federal deficit. This, of course, would require that strong decisive actions be taken and that parts of budget be cut that would arouse the anger of certain special interest groups. But if we are truly convinced that the inflation problem must be solved, these decisive steps must be taken.

II. Market Intervention

In addition to fiscal policy the federal government has contributed to the inflation problem by passing laws that alter the structure of markets in ways which produce higher prices. All of these policies were chosen in order to achieve very worthwhile objectives but I would guess their potential effects on inflation received, in most cases, only a very cursory examination during the decision-making process.

The laws to which I refer contribute to inflation in one of two ways. Either they raise a price directly or they limit the ability of the economy to absorb an increase in the price of some factor of production.

Direct Setting of Prices

The government and its agencies fuel inflation by raising the prices of certain goods and services directly. Either these goods and services are consumed directly by the public or they are used in producing goods which are later consumed. In either case the public ultimately pays a higher price for the goods and services it uses.

Examples of increases in government-controlled prices are not hard to find. The recent increase in the minimum wage received opposition from economists of all political persuasions, though not enough to defeat or postpone it. Increases in agricultural price supports also fuel inflation, and I strongly urge the gentlemen on this committee to show restraint when they are asked to vote on a future proposal.

Curiously enough, the government contributes to the inflation problem not only by raising prices but also by just keeping controlled prices constant. In the field of transportation, I would argue regulation keeps prices too high and restricts entry into the markets for air, land, and water transport. This effectively forestalls competition that could bring the price of these goods and services down in the absence of regulation. Such a situation has existed in the airline industry for some time. It is well known that unregulated intrastate airfares in Texas and California are roughly half the regulated fares. Deregulation could help bring other fares down as well.

Another example of the benefits to be derived by decreasing such regulation is provided by experience with the shipment of frozen poultry and frozen fruits and vegetables in the 1950s. The commodities were added to the list of agricultural commodities whose shipment was exempt from I.C.C. control. A Department of Agriculture study of this limited deregulation concluded that there were two basic effects: the

cost of shipping these goods declined (approximately 30 percent for poultry and 20 percent for fruit) and shippers reported that the quality of service for these commodities improved.

Even when government regulation keeps a price too low, it can contribute to inflation. A good case can be made that the maintenance of a very low price on natural gas discourages exploration, prevents growth in supply, and prevents natural gas from competing with foreign petroleum. Discouraging this potential competition makes it harder to decrease our dependence on foreign oil whose price is rising and, hence, makes the inflationary impact of that price rise greater than it would be if energy users had more opportunity to switch away from the more expensive fuel.

Limiting the Economy's Flexibility

The previous example of competition between fuels might be used equally well as an illustration of how government regulation limits the economy's ability to adjust and to absorb increases in the costs of factors of production.

As a businessman, I can assure you that a rise in the cost of a factor of production is not viewed by business as an excuse to increase the price to consumers and widen the profit margin. Rather my experience in the private sector has been that a rise in the price of a key input almost inevitably leads to a decline in profit. With the price of one input higher than it used to be, we try to redesign our product to maintain quality but use less of the more expensive material than previously. We may also respond by restructuring our production process to produce the same product in a less costly way.

In any case, the emphasis is on minimizing the effect on the quality and price of our product. Rarely can a producer even consider

the option of passing the entire increase along to the consumer. Zealous competitors (domestic and foreign) are usually ready and able to undertake any cost-saving alteration a producer might be tempted to forego.

When, as a result of government regulatory restriction, producers are discouraged or prohibited from making such adjustments, the consumer is the loser. The price increase the consumer faces is higher than it would have been in the absence of regulatory constraints.

Examples of this kind of situation abound. Environmental standards raise the cost of mining coal for fuel and the cost of adapting existing facilities to burning cheap, yet polluting coal. This limits industry's ability to shift away from cleaner burning petroleum whose price is rising rapidly. The producer's higher costs will be reflected in the price the consumer pays. Building codes and work rules in the construction industry and environmental standards for construction produce similar effects. Protection of domestic industries from foreign competition by the use of trade restrictions can also have the effect of increasing the inflationary impact of cost rises in those industries.

This list could be extended as I'm sure you are all aware, but my point has, I hope, been made. With the growth of regulation (and I don't feel I need to document that), the economy is less able to absorb a rise in the price of a factor of production.

In pointing out the inflationary consequences of these and other regulatory policies, I do not mean to imply that they are all bad policies which should be repealed. But I do claim that in many cases, the laws have been drafted and enforced with little attention to their inflationary consequences. Approached with this additional consideration in mind, these programs can and should be tailored and modified to

minimize their inflationary impact while attaining their other goals.

(In November of 1977, I submitted to Vice-President Mondale some of my suggestions of how this might be done.)

III. Policy Options

My policy preferences flow directly from my belief that rises in the general level of prices should be attributed to government actions instead of private actions. Let us first consider the policies that I (and large part of the economics profession) say won't help the economy.

Policies That Won't Help

Several policies currently under discussion (or in use!) will not help the economy towards better health because they are directed at the symptoms of the disease not at the root cause.

Wage and price controls are misdirected at the private sector and would provide little help to the economy. Controls proceed from the view that inflation grows out of the greed of workers and the greed of employers, a view I strenuously dispute.

There is no doubt that the CPI could be held down temporarily by controls, but the bulk of professional economic opinion agrees that this cure for inflation is worse than the disease itself. The real resource cost from delaying the kinds of adjustments the private sector is forced to make when relative prices change outweighs the gains from temporarily forestalling a general price rise. And we must add to this the costs of administration which are usually substantial. In my reading, I find that economists vastly different ideological and political stripe find agreement on this point. Only when inflation really starts to heat up do a few economists start to reevaluate history until they conclude eventually that controls (usually in some slightly new form) are worth a try.

Tax-based Incomes Policies have received a lot of attention at these hearings are, it is claimed, a new and better form of controls. These proposals are still directed at the private sector only this time with the belief that inflation is caused by the greed of workers and the timidity of employers. I do not share either half of that belief.

TIP is presented as a mild form of wage-price controls. I agree that, as such, it will probably deliver less of the good effects of controls, and I fear it will deliver as much or more of the bad effects of more general controls.

TIP could have some good effect. It could effectively limit the growth of wages and to some extent the growth of prices. However, the bad effects would, I think, outweigh the good by at least as great a margin as they do for complete controls.

The bad effects may be very great because TIP may produce even greater distortions than standard controls and will also be very costly to enforce.

First, it is argued that TIP will create fewer distortions than standard controls by allowing market forces to help allocate resources. Yet since TIP acts as tax on only a single factor, labor, the action of those market forces may indeed push the allocation of resources in the wrong direction. Making labor relatively more expensive to firms will encourage them to substitute machines for workers wherever possible and reward those who do so with actual subsidies. This could create distortions far worse than those caused by general controls on all inputs which do not provide such encouragement.

Second, TIP is often portrayed as being less costly to administer than more general controls, but I feel the administrative costs would

still be substantial. I prepared a short list of administrative questions which I think have not, as of the date these hearings, been adequately addressed:

Since TIP would be adjoined to the corporate income tax, how would unincorporated businesses and nonprofit institutions be treated? How would the program be applied to new firms with no past records of salary expenses? How would TIP be applied to salary increases based on previously negotiated contracts? Couldn't TIP be evaded by granting "promotions" to employees receiving above-guideline pay increases? Couldn't payments "in kind," such as longer lunch breaks and vacations, be used to evade the program? How would TIP handle costs associated with work contracted out? How would demands for "catch up" wage increases be handled? Might not the aluminum workers argue that a large pay increase would be required in their next contract to preserve comparability with steel workers who received a large settlement in 1977?

In short, if costs of more general controls outweigh their benefits, it is my feeling TIP does not offer a decrease in costs or an increase in benefits sufficient to swing the balance in favor of intervention.

A Policy That Will Help

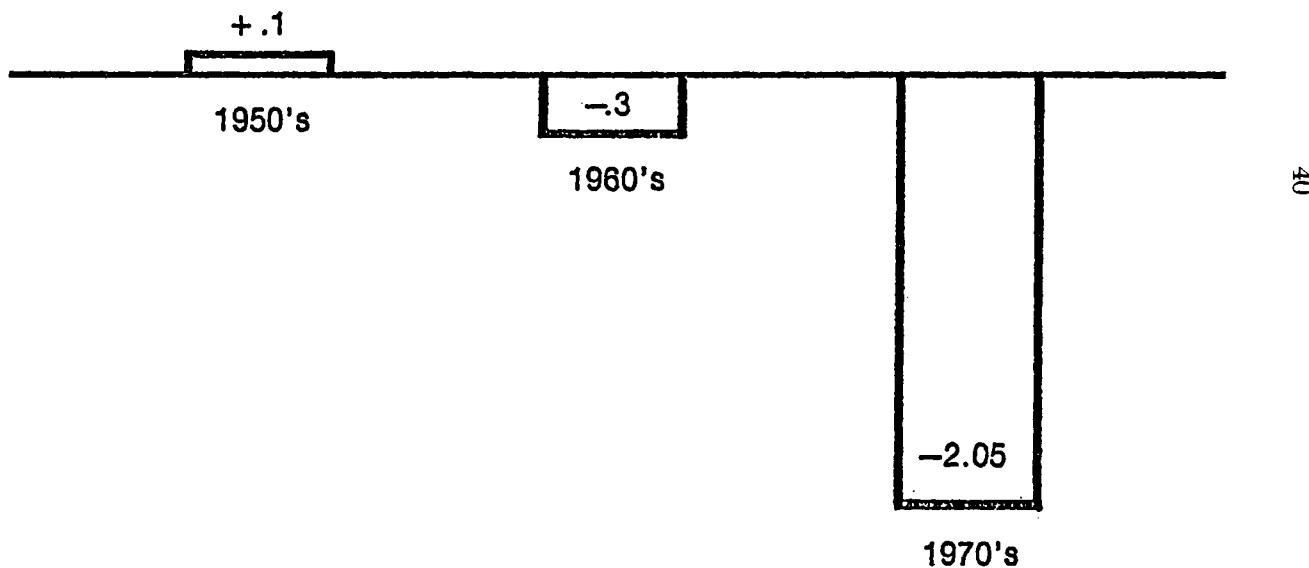
If, as I believe, the cause of inflation is the spending and regulatory behavior of the federal government, changing that behavior is the only real solution to the inflation problem.

The first order of business for a government intent on stopping inflation should be to cut the budget deficit. Only by slowing the growth of government debt can we slow the growth of the price level in a fundamental nondistorting way.

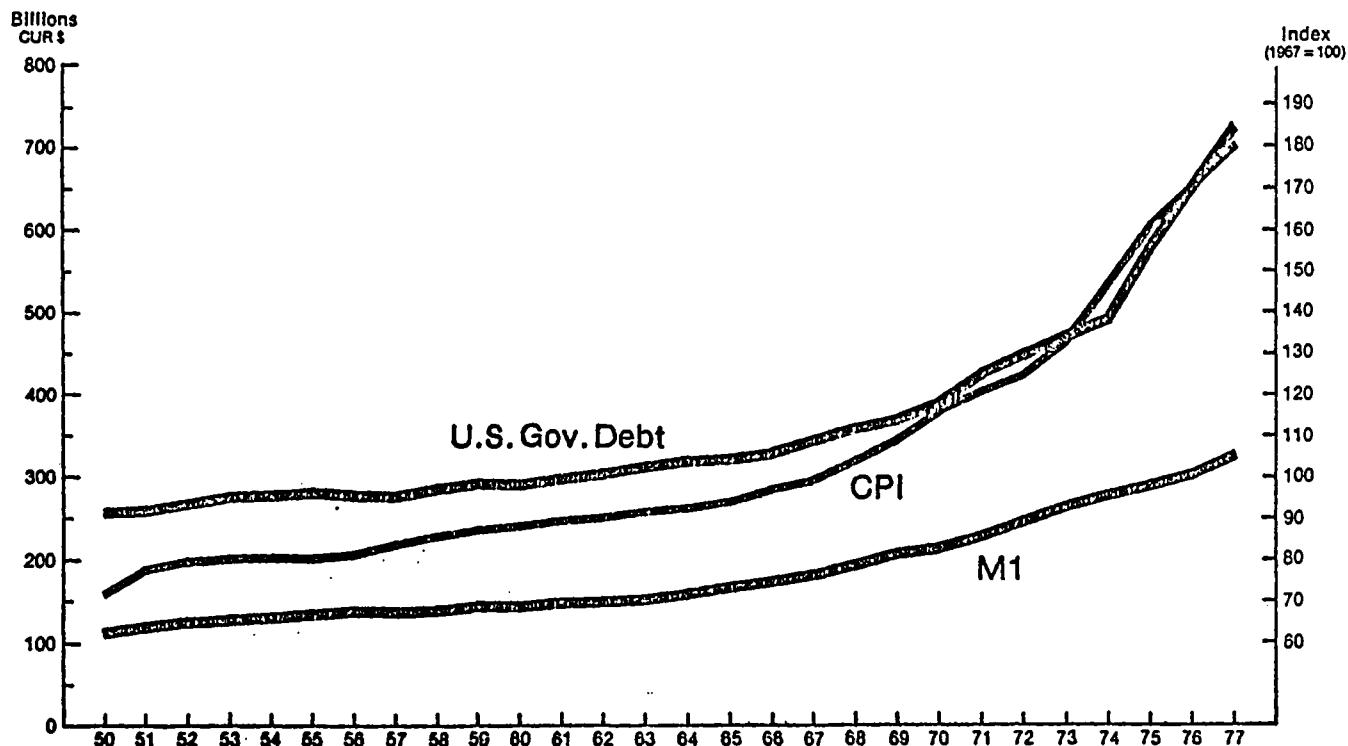
This reduction of the deficit will have the largest effect on the economy if it is perceived by the public as the first step of a continuing program of fiscal restraint. If such a reduction, say for fiscal 1979, is viewed as a one-time experiment to be followed by controls if prices don't slow, it is almost surely doomed to failure. We must abandon the sequence of "quick fixes" for a slower and surer regimen.

The task facing a Congress seeking to implement such a policy is indeed a formidable one. It will involve hard political choices, either denying the demands of various deserving special interests or abandoning a general tax cut which many people are already anticipating. But, if you can ignore the short-term political pressure that such a policy would generate in order to attain the long-term good that such a policy would deliver, you will be acting in a tradition of principle for which the Senate has been deservedly revered.

U.S. Deficit as % of GNP



Relationship Between Money, U.S. Government Debt and Prices



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The CHAIRMAN. Thank you, Governor Lilly.
Mr. Sunley.

**STATEMENT OF EMIL M. SUNLEY, DEPUTY ASSISTANT SECRETARY
FOR TAX ANALYSIS, DEPARTMENT OF THE TREASURY**

Mr. SUNLEY. Thank you, Mr. Chairman.

I am most pleased to be here. There are comments that I will be making today that are very similar—

The CHAIRMAN. Before you came in—incidentally, your statement will be printed in full in the record. It's a substantial statement. The lights here—the green is 9 minutes, the yellow is 1 minute, and then the red goes on.

Mr. SUNLEY. Fine. The statement I'm making today is very similar in content to a paper that Larry Dildine of the Treasury and I prepared for a recent Brookings conference, so not only will there some day be published the statement of this hearing today, but a much longer statement that Larry Dildine and I wrote will be published in the Brookings papers.

I will address my remarks here to the administrative problems of a tax-based incomes policy. A workable scheme must permit the Internal Revenue Service and businesses to determine the amount of tax benefit or penalty that a firm qualifies for or is subject to. As one might expect, finding solutions to the administrative problems often involves tradeoffs with features that would otherwise be desirable on economic or political grounds.

[Complete statement follows:]

FOR RELEASE UPON DELIVERY**Expected at 10:00 a.m.****May 22, 1978**

**STATEMENT OF EMIL M. SUNLEY,
DEPUTY ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY
BEFORE THE SENATE COMMITTEE ON BANKING,
HOUSING, AND URBAN AFFAIRS**

Mr. Chairman and Members of this Distinguished Committee:

I am pleased to appear today to discuss with you the potential for use of tax incentives to hold down wage and price increases. These imaginative proposals have recently been receiving increasing attention and I am happy to see that this Committee is giving them a thorough hearing.

I will address my remarks here to the administrative problems of tax-based incomes policies, such as those put forth by Arthur Okun and by Henry Wallich and Sidney Weintraub. A workable scheme must permit the Internal Revenue Service and businesses to determine the amount of tax benefit or penalty that a firm qualifies for or is subject to. As one might expect, finding solutions to the administrative problems often involves trade-offs with features that would otherwise be desirable on economic or political grounds.

Preliminary Observations

The administrative problems of implementing a tax-based incomes policy depend crucially on five initial design decisions. First, the scheme may impose tax penalties on firms granting excessive wage or price increases, or it may provide tax reductions for firms or workers restraining price or wage increases. If the stick approach is taken; that is, penalties are imposed, then unincorporated businesses and small firms, which often employ only rudimentary accounting, can be excluded from the program. Limiting the penalties to larger corporations would greatly reduce administrative problems without seriously impacting the effectiveness of the program.

The carrot approach is politically attractive because it could probably provide tax reductions directly for workers as well as employers if wages did not rise above the threshold amount. But, providing tax reductions for workers raises some vexing administrative problems. Firms would have to inform workers on the W-2 Form that they qualify for the tax break, or, following Okun's suggestion, they might adjust withholding in anticipation of qualifying for the tax break. If on audit it is found that the workers did not qualify, the Internal Revenue Service would have to collect from the firm, leaving the tax break for the workers intact. This solution is practical, but it seems to suggest that employees are responsible for successful wage restraint, while companies are to blame for any failure.

Furthermore, it would not be desirable to deny small business taxpayers and their employees the rewards for good behavior. A program that has universal coverage of all taxpayers would be much more costly to administer than one that covers only larger corporations. I conclude, therefore, that the stick approach involving penalties on firms is to be preferred on administrative grounds to the carrot approach involving tax breaks for workers.

The second initial decision with important administrative implications is whether the rewards and penalties apply over the full range of possible wage and price changes, such as under the program proposed by Laurence Seidman, or whether they depend on the firm remaining above or below a threshold or hurdle. Under a continuous program, higher prices and wages reduce the rewards or increase the penalties according to some formula. Continuous incentives are more efficient but also would require that for every firm the exact increase in wages or prices must be known.

In the hurdle approach, the rewards and penalties depend simply on whether a firm's wage increases are below, say, 5 percent per year. In this approach, IRS enforcement efforts can be concentrated on firms that are near the hurdle. Consequently, the hurdle approach is more attractive on administrative grounds.

Whether the program is a temporary or permanent one is the third initial design decision. If a tax penalty is imposed for only one year it is likely to have very arbitrary effects among firms depending on when they customarily raise wages and prices. Complicated intra-year adjustments annualizing wage and price increases occurring during the year may be needed to reduce the arbitrariness of the program. Also, special rules or exceptions may be needed for multi-year contracts that provide future wage or price increases. A temporary program may result in firms and workers agreeing to compensatory wage increases or bonuses to be paid after TIP expires. The best way to avoid this problem is to indicate initially that a temporary program may very well be extended if it is successful in moderating inflation.

The fourth initial decision is whether the basic accounting unit for wage and price increases should be the plant, the corporate entity, or the conglomerate. In the case of a tax-based incomes policy applying only to wages, the basic accounting unit could also be the bargaining unit, or class of workers.

By far the simplest arrangement for administration is to have the basic accounting unit be the group of related corporations that file a consolidated tax return, and to have the basic time period be the accounting period of that group. Some corporations may be on a calendar year time period, and others on a fiscal year.

If the TIP penalties or rewards are to be applied directly to tax liabilities of employees, it may also be necessary to apply them to each bargaining unit or broad class of employees. Otherwise, one group of employees may be penalized for the greater demands or stronger market positions of another union or class of workers.

The fifth initial design decision is to specify the nature of the TIP penalty or reward. Most TIP proposals have been cast in terms of changes in the rate of the income tax. Thus, the Okun proposal would rebate a percentage of the income tax for firms and employees of firms that pass the hurdle, while Wallich and Weintraub propose a surtax on income for firms that fail the hurdle. Laurence Seidman has suggested a variable system with rebates for firms that do better than a specified standard and a surtax for those that do worse.

However, an economic case may be made for tying a wage restraint to the Federal payroll taxes. A payroll tax variant of TIP would then be directly related to a measure of labor cost rather than to capital income. Some approach other than altering the income tax rate should be proposed, if it is deemed important that businesses be subject to TIP, regardless of the amount of income tax currently paid. In 1973, 56 percent of corporate taxpayers paid no Federal income tax. A TIP that alters the income tax rate for the current tax year would have no consequence for such firms.

The most easily administered type of TIP incentive that would also apply to deficit companies is a credit or surcharge applied to one of the payroll tax bases. These incentives could be defined as additional income tax liabilities or credits so as not to affect the trust funds.

Having settled on (1) carrot or stick, (2) a hurdle or continuous formula, (3) temporary or permanent, and upon (4) the level of consolidation, and (5) the type of penalty or reward, any TIP program must specify rules to determine the extent of wage increases. If price increases are to be explicitly treated, these must also be defined. In each case, there are problems of defining the prior year base and measuring the increase over the base. The administrative problems are considerable, particularly in the case of prices, unless simplified procedures are adopted. These procedures would be somewhat arbitrary and could distort business decisions such as the choice between debt and equity or the choice between money wages and fringe benefits.

The Measurement of Wage Increases

A comprehensive measure of pay increases would include all elements of labor compensation that can be reasonably valued in dollars. That is, the numerator of the hourly wage rate would be the sum of money wages and salaries, including overtime; the accruals of pension rights; profit sharing and other incentive awards; contributions to annuities and group insurance; commissions; bonuses, and any other valuable compensation. The denominator would be the annual total of manhours worked. Such a thoroughgoing definition of wages is desirable unless there is some reason to promote the substitution of nonwage benefits for money wages.

All of the practical problems of measuring nonwage compensation are already encountered in defining and administering the income tax. For employees, the incentives to seek substitution of certain tax-exempt or unreported nonwage benefits such as reduced-rate merchandise or company-paid insurance already exists. For corporations, there is a strong incentive to avoid understatement of deductible labor costs since these directly reduce corporate tax liability; but, in many cases, fringe benefits that are not reported as income by employees are deductible to employers as business costs.

Under a hurdle-type TIP program, the payoff at the margin for reducing measured pay increases by increasing benefits that are not recognized as compensation may be very large. For some versions of TIP, if the wage hurdle is set at 6 percent, any device that allows a firm to reduce the measured increase from 6.1 percent will result in a tax rate reduction (or avoidance of a rate increase) on the entire income of the firm. Because of this "notch", firms that are near the margin of target wage increases would have very strong inducement to underreport increases in compensation, even if the average rate of the TIP penalties or rewards is small. A similar potential notch problem would exist on the price side of TIP.

Adjustments and Exceptions

One set of wage measurement issues thus involves defining enforceable rules for measuring accruals of pensions and unfunded insurance benefits, for measuring the value of employee fringe benefits, and for estimating hours worked for those on salary or commissions. Another set of wage measurement issues is the adjustment of gross increases in hourly compensation for such considerations as year-to-year variations in the amount of overtime, changes in the skills mix, changes in the average length of service, explicit escalator clauses, and incentive awards.

Equity would suggest that a firm with above-average overtime in the current year should not be penalized under a TIP. This would require that an adjustment for overtime be made in both the base period and for the current year. Many firms, however, would not have records to support the amount of overtime pay in the base period.

It may also be unfair to penalize a firm for pay increases that result from adding more highly skilled employees, or for rewarding employees who complete training programs or surpass quotas. To the extent that employee incentive awards, increases for length of service, and promotions are intended to reflect increased productivity, these changes in compensation are already allowed for in setting the wage increase hurdle. But firms in a cyclical downturn may be caught by TIP if layoffs are mainly lower-skill, lower-pay employees. Actual shifts in the mix of employment toward higher-paid classes will, of course, be penalized if TIP is based only on the change in aggregate hourly compensation.

TIP could also provide an incentive for firms to contract out for high-wage labor services. Suppose, for example, that a small construction firm, consisting of 5 laborers and 2 engineers, wishes to hire an additional engineer. Under a straight hourly wage hurdle with no adjustment for classes of workers, hiring the engineer outright could cause the firm to fail the TIP hurdle. Hiring the additional engineer as a consultant would allow the firm to qualify unless there were regulations to count consultants as employees.

During the 1971-72 wage controls, the meaning of the term "wage increase" was rather narrowly construed to mean increases in the regular compensation, not including overtime and bonuses, for a given job held by employees with the same length of service and quality of performance. This concept requires the specification of an index to adjust "compensation per hour" for changes in job definitions, longevity, and the mix of skills.

A wage index could take the form of a weighted average of hourly wages in each job classification or grade. But the specification of such an index adds significantly to the compliance and administrative burden as compared to a simple average hourly wage measure. It also puts heavy reliance on the job classification system of business organizations. If the coverage of the TIP program is to be nearly universal, most small employers would need to invent a classification system and all employers would be tempted to bend their classification systems to help achieve the specified standard. The promotion of a relatively high-paid secretary to administrative assistant can reduce the average wage in each

category, giving the appearance of wage reductions. Such promotions would give more room for pay increases within grades without encountering the TIP penalty or foregoing the TIP reward.

The worst injustices resulting from shifts in the employment mix may be accommodated, without adding greatly to administrative burden, if a calculation of the average increase in hourly compensation defined to include all types of compensation, were made separately for certain broad and recognizable classes, such as (1) hourly rated employees, (2) salaried and commissioned employees, and (3) corporate officers or partners. The increase in these classes could then be averaged using the number of full-time equivalent employees of each class in the base period as weights.

Finally, Congress would need to decide whether exceptions should be allowed for low-wage employees and, especially, for wage increases mandated by increases in the minimum wage. Again, exceptions of this type that are attractive on equity grounds will complicate administration and compliance.

The Measurement of Price Increases

Extending a tax-based incomes program to prices would increase the administrative problems severalfold. In the case of wages, there is a basic unit of labor, a man-hour, which can be adequately defined. Total compensation, somehow defined, can then be divided by total man-hours to obtain compensation per man hour.

In the case of prices there is not a basic unit of output. Thus it is not possible to divide total sales revenue by total units of output to obtain price per unit of output. Instead, a price index must be created for each covered firm. This is not a simple task, when there are some companies, such as Dow Chemical, that produce over 100,000 separate products.

What makes matters even more difficult is that a firm may have raised its price only because it was passing through an increase in the cost of purchased materials. Allowing a pass-through of cost increases is a simple concept, but it does raise a number of issues, particularly as to just what costs are going to be passed through and how purchased materials are to be priced. In general, firms should be permitted to pass-through costs of inputs if the

firm is a price taker. However, if the firm has some control over the price of the input, pass-through should not be permitted. But this would be a very tough judgment to make in developing a TIP program, and the rules would inevitably be more appropriate for some taxpayers than for others.

To determine whether there has been a price increase net of costs of materials, i.e., a value added price increase, the firm must know last year's prices of purchased materials and output. Last year's price of a product very likely will be a weighted average of the prices at which the product was sold during the previous year, and special rules may be required for temporary special allowances offered during the base period. The firm would then measure this year's value added using last year's prices and compare that with this year's value added measured using this year's prices. In short, the firm would construct a value added price index using this year's quantity weights for both outputs and purchased materials. Constructing such an index would raise all the traditional problems involved in constructing a price index.

The first problem in developing a value added price index is to define by statute or regulation what is a product or an input. For example, how many kinds of automobiles does General Motors sell in one year or how many kinds of steel does Bethlehem Steel produce? In the case of a drug store, are felt tipped pens different from ball point pens? Just what is a separate product or input would have to be defined with sufficient clarity that the firm and the Internal Revenue Service can easily compute the value added price index.

Closely related to the problem of new products is the problem of quality changes. This year's automobile is different from last year's. Some adjustment would have to be made for product improvement such as disc brakes, safety equipment, and more durable bumpers. Again, the statute or the regulations would have to provide specific rules for quality improvements that both businesses and IRS agents can easily follow.

An additional problem with constructing an index is that the base period may not be a "normal" year. Companies whose base period prices or wages were abnormally low will seek an exception or special relief. For example, the major

firms in the steel industry raised prices just before the August 15, 1971 freeze. These firms thus had a high base period price. The smaller firms in the steel industry had not raised prices. These firms, as a result, were doubly penalized since they purchase raw steel from the majors and sell finished products in the same market as the majors.

The problems of measuring average price increases arose during Phase II and later phases of the economic stabilization program. Unfortunately, the experience during the economic stabilization program gives little guidance for administration of a tax-based incomes policy since little auditing of company reports was ever done. Firms were essentially on an honor system, and the Cost of Living Council generally accepted the reports as filed.

I conclude that computing a value added price index for each firm would involve considerable complexity for business. There is no easy way to define what are separate products or inputs or to handle new products, quality improvements, and the various issues surrounding cost pass through. Sampling techniques could ease the administrative burdens for large business but would be beyond the capabilities of a small retail firm with many different products. If it is desirable to apply a tax-based incomes policy to prices, consideration should be given to a scheme that does not involve the construction of an index.

Profit Margin Test

During wage and price controls, a profit margin limitation was employed as a supplemental device to allowable cost pass through. It was assumed that a firm that had not increased its profit margin; i.e., the ratio of profits to sales, had not increased its prices excessively.

A profit margin limitation would solve many of the problems of a value added price index. No special rules would be required for new products or quality improvements. All costs could be passed through including increases in wages. Presumably, a parallel portion of the tax-based incomes policy would provide a brake on excessive wage increases.

Firms would, however, have an incentive to increase expenditures for advertising and R&D so as to shrink profit margins. Unless the test was applied to gross profit margins, that is, profits before debt service, firms would

have an incentive to substitute debt for equity financing. Base-year problems would also remain, though they would be mitigated since the base period could be an average of several prior years and not just the immediate proceeding year. Special exceptions would have to be made for losses or very low profits in the base year. One possibility would be for the government to publish minimum profit margins for specific industries based on industry averages.

The major advantage of a profit margin limitation is that the Internal Revenue Service could much more easily administer it. Sales revenue and profits, either net or gross, are concepts with which the Service has had long experience.

Like any excess profits test, a profit margin limitation would be a penalty on efficiency. It would also penalize industries that are becoming more capital intensive. But, if some form of price controls are regarded as a necessary complement to a TIP for wages, the profit margin limitation is the most tractable version.

Special Rules and Exceptions

A tax-based incomes policy applying either to wages or prices may require a number of special rules relating to exports, coverage of particular industries, and corporate mergers and other reorganizations.

The objective of a tax-based incomes policy is to hold down domestic wages and prices. There is, however, no particular policy reason to be concerned about export price increases. Thus, firms should probably be permitted or required to disaggregate exports in determining the value added price increase or the gross profit margin. This would require special regulations to allocate certain costs and profits.

As indicated at the beginning of my testimony, if a tax-based incomes policy provides tax benefits, all business taxpayers and even nonprofit organizations would want to be permitted to participate. If, however, tax penalties are to be provided, a number of exclusions that would greatly simplify the administrative complexities would be possible. An effective tax-based incomes policy could exclude new firms, unincorporated businesses, small corporations, and certain industries. There are very substantial administrative advantages to such exclusions.

Determining base period prices and wages would be a considerable burden on new firms, if they are included in the tax-based incomes policy. If the firm began midway through the year, an intra-year adjustment might also be required.

If anything more than the most perfunctory auditing were to be contemplated for small firms, the sheer magnitude of necessary paper work for firms and for the IRS argues against including them. Precisely this kind of paper work burden was encountered in administering Phase II controls, and this was eventually accommodated by the exemption of most firms having fewer than 60 employees.

Small firms are most likely to make use of the potential for contracting out in order to avoid the apparent wage increase from adding or replacing high-paid workers. Also, small corporations present significant opportunities to reduce salaries and increase corporate taxable income when the owners are also employees. This is particularly true when a small corporation is subject to only the 20 or 22 percent corporate tax rate.

In general, the proportion of cases for which some special relief from the rules may be needed is probably much larger for small firms. Large changes in skill mix, changes in the amount of overtime, and other such potentially variable elements in the calculation of the wage increase would be more likely where small firms are involved. Exempting the smaller firms would also exclude most sectors of the economy, such as agriculture and small retailing, where wages and prices are the most market sensitive. Excluding unincorporated businesses and Subchapter S corporations from TIP would avoid the necessity for special rules to distinguish labor compensation in the earnings of partners, proprietors, and shareholders that are active in management.

Conclusion

I conclude that tax-based incomes policies would involve significant administrative problems for the IRS and compliance problems for businesses. These problems can be reduced to a manageable size if the scheme is applied only to business taxpayers, limited to wages, if the hurdle approach is adopted, and if it does not apply to small companies. The administrative and compliance problems, however, still would be significant.

There would be a strong incentive for firms near the hurdle to pass the test by substituting forms of compensation that are not included or are under valued in the wage index. Experience with wage measurement problems under the income tax suggests that opportunities for substituting forms of compensation that underestimate the true increase in labor cost cannot be fully closed off. Establishing the base period wage level is an added problem. Adjustments are required for firms that reorganize or add major new activities. Further adjustments may be demanded for year-to-year changes in the skills mix, overtime pay, or wage increases mandated by law or prior contracts.

If a parallel price restraint program is adopted, there are strong administrative reasons for preferring a profit margin limitation rather than an explicit price index.

The remaining administrative and compliance problems must be weighted against the expected gains from a tax-based incomes policy in moderating wage and price increases.

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The CHAIRMAN. Thank you, Mr. Sunley.

I want to thank all of you gentlemen very much. This is, as we said, a terribly perplexing, frustrating problem. I think Dr. Okun put it well when he indicated that we have to look at these as the least worst or the least ugly alternatives and there's no option that's good. Obviously, if there were, we would put it into effect.

I'd like to start off by asking each of you gentlemen to comment, if you could, on the President's program as he announced it so far.

As I understand it, even if TIP went forward with full vigor and the Congress adopted it and passed it, it would not go into effect probably for 1½ or 2 years and, therefore, we would be faced in the immediate future with a problem of what we can do with what we have.

President Carter's anti-inflation program was announced about a month ago. It consisted of the following, brought up to date in view of his present attitude on the deficit: (1) a pledge to hold the fiscal year 1979 budget deficit to \$50 billion and to veto any bills that threaten a larger deficit; (2) a limit of raises for 3.4 million Federal civilian workers and military personnel to 5.5 or 6.5 percent recently budgeted; also, the salaries of 2,300 political appointees were frozen and letters were sent to all Governors and mayors asking them to hold down pay of the State and city employees; (3) a vow to reduce the burden of Federal regulations on business; (4) a request that labor and industry bring wage and price increases below the average of the past 2 years, and the President also called on high executives to freeze their own salaries and bonuses; (5) help us to meet with executives of certain industries to formulate goals for wage and price boosts—and as we know, Robert Strauss, who was appointed Special Counselor on Inflation, will appear this afternoon as a witness before this committee.

A recent column in the Washington Post commented on this and I'd like to know whether this would be your view. The President's reliance on totally voluntary restraints and the wagging of Strauss' jawbone is likely to produce little more than a temporary euphoria. It is clear, as President Carter himself said at last week's press conference, that the present inflation is a product of a self-maintaining spiral of wages and prices. Something dramatic is needed to break the cycle and it is doubtful that even Bob Strauss can do it by himself in the face of a stubborn 7 percent inflation rate.

Mr. WALLICH. Mr. Chairman, holding down the deficit is certainly an important first step. I would prefer, however, a more dramatic move in that direction: a reduction in the proposed tax cut to an amount no larger than that required to offset the inflationary push into higher tax brackets. I would estimate that to be no more than \$5 or \$10 billion.

The CHAIRMAN. By that, you mean \$5 or \$10 billion below the \$19.5 billion that is the President's request?

Mr. WALLICH. A tax cut of \$5 or \$10 billion is what I had in mind.

The CHAIRMAN. Instead of the \$19.5 billion?

Mr. WALLICH. Yes.

The CHAIRMAN. I see. Thank you.

Mr. WALLICH. Pressuring labor and business to decelerate wage and price increases has the appeal of being very logical; that is, smaller wage and price increases each year will eventually lead to reasonable price stability. Although I think it is too early to say that the President's anti-inflation program is likely to be only partially effective, we must bear in mind that ours is a very competitive society in which people in their official capacity as union leaders and leaders of businesses cannot do what they might be willing to do as individuals; that is, to make a sacrifice for the common good. So, while I wish this program well, I do not think we should rely wholly on it. The same applies to the approach described by Ambassador Strauss.

I fear that the forces of accelerating inflation are staring us in the face and that if we do not do something more intensive than the President has proposed so far, we may find that inflation will further accelerate.

The CHAIRMAN. Dr. Okun, how do you feel about the President's proposed anti-inflation program?

Mr. OKUN. I think the President took an important step in the right direction when he introduced that program last month. I wish he had done it a year ago, frankly.

To me, he showed for the first time that he's willing to stand firm and take some political heat from interest groups ranging from Federal workers to farmers to business and labor and to environmentalists on timber cutting in order to pursue a course of containment of the inflation rate.

I was also pleased that he has explicitly committed himself to a voluntary price and wage restraint program with some jawboning. The evidence of the 1960's indicates that there were benefits from that type of program before it was overwhelmed by the tides of excessive demand. I think it's well worth doing.

I rather regret that the President and the administration have fought so hard and apparently seem to have defeated, at least at this stage, any tax-cutting in the form of rolling back the payroll tax, which is clearly an inflationary tax. I think that the form of the tax cut is much more important than whether the size of the tax cut is \$10 billion or \$20 billion. There's much more opportunity for fighting inflation by adjusting the form of the tax cut to be cost reducing than by adjusting the size to change the amount of total pressure on aggregate demand.

My understanding, as I look at the economic indicators, is that we are still not facing an excess demand inflation and I don't think a major reduction in the deficit is at all a sensible, efficient medicine for an inflation that is not excess demand. It's just saying let's slow down the economy.

Mr. Lilly said he doesn't have a precise theory of the link between deficits and inflation. I guess none of us really do, but to believe that there's something magic about Federal dollars being spent or being returned to citizens in the form of tax cuts that makes it inherently more inflationary than private spending is something that just strains my credibility.

At this point I don't think the right answer to inflation is any major change in fiscal policy. All things considered, I guess it's two cheers for the April program. It's better than what we had before,

but as your quotation from the Post and as Henry Wallich's summary pointed out, I don't think we can rely on it entirely as a cure. That is precisely why we have to act well ahead and why we should proceed to have further discussion and legislative consideration of TIP.

The CHAIRMAN. Governor Lilly.

Mr. LILLY. Well, I think the program is fine. I agree with Dr. Okun, it's too bad it didn't start a year ago or even prior to that.

I am more concerned that there be follow-through. I disagree with Dr. Okun, as you know, on the impact of the deficit, however, I do agree with him on the cost-raising actions and I certainly agree that if there is to be a tax cut it should become in the form of decreased payroll taxes rather than just decreasing the income tax.

So I would like to see the program—I endorse the program. I would like to see a follow-through and a further decrease in the budget deficit in the years following and I'd like to further see as part of the program that any cost-raising action by the Government be offset by a cost-cutting action. This could require—as I have recommended before—that an inflationary impact statement accompany any new legislation or increase in funding by the Congress.

The CHAIRMAN. Mr. Sunley.

Mr. SUNLEY. Thank you, Mr. Chairman.

President Carter, as you know, reduced the size of the proposed income tax reduction from \$25 billion to \$20 billion in response really to the somewhat higher levels of inflation that we were fighting in the first part of this year than what the administration and private forecasters had expected.

I think we need to recognize at this lower level of \$20 billion the portion that will be going to individuals in 1979 will not offset fully the social security tax increases or the impact of inflation on pushing taxpayers up into higher tax brackets which was alluded to by Governor Wallich. So I think with the size of the tax cut the President is now proposing it is important that we enact that cut.

With respect to social security tax cuts instead of income tax cuts, it was the administration's view—and I think now borne out after the consideration in the House—that it was very difficult to do anything this year other than putting a small bandaid on the problem without raising very fundamental issues, and that, of course, is what happened in the Ways and Means Committee. It appeared that it was impossible to get 19 votes for any one proposal for cutting social security taxes for 1979, even though there were 19 votes in favor of cutting social security taxes as a general principle. But the fundamental issues raised in terms of where did the general financing go, did it go into the health insurance fund, the disability trust fund or maybe spewed into all three, could not be resolved in that Committee. The Administration believes, and I believe, we should not do a quick fix on social security. Instead, income tax cuts can be adopted that would at least offset the impact of the increased social security taxes for each family up through the median income level.

The CHAIRMAN. Thank you.

Senator Schmitt.

Senator SCHMITT. Thank you very much, Mr. Chairman.

We have had a lot of interesting testimony and a large number of understatements. With Governor Lilly maybe being the under-statement of the morning, that we must take very seriously the possibility that large government deficits contribute significantly to inflation.

Certainly I realize what you're saying. I don't think that anybody can really seriously question that the Government deficits don't have a very significant impact on inflation. I guess the question is: can we do anything about it? And that's where we tend to have our arguments.

The tax-based incomes policy seems to me to be a classic example of "Potomac fever" and that the Government can do anything whether it's necessary or not and in this case it seems to me an effort to relieve the conscience of those who won't take the kind of actions necessary to reduce the Federal deficit.

Mr. Sunley's testimony indicates very clearly that TIP is going to be a bureaucratic dream and a taxpayers' nightmare, no matter how we structure it, whether we leave small business out or not. It reminds me, Mr. Chairman, to paraphrase an old Army adage which could be applied to the economy, that if it begins to move, tax it; if it doesn't move, regulate it; and if it's too big to regulate, break it up. And I have a feeling that's exactly what this Government has been trying to do for at least a decade if not longer.

I just don't see how we could ever implement a program such as this, first of all, in a pragmatic way. Secondly, if we don't also take the basic steps that are required to eliminate the basic inflationary pressures that exist in our economy, if we don't begin to gradually reduce that Federal deficit, if we don't begin to gradually reduce the tax burden on the American taxpayer and business, then we must also realize that it is that deficit which creates the pressures on the Federal Reserve System to increase the money supply.

And your chart, Mr. Lilly, I think is a very real chart. Whether you can come up with a theory or not, we have had enough time now to see those trends and they are very clearly coupled, the linkage is very obvious. I think it's very obvious what we have to do.

Now I would ask you gentlemen, don't you think that it is possible to set up a schedule of economic goals, not specific goals but schedules, where we begin to reduce the tax burden by say \$10 billion a year in a permanent fashion? In this way would we begin to reduce the annual deficits by about \$10 billion a year and simultaneously reduce the rate of growth of the money supply by about half a percent until we come into balance with the rate of growth of the GNP? Mr. Lilly, would you like to comment first?

Mr. LILLY. I can't do that math in my head and I'm not sure—

Senator SCHMITT. Well, I just threw something out.

Mr. LILLY. But I certainly would agree generally.

Senator SCHMITT. The coupling of those kind of factors—

Mr. LILLY. I would certainly agree.

Senator SCHMITT. Mr. Okun?

Mr. OKUN. I do not agree, Mr. Schmitt. I spent my professional life studying the relationship between fiscal and monetary policy and the performance of the economy, both production and inflation, and

nothing I know tells me that a change in the deficit or in monetary policy will have an effect on inflation.

Senator SCHMITT. You aren't impressed by that diagram, Mr. Okun?

Mr. OKUN. No.

Senator SCHMITT. Do you have an explanation for it?

Mr. OKUN. Yes, I have an explanation for it very definitely. If you cover up the last period until 1970 you don't find a very remarkable correlation between the CPI and U.S. debt. I think you do find that the Vietnam experience was a classical case of an overheated economy where the deficit played a major role. What happened the last 2 years is that we created a recession because we had too much inflation. The recession forced us to have very high Federal deficits. So the direction of causation is exactly the reverse. It's the rapid inflation that created the recession that led to very large Federal deficits.

There's such a difficulty in communication on this issue. I wish we could understand each other better. As I see it, the only way in which you can say that we would have been better off in the last 2 years with a lower federal deficit and lower money growth is if you believe the economy has grown too fast. If you believe we should have had a longer, deeper recession and a slower recovery, I understand what you're saying, and then I'm prepared to tell you how painful that would have been. But everything I know tells me that Federal dollars behave like any other dollars. They go into people's hands whether they're Government expenditures or whether they take the form of tax cuts, and people decide what to do with them. If the economy has a lot of slack those dollars create more production and more employment and very little added inflation. If you're talking about a major cut in the deficit or a major reduction in money growth today you're talking about getting rid of inflation by causing another recession.

I have studied every analysis that I could lay my hands on in the literature of the relationship between total spending and inflation and, as I report in my testimony, the most optimistic one that I could find says that cutting back a dollar of GNP in 1979 by cutting the deficit or cutting money growth will save no more than 15 cents worth of inflation and will lose 85 cents of real production. I call that burning down the house to roast the pig.

If we're going to ask is it worth paying that price—

Senator SCHMITT. Don't you think you're in a minority with that kind of analysis?

Mr. OKUN. I'm not in the minority. Indeed I don't know anybody in the economics profession who has done a study—

Senator SCHMITT. You think you can continue to pump \$60 billion a year into the economy without any commensurate increase in the production of goods and services and not have an inflationary pressure?

Mr. OKUN. That's precisely the point. That would become dangerous when it has created enough production of goods and services so that we're fully using our resources. We're close to that point now, a lot closer than we were a year or two or three ago. We had plenty of slack in this economy by my standards in 1975 and 1976. The real

question is what is there about the price and wage making process that does not convert slack and excess supply into disinflation.

The fundamental problem is in the price and wage setting process and TIP is a way of dealing with fundamentals.

Senator SCHMITT. Mr. Okun, you don't think that the price and wage increases are a direct reflection of the inflation? Do you think they are generally inflationary, to have wage and price increases?

Mr. OKUN. I think that the price and wage decisions are clearly influenced by what has been happening to inflation. That's precisely the way we became entrenched in a price-wage spiral. We have been having that much inflation. There's no obvious reason to expect it to go away. People have to protect themselves and in the process wage earners have become accustomed to something like 8 percent in wage increases. When they get 8 percent, price makers need 6 percent to cover their costs and it's precisely that spiral which had been remarkably—

Senator SCHMITT. You propose then that we begin to cut prices and wages, and that somehow inflation is going to go away. Also that there will be sufficient profit margins both for the wage earners and business that the economy can continue to operate—inflation at 6 percent and limiting wage increases to something like 3 percent?

Mr. OKUN. My proposal is 6 percent. I'm proposing to provide a tax credit for wage earners in those firms that pledge to hold wage increases to 6 percent. I'm not looking for a major change. I don't think we can get a major change. I don't think you can stop inflation dead in its tracks because you create a major inequity problem with respect to people who just got their price and wage increases recently and those that came into the new program. I think it's got to be gradual.

Senator SCHMITT. So, under your basic economic philosophy, we could have any size Federal deficit and it would not be inflationary?

Mr. OKUN. I hope I didn't give that impression at all.

Senator SCHMITT. \$60 billion is not inflationary according to you. \$100 billion presumably would not be also.

Mr. OKUN. That's not the case at all.

Senator SCHMITT. Where can we go to then? Obviously, you are satisfied with \$60 billion.

Mr. OKUN. No, I'm not. That's not my figure, sir.

Senator SCHMITT. Well, that's where we are and you're saying that's not inflationary. I'm a geologist. I'm not an economist. And out in the real world of geology when you deal with mineral deposit economics you have to live with the real world. You can't live with what Washington tells you economics is. You have to live with what that mineral deposit tells you what economics is. You're telling me that \$60 billion is not an inflationary budget, a deficit of \$60 billion is not an inflationary budget. There's nobody in this country that I've run into who's paying taxes for that budget that believes you, but that's what you said here this morning.

Mr. OKUN. The question of what deficit becomes inflationary is a question of at what point does the economy go too fast and get overheated. We should be able to agree that that's the question. There is no magic by which a deficit gets into prices or wages. It gets into

prices and wages because of what it does to demand and supply. You can have bad taxes that discourage supply. You can have bad expenditures. If you don't have an overheated economy, then the deficit isn't inflationary. The reason we have had to have \$45 and \$50 billion deficits—I don't think we've hit \$60 billion yet and I don't think we will—in recent years is because we dropped this economy over a cliff in 1974 and it has needed Federal support to get back. If we didn't have the tax cuts we had in 1975 and 1976, we'd still have 8 percent unemployment rates and we'd still have capital spending down where it was then.

It is precisely because the economy has been hit by inflation—by monetary restraints in the face of the oil and the food explosion in 1974 and 1975—that there's no way of getting back to a balanced budget soon. No economist I know will tell you that you could quickly reduce that deficit from \$60 billion to zero without causing a recession. There's a good deal of question about whether the deficit ought to be \$50 billion or \$40 billion, it shouldn't be \$20 billion and it shouldn't be zero.

Senator SCHMITT. My question to you, sir, was, don't you think we should decrease by \$10 billion a year now that we're supposedly coming out of this recession?

Mr. OKUN. I think that's a reasonable path to be on once we get the economy back to health.

Senator SCHMITT. The economy is strong. You said so yourself. We have been coming out of the recession far too slowly, but we are coming out. We are employing all the new people by the numbers that are coming into the labor market. The unemployment rate, even by the Labor Department's figures, is decreasing, even though they are inflated. I think most people now are agreeing that those numbers are inflated. So when do we start to reduce the deficit?

Mr. Chairman, I'm over my time. I will pursue this later.

Mr. OKUN. I'm sorry that I'm prolonging the dialog, but I think this is a crucial issue, Senator.

The CHAIRMAN. Let me get back briefly to TIP. I want to congratulate both of you gentlemen for taking this initiative. It's very, very welcome. It's always hard to come into something that's new and different and far-reaching. You obviously are going to encounter a lot of opposition and I know you realized that when you made the proposal, but I think it has great merit of being something that could work. It does go to the heart of a big element of the inflation problem which is the wage-price spiral, the momentum of inflation. The fact is that once you get inflation built into the system it's the hardest thing in the world to overcome it.

Let me ask you first, Dr. Okun, was I right or wrong in assuming that this would not go into effect for 1½ or maybe 2 years? What's your assumption on that?

Mr. OKUN. I suppose that's a realistic assumption. In principle, there's still a tax bill before the Congress this year and the tax cut could take the form of a TIP to go into effect in January 1979. There's nothing that requires more prolonged advance work. It is the problem of building a consensus, building an understanding, and quite frankly, we don't have it right now.

The CHAIRMAN. So you acknowledge you don't have it. Do you agree with that, Dr. Wallich, that there's not sufficient consensus now for Congress to enact this so it could go into effect in 1979?

Mr. WALLICH. I think that is true. I think progress is being made on that front.

The CHAIRMAN. What evidence is there that progress is being made on that point?

Mr. WALLICH. The growing interest in TIP. TIP is not being sold on the basis that it is an attractive innovation. TIP commends itself because all alternatives seem to be—

The CHAIRMAN. You say "growing interest." Who do you mean? Are there people in business and labor and Government and so forth who are beginning to call out for it, indicating they will support it?

Mr. WALLICH. I think there are, without imputing it to anybody in particular. Certainly the amount of public attention that it has received has mounted very rapidly.

The CHAIRMAN. Is there any prospect that it could be tried on a pilot basis? I think many people feel that it's too complicated, that it wouldn't work for one reason or another. Mr. Sunley has given some administration objections to it. Do you think that would be possible? Would that help to build either a consensus or a recognition that we have to try something else?

Mr. WALLICH. The relationship of wages and prices make that rather difficult. If wages slowed down across the Nation, then prices would slow down; but one couldn't hope, for instance, to slow down wages in one industry or in one area of the country. It wouldn't have the proper effect on prices, in which case it would just cause inappropriate pressure on wages.

The CHAIRMAN. Why couldn't it be workable in a particular industry? After all, the carrot approach—you'd have the advantages for the people that took part in that industry. You possibly could have some reflection on what would happen to the price in that industry. Do you think that has any merit, Dr. Okun, or do you have to have this on a comprehensive nationwide basis?

Mr. OKUN. I think the only issue there would be whether you could justify, in terms of equity and the politics of the situation, singling out that industry as a beneficiary of a reward or—

The CHAIRMAN. What you need, of course, is a leadership in both the industry and labor unions who would say "Let's try it. We're going to give it a shot." Maybe the automobile industry or maybe some other area where you've got people who might have the imagination and the understanding to do it.

Mr. OKUN. I think that would be very worthwhile. At a perhaps less ambitious level of not actually putting the program into practice on a pilot basis but of trying to simulate its workings, there has been some expression of interest by an economic development council in the Baltimore area. They have shown some interest in trying to see whether firms might consider what set of rules they could easily implement, how they could handle it, what administrative problems they would see within the firm, trying to guess how they might react, and whether some of the loopholes and compliance problems that have been mentioned would look serious or trivial in their judgment. I think something like that would be valuable.

The CHAIRMAN. Governor Lilly, let me ask you—I think Senator Schmitt has taken a very strong position. It does reflect the views of many Members of Congress and many people in business and the public generally, but at this stage in the business cycle when you have 6 percent unemployment, when you have 82 percent capacity operation, 18 percent vacancy in capacity, when you have no evident shortages, I do favor, as you may know, reducing the budget and reducing taxes too because I think the Government is growing too fast, it's too big, too awkward and too wasteful, but I frankly am not sure—and I would tend to agree with Dr. Okun, that that would not be an answer to our inflation problem necessarily because, as I say, I would reduce both spending and taxing at the same time. The fiscal effect might be a washout.

At any rate, on the assumption that Congress is going to go ahead and have at least a \$50 billion deficit, how do you feel about TIP as an option, if that's all you have, unless you can suggest something else?

Mr. LILLY. Well, I think what you're doing is treating the symptom rather than the cause. If you have a longer range program in effect—

The CHAIRMAN. Do you still maintain, in spite of what Dr. Okun has so eloquently argued, that the present deficit is the cause of the inflation?

Mr. LILLY. I think that the present deficit certainly has something to do with the present inflation.

The CHAIRMAN. What does it have to do with it right now, recognizing the deficit we had in 1968 and 1969 was a cause of inflation, recognizing it could be a cause a year from now if we continue to have unemployment drop and we move down to say 90 percent capacity utilization?

Mr. LILLY. Well, Senator, first of all, let me say that I do not believe that we should try and remove the whole deficit immediately. I think this is going to take a very long time.

The CHAIRMAN. My question is, if we don't move faster—say Congress is going to stay and take a realistic position that a \$50 billion deficit—maybe we shouldn't do it but we're going to do it—then would you feel it might be practical to try it?

Mr. LILLY. Then I think you have to move to controls of some kind and I would prefer TIP to wage and price controls.

The CHAIRMAN. Why do you call TIP controls? It's not controls in the sense of mandating a particular wage or price. People are still free to do what they want. The tax system is just an incentive.

Mr. LILLY. They are very persuasive guidelines and they are designed to control the rate of increase in wages.

The CHAIRMAN. Well, maybe they are persuasive in that they might work, but what's wrong with that? You're not mandating business or labor to agree for that matter.

Mr. LILLY. Well, as I say, I would prefer TIP to wage and price controls, given the situation where we seem unable to do anything about the basic causes of inflation. And I might interject here that I think we may be very close to the top of this particular cycle and we

have a higher percentage of the adult population in the country employed than we have ever had in our history.

The CHAIRMAN. That's right, of the whole population.

Mr. LILLY. Of the adult population.

The CHAIRMAN. The work force is so big, it's exploded so much that we now have—people 16 years old or older are the only people who are measured according to testimony we had last month before the Joint Economic Committee.

Let me ask you, Mr. Sunley, I'm not sure from your conclusion whether you would flatly reject TIP or not. You indicated a lot of difficulties with it. You indicated the cost seemed to make it unworkable. Does that mean that you would not accept it or does that mean that if inflation continued—and you seem to have a realistic appreciation of the tough political obstacles in the way of meeting inflation any other way—would you consider this as an option?

Mr. SUNLEY. Yes, I would. I think what I conclude in my statement, Mr. Chairman, is that TIP does involve some serious administrative problems for the IRS and the IRS is not looking for a new program to administer. TIP does involve some serious compliance problems for firms. But, there are versions of TIP which involve considerably less administrative and compliance problems.

For example, you can hold it down to only the large firms, if you apply it only to wages—

The CHAIRMAN. That's pretty much the way it was presented by Mr. Wallich and Mr. Okun. They didn't mean to cover every one of the 5 million firms in the country by any means.

Mr. SUNLEY. That's the direction TIP has been moving, that's quite clear, in the public discussion. I think what you then need to weigh, and I was not trying to do this in my testimony, is the benefits from moderating wage and price increases that you could achieve through TIP compared to those costs which we will try to minimize in a carefully designed TIP program. Presumably, TIP would allow you to further reduce the level of unemployment or, at any given level of unemployment, have a lower rate of increase in prices.

It's clear to me that if the choice is between TIP and wage and price controls, we should give TIP a try. But the President's program may be adequate, and it's clear that we aren't at this point ready to move TIP into place. Nobody has done a legislative draft of it. Several of us have looked very carefully at what we think are the administrative problems, but sometimes you don't discover what all the problems are until you start to draft the legislation. So I think TIP is one of those options that deserves continued study.

The CHAIRMAN. Would you submit for the committee for the record the studies that have been done? You say several people have made studies. We'd like to have everything you've got over there on this.

Mr. SUNLEY. I would be glad to submit the paper that Larry Dildine and I did for Brookings and there was an interesting paper done for Henry Wallich. If it is public I will be glad to submit it.

Mr. WALLICH. I will supply that, Mr. Chairman.

[Governor Wallich subsequently provided the Committee with the report prepared for the Board of Governors of the Federal Reserve

System by Richard E. Slitor, "Tax-Based Incomes Policy: Technical and Administrative Aspects."]

The CHAIRMAN. My time is up.

Senator SCHMITT. Mr. Chairman, there's a recent Library of Congress research paper by Mr. Edward Knight on inflation and Government policy which covers a number of these items. I think it might be useful, if it's not already in our record, to have that inserted in the record also.

The CHAIRMAN. Without objection, it will be inserted in the record.

[Both papers are reprinted as follows:]



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D.C. 20551

HENRY C. WALLICH
MEMBER OF THE BOARD

April 7, 1978

The ongoing discussion of tax-based incomes policies (TIP) makes desirable a thorough examination of the technical aspects of these proposals from the viewpoint of the tax administrator. The report transmitted herewith seeks to contribute to meeting this need. Its author is Richard E. Slitor, Economic Consultant, former member of the Treasury's Tax Analysis Staff in charge of corporate income taxes.

The report covers the technical aspects of a TIP, based mainly on Wallich-Weintraub lines, but also examines other versions of the penalty or "stick" approach. In summary form it deals with variants of the "carrot" approach and with combinations of the two approaches. The body of the report is preceded by a 10-page executive summary.

Slitor's views are entirely his own and do not represent those of the Federal Reserve Board nor even in all cases my own. His report was financed by the Federal Reserve Board in connection with my ongoing work and Congressional testimony on TIP.

Henry C. Wallich

Attachment

**TAX-BASED INCOMES POLICY:
TECHNICAL AND ADMINISTRATIVE ASPECTS**

A Report Prepared for the
Board of Governors of the Federal Reserve System

by

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March 20, 1978

**TAX-BASED INCOMES POLICY:
TECHNICAL AND ADMINISTRATIVE ASPECTS**

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EXECUTIVE SUMMARY

A. Overview of content

This report analyzes the technical and administrative aspects of proposals for a tax-based incomes policy (TIP) under several basic topical headings:

1. Basic tax design options

This covers the issue of the form of the tax penalty on excess wage settlements (adjustment of income tax rate, disallowance of excess wage deductions, and other alternatives); the scope or coverage of the tax in terms of type and size of business organization; and the duration of application of the penalty tax, once incurred.

2. Definition and measurement issues

This topic includes:

-- the achievement of a suitably comprehensive definition of compensation which would capture both the standard forms of fringe benefits and more novel or exotic forms, more difficult to identify, measure, and attribute

-- the measurement of the average percentage increases in rates of compensation in the current year over the preceding year (or other specified base) for purposes of determining the excess of compensation increases over the guideline standard; this to be done either by averaging the percentage increases among different labor categories or by equivalent "indexation"

-- the definition of the taxpayer unit in an economy characterized by frequently changing multicorporate aggregations with different degrees of common control, frequently "conglomerate" in character, embracing quite distinct industrial classifications or lines of industrial activity with possibly disparate wage classifications and experience, and

-- a variety of timing problems, including the start-up of TIP with reference to a pre-TIP compensation base, the treatment of new firms, the handling of catch-up wage settlements, the

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coordination of TIP tax penalty and the inflationary behavior which triggered it, and similar matters.

3. Specific problems of tax avoidance and evasion, hardship, and adverse economic impact

This discussion partially overlaps other portions of the report but stresses constructive solutions. It includes:

- various tax avoidance and tax evasion routes and appropriate methods of closing these avenues of concealment or escape
- some possible hardship situations and suggested methods of providing relief
- possible undesirable economic impacts such as the transfer of operations outside the U.S. by direct or indirect means (e.g., import of product components, resulting in "export of jobs").

Highlights of these various discussion areas are set forth below.

B. Form of TIP tax

With respect to the form of the TIP tax, the report (1) rates an adjustment of the general corporate or individual income tax rather low since it tends to (a) impose penalties on a net income base not closely related to the excess compensation and (b) to discriminate against capital intensive businesses. (2)Disallowance of excess compensation as income tax deductions would avoid distortions due to variations in capital intensiveness but, in common with the rate adjustment approach, would be at least partially ineffective as a wage settlement restraint in the case of businesses without net taxable income. While the deficit business area may not be regarded as critically important to TIP, it cannot be overlooked. (3) An alternative form

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of TIP tax penalty applicable directly and separately to determine excess compensation may be appropriate to assure universal industrial coverage without regard to net taxable income or loss status.

The report is inclined to be concerned with TIP approaches which leave deficit companies unscathed. With this as a standard, the adjustment of income tax rate approach rates low; the disallowance of deduction method somewhat higher -- since it would affect loss carryovers, a matter of importance to any but the most chronic loss companies; and a direct tax on the compensation excess as such, still higher. However, considerations of shiftability and the adverse semantics and public relations of proposing to tax wages as such rather than profits tend to argue against the latter.

The report observes that TIP may take the form of rewarding conformity with wage guidelines, thus indirectly penalizing firms paying excess compensation by denying them otherwise available tax reduction (Okun approach). This approach would involve no special technical problems except that unless appropriately devised it may involve indirect tax penalties on capital intensiveness, differentially high penalties on very profitable firms, or blind spots with respect to tax haven or non-taxable operations of the same types encountered in formulating direct tax penalties.

C. Area of application

With respect to the area or scope of application of TIP, the report recognizes the appeal of excluding all but a few thousand large corporations in order to focus on major wage settlements and

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contain its compliance and administrative burden. However, any specific size test appropriate for some industries marked by concentration in large units would be inappropriate in covering the action in others where numerous relatively small firms account for the bulk of the business. Construction, trucking, and to some extent retail trade are industries in which relatively small firms predominate and union wage settlements are important to national incomes policy.

The report examines other technical questions of scope such as the treatment of unincorporated businesses and subchapter S (tax option) corporations, and point out workable methods of including them, if that should be desired.

D. Duration of tax

The report considers the relative merits and technical problems associated with applying the TIP penalty for (1) one year only, (2) for a fixed multi-year period, or (3) for a lengthy or indefinite period. It concludes that lengthy periods of cumulative build-up of TIP tax penalties stemming from various historic layers of excess compensation would be complex and burdensome. It suggests, however, that some extended duration or cumulation with carryovers of good or bad wage settlement experience would be practicable and desirable to exert continuous pressure towards conformity with non-inflationary compensation policies and to provide equity for lumpy or irregular wage adjustments.

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E. Measurement of compensation

As the report points out, the definition and measurement of compensation for TIP purposes involves two steps:

-- the definition and measurement of total compensation per se, involving the identification and valuation of the whole range of fringe benefits and wage supplements among classes of employees, and

-- the allocation and apportionment of these compensation benefits among classes of employees.

Fringe benefit measurement may require alertness and thorough "costing-out" of wage settlements and compensation increases of all kinds. The report points out that this is not a novel operation. Labor Department (BLS) statistics-gathering functions already provide precedents for this step.

Compensation items, such as use of recreational or medical facilities, which may not be directly allocable to classes of employees for purposes of calculating a weighted average rate of increase in compensation (discussed in the next paragraph) may be apportioned according to total compensation or other apportionment factor.

F. Determination of excess compensation

The determination of excess compensation for TIP purposes on a reasonable basis involves the calculation of the average percentage pay increase. The report demonstrates that crude unweighted averages would be unsuitable. A fair and accurate measure of pay increase would involve employee classes. Reasonable personnel classifications would be provided by statute and refined by regulations pursuant to the statutory directive. The analysis indicates that a relatively few

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categories would serve TIP purposes, although classification might need to be adapted to the varying complexity of the skill mix and compensation hierarchy in different industries.

As the report indicates, calculation of weighted average percentage increases in the rate of compensation involves a policy choice among averaging methods.

The report examines and illustrates various methods of weighting and averaging for purposes of calculating the over-all average pay increase percentage to be compared with the guideline in arriving at the excess compensation on which the TIP tax penalty would be based. The calculation of average rates of pay increase is equivalent to an indexation procedure. The report demonstrates that in typical compensation increase situations different well-designed methods of pay increase averaging or indexation yield closely similar results.

As background for the whole question of measuring average rates of pay increase, the report provides an appendix (Appendix A) in the form of a primer on index number construction for TIP. The computation is not conceptually complex or laborious.

G. Definition of the TIP taxpayer unit

The report takes up the various problems of defining the taxpayer unit for TIP purposes in an economy characterized by multi-corporate enterprises, many of them industrially conglomerate in character. (1) While the income taxpayer unit would be the unit for purposes of asserting ultimate TIP tax liability, a smaller component unit might be designated for purposes of calculating a particular excess

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of compensation over the guideline level. Separate excesses might then be assembled algebraically for purposes of the over-all TIP tax liability. (2) The mechanical alternative would be to combine all intra-firm components in making the final determination of the average percentage pay increase and comparing it with the guideline figure. Separate divisions or even separate plant units are conceivable for purposes of calculating percentage changes in the average rate of pay. However, the report is concerned chiefly with the choice between separate and consolidated reporting, and year-to-year continuity and consistency, in the case of the multicorporate business entity, for purposes of computing the overall average percentage increase in pay rates.

In general, the resulting overall TIP liability would be larger if there are any "unused" margins of below-guideline compensation to be offset against excesses within the more comprehensively defined unit. However, this generalization would not hold if TIP compensation excesses were taxed as part of the regular income tax (either via rate adjustment or via disallowance of deductions). The reason for the latter point is that segregation of TIP compensation excesses in "component" units or sub-units without taxable income would offer obvious TIP tax-saving opportunities.

A second appendix to the report (Appendix B) deals briefly with TIP tax disparities which may result from separate vs. combined reporting of affiliated corporations due to various technical factors. This appendix suggests the need for further more detailed study of this aspect, including the relative merits of different averaging or index methods.

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The report tends to favor a simplifying but equitable combination approach:

- a comprehensive TIP tax which would be payable by deficit as well as net profit business units, and
- a comprehensive, consistent year-to-year definition of the TIP taxpayer unit.

The report gives specific attention to the treatment of foreign business operations, including parallel TIP treatment of foreign subsidiaries and foreign branches.

H. Timing problems

A frequently raised issue in the design and operation of a TIP initiative involves a whole range of technical questions relating to "timing," including start-up and similar transition matters such as new companies, defunct companies, treatment of pre-existing contracts, catch-up settlements, coordination of tax and wage contract years, timing of TIP tax payment, and provision for current payment. The report examines these matters in some detail, finds many of them less than serious, and offers constructive solutions for others.

I. Specific problems of administration and economic impact

Finally, the report canvasses an extensive miscellany of problems of:

- tax avoidance and evasion
- hardship situations
- undesirable economic impacts
- TIP tax accounting for small business
- precise and up-to-date formulation and regulatory statement of standards and procedures.

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The emphasis in this round-up is on evaluating the weight of suggested problems and suggesting constructive solutions.

* * * *

Discussions public and private will confront a number of arguments, chiefly technical, partially economic in character, to the effect that the TIP plan will involve all the problems of

- an incremental tax with complex measurement of an excess over a base
- a non-revenue, regulatory measure, susceptible to neglect by tax administrators in partially unconscious sympathy with business, labor, or other popular resistance to such a measure
- a measure which calls upon an "overburdened" Internal Revenue Service to carry out "extraneous" duties in the field of monitoring economic stabilization efforts
- a plan which appears to interpose tax burdens on generosity to labor.

A systematic canvass of numerous technical issues, such as that conducted in this report, tends to overemphasize the range and complexity of possible problem areas encountered by the TIP plan. Actually, TIP is less complex and less prone to distortion and inequity than an excess profits tax. Its so-called base period or base period abnormality problems are minor compared with those of an historic-base type excess profits tax. It does not entail the incentives to waste characteristic of excess profits tax. TIP is no more "regulatory" and possibly simpler than the interest equalization tax of 1967-74 and a variety of environmental tax plans such as the government tax initiative to curb sulfur emissions.

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TIP is practicable and workable in a number of variant forms. Like most tax measures it would benefit from careful design at a number of policy option points. However, it presents a classic case of policy determination where perfection is the enemy of the best; the best, of the good.

TAX-BASED INCOMES POLICY:
TECHNICAL AND ADMINISTRATIVE ASPECTS

I. Introduction

This report is concerned with the practical aspects of a tax-based incomes policy (TIP) designed to curb the wage-price spiral by applying a stabilizing tax incentive to the process of wage determination.

A. Scope of the analysis

A number of economists have supported the TIP approach in the form of a tax on wage increases in excess of a specified non-inflationary, productivity standard. Such a tax has been the subject of discussions in the financial press and economic literature. These discussions have been concerned chiefly with the economic theory and rationale of the TIP plan. They have dealt only in a very limited and cursory manner with the practical tasks and problems of its detailed design, implementation, and administration.

This report deals almost exclusively with these important practical questions. It represents a pioneer effort in exploring technical and administrative problems and alternative solutions -- the "nitty-gritty" of developing an effective TIP model and making it work.

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B. Technical particulars examined

The analysis first examines a number of basic tax design options that are critical in shaping the framework of TIP: the form of the tax, its scope of application, the duration of a given tax penalty on excess wages, and related matters.

It then proceeds to deal with key definitional and measurement questions: the definition and measurement of wages/salaries, the determination of the taxable excess over the non-inflationary standard, the definition of the taxpayer unit, and a group of "timing" problems ranging from start-up and transition questions to the possibility of perverse timing of tax payment based on ex post tax determination.

The remaining sections of the report review a series of specific problems of administration and economic impact of the plan, including possible tax avoidance and evasion devices and the economic consequences of certain adaptive mechanisms that might arise under TIP.

The report concludes with a short section devoted to rough estimates of the administrative-compliance costs of TIP in the light of proposed and historic analogues.

II. Basic tax design options

The basic concept of TIP involves the application of a tax disincentive or penalty to firms involved in wage increases which exceed a specified non-inflationary standard.



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In the language of the Council of Economic Advisers enunciating the principle guideposts:

"The general guide for noninflationary wage behavior is that the rate of increase in wage rates (including fringe benefits) in each industry be equal to the trend rate of over-all productivity increase. General acceptance of this guide would maintain stability of labor cost per unit of output for the economy as a whole -- though not of course for individual industries."^{1/}

The 1962 CEA statement also described a companion general guide for non-inflationary price behavior, as well as specific modifications of the general guides for non-inflationary wage and price behavior depending upon particular industry conditions.^{2/}

In lieu of the general sanction of public opinion and government pressure relied upon in supporting the guideposts of the early 1960's, TIP would apply a specific tax related quantitatively to specific amounts of excess wages reflecting the extent of inflationary wage behavior. Leaving aside for the moment the related questions of excess wage measurement, the first major design questions which arise are:

- What form would the tax take?
- How would it operate?

A. Form of the tax

Several alternative forms of tax disincentive immediately suggest themselves, with their particular sets

^{1/} Economic Report of the President, 1962, p. 189.

^{2/} Ibid. See also John Sheahan, The Wage-Price Guideposts, The Brookings Institution, Washington: 1967, pp. 14-16.

of advantages and disadvantages. These basic tax design options and their variants include: (1) adjustment of the regularly applicable corporate (or individual income tax, (2) disallowance of part or all of excess wages as an income tax deduction, and (3) special penalty tax on excess wages, including use of a special gross income, turnover, or value-added tax which would in effect single out excess wages.

1. Adjustment of the regularly applicable income tax rates

One major option would be an upward adjustment of the regularly applicable corporation (or individual) income tax rates for employers paying wage increases in excess of the non inflationary standard. This adjustment might consist of a fixed number of percentage points regardless of the extent of the excess or might vary proportionately with the proportionate excess. Such an approach was originally suggested by the originators of the TIP plan, Professor Sidney Weintraub and Dr. Henry C. Wallich, now a member of the Board of Governors of the Federal Reserve System. In the words of Dr. Wallich:

"Under our tax-based incomes policy (TIP), a businessman considering an 8 percent wage increase (at a time when labor productivity increase was less) would find that this would raise his tax from 48 percent to 60, 70, or 80 percent. The exact amount would depend on the degree to which the wage increase exceeded a wage guideline to be set by the government."^{1/}

This method of corporate tax adjustment for those

^{1/}Henry C. Wallich, "TIP vs Wage-Price Curbs", Journal of Commerce, August 15, 1977.

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paying excess wages was also tentatively linked with an adjustment of the general corporate income tax rate on all corporations to make sure that profit levels generally would not "benefit inappropriately from TIP."^{1/} This auxiliary feature would be designed to make the plan fairer and more acceptable to labor, which might otherwise be concerned that the restraint on wages achieved by TIP would be reflected in a general rise in profits. The auxiliary adjustment in the general corporate rate might thus be set at a level which would keep the after-tax share of profits in national income at some historic benchmark such as the 6 percent of GNP prevailing in the prosperous 1960's.

There are various ways of making the increase in the income tax more or less proportional to the excess of the wage increase over the guidepost or non-inflationary standard. The factor of proportionality could be anything from less than unity to a multiple of 2, 3, or more.

It may be desirable to have a minimum percentage penalty, in terms of the corporate tax rate, for any excess of wage increases over the non-inflationary norm, however small. Large excesses, on the other hand, which in some cases a company may not be able to avoid, should not be penalized so heavily as to wipe out profit altogether.^{2/}

^{1/}Ibid.

^{2/}Memorandum "Guidepost Tax" by Henry C. Wallich, dated December 29, 1970.

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a. Illustrative formulas

One possible formulation of the adjustment or penalty addition to the regularly applicable income tax rates would be:

$$\text{Formula (1)} \quad A = (I - G) \frac{I}{G}, \text{ where}$$

A = percentage adjustment,

I = actual percentage increase in employer's average rate of compensation, and

G = guideline or non-inflationary standard percentage increase.^{1/}

Under this formulation if the guideline (G) was .05 (5 percent) and the actual percentage increase (I) was .10 (10 percent), the calculation of A would be $(.10 - .05) \frac{.10}{.05} = .05 \times 2 = .10$ or 10 percent.

The adjustment factor A as calculated above might be taken as a penalty addition of the equivalent number of percentage points to the regularly applicable income tax rate. Or it might be used as an adjustment factor or coefficient to be multiplied by the applicable income tax. The adjustment factor calculated and used as described here might be made subject to a further "scaling factor"^{2/} which would either heighten or tone down the sensitivity of the penalty adjustment to a given spread between I and G.

^{1/}A penalty tax formula of this type was selected as "probably the simplest," in a Treasury memorandum on the subject. "An Income Tax Deterrent to Inflationary Wage Settlements," by Seymour Fiekowsky, dated December 2, 1970.

^{2/}The $\frac{I}{G}$ factor in formula (1) is itself a scaling factor which heightens the sensitivity of the penalty to increases in the excess of I over G.

The values of the penalty under this formulation and selected variant applications are illustrated below for a range of values of I, assuming G to be .05.

Illustrations: Formula (1) and variants

(1)	(2)	(3)	(4)	(5)	(6)	(7)
I	A	.5	1.5	A multiplied by a scaling factor of:	Values in columns (2) - (4) multiplied by .48 corporate tax rate	
.06	.012	.006	.018	.006	.003	.009
.07	.028	.014	.042	.013	.007	.020
.08	.048	.024	.072	.023	.012	.035
.09	.072	.036	.108	.035	.017	.052
.10	.100	.050	.150	.048	.024	.072
.12	.168	.084	.252	.081	.040	.121
.15	.300	.150	.450	.144	.072	.216
.20	.600	.300	.900	.288	.144	.432
.30	1.500	.750	2.250	.720	.360	1.080

Another, simpler formulation, which eliminates the scaling factor measured by the ratio of I to G employed in Formula (1) would be:

Formula (2) $A = I - G$.

Under this simplified formulation, the penalty addition would be equal to the spread between the actual and the guideline percentage increase in the average compensation rate. Thus, if the actual percentage increase (I) was .10

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and the guideline (G) .05, the penalty addition would be .05 as against .10 under formula (1). Again, the penalty as thus calculated could be multiplied by a scaling factor as desired, or applied as a coefficient with or without a scaling factor to be multiplied times the applicable income tax rate. The resulting values of the penalty are illustrated in the table below.

Illustrations: Formula (2) and variants

(1)	(2)	(3) Multiplied by a scaling factor of:	(4)	(5) Values in columns (2)-(4) multiplied by .48 corporate tax rate	(6)	(7)
I	A	.5	1.5			
.06	.01	.005	.015	.005	.002	.007
.07	.02	.010	.030	.010	.005	.014
.08	.03	.015	.045	.014	.007	.022
.09	.04	.020	.060	.019	.010	.029
.10	.05	.025	.075	.024	.012	.036
.12	.07	.035	.105	.034	.017	.050
.15	.10	.050	.150	.048	.024	.072
.20	.15	.075	.225	.072	.036	.108
.30	.25	1125	.375	.120	.060	.180

As indicated by the foregoing exploration of alternative tax formulas, virtually any level of penalty tax and any degree of progression or sensitivity to the proportionate excess of I over G may be obtained by formula construction.

Formula (1), it will be noted, tends to impose extremely severe penalties for large excesses of I over G unless these effects are toned down by a scaling factor and/or multiplied by the tax rate. These extreme penalty impacts reflect in large part the operation of the implicit scaling factor $\frac{I}{G}$ in Formula (1). This multiplies the absolute spread between I and G by a ratio reflecting the proportionate difference between I and G. This multiplier effect is avoided under Formula (2).

Under any of these formulations or their variants a minimum or maximum limitation might be appropriate for reasons previously indicated.

b. Problems and difficulties

Apart from the minor technical problems involved in achieving a satisfactory level and responsiveness of the penalty, the application of the deterrent through an adjustment of income tax rates involves serious problems of equity and economic impact. These problems stem from the fact that while the penalty rate under the income tax adjustment approach is geared to the extent of the excess wages, the actual base of the added tax is not the excess compensation but the net income of the business.

(1) Discrimination against equity capital intensiveness

A basic defect in the method of applying the

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deterrant tax to a base consisting of the taxable net income of the firm is the substantive discrimination against firms and industries which tend to be equity capital intensive. This discrimination tends to be perverse in relation to the objective of penalizing inflationary compensation increases since, for a given value-added contribution, the less equity capital intensive operation tends to have greater wage and salary payments and therefore greater inflationary impact while the more equity capital intensive operation has less labor costs relative to value added and therefore smaller inflation potential from labor compensation increases. Moreover, this discrimination would tend to encourage debt financing as a means of supporting capital intensiveness but reduce the equity capital returns on which the computation of the tax penalty for excess wage/salary increases is based.

These discriminatory impacts on equity capital intensive operations are illustrated below.

Illustration: Equity capital intensive discrimination

Firm or industry	Total value added	Wages and salaries	Equity capital return	Adjustment to corporation income tax = 10 percent of net profits	Inflationary wage increase ^{1/}
A	100	90	10	1	4.5
B	100	60	40	4	3

^{1/} Assumed to be 5 percent of wages and salaries

In the above simplified illustration, if the average percentage excess of compensation increases over the manufacturing norm is the same for both A and B, triggering the same 10 percent added tax on earnings, B would pay four times as great a penalty as A, due to its greater capital intensiveness. This would occur in spite of the fact that a compensation increase of, say, 10 percent which was 5 percent in excess of the guideline would represent inflationary infusion into the economy which was 50 percent greater for A than for B ($4.5+3=1.5$).

(2) Inappropriateness of base of penalty tax adjustment:
economic and equity aspects

a. Economic

The fact that the rate of the tax adjustment is geared to the degree of transgression of the guideline may be nullified if the base of the tax adjustment, net income, is small or non-existent, or it may be blown out of proportion if the wage bill is low, but business net income is large due to the contribution of capital or other non-wage factors in the production process. Moreover, the anti-inflation penalty under this approach is tied to the technical characteristics and vagaries of the definition of the net income base. This reduces the uniformity and reliability of the proposed restraint on inflationary wage revisions. Wage settlements in industries

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which might be critical in cost-push inflationary situations would not be well covered by the income tax adjustment approach. Example: building operation (rental real estate, such as residential, office, or commercial facilities where liberal depreciation wiped out most or all of net income and operation was combined with calculation of basic rental income).

b. Equity

The equity and therefore the acceptability of the plan are also involved. Taxable business income often departs from conventional measures of income, chiefly as a result of incentive measures built into the definition of the tax base. These differences frequently relate to the allowances for capital recovery, particularly depreciation and depletion. Capital gains are also involved. In addition to the mineral industries, agriculture, timber, and real estate, there are others with large outlays on depreciable assets subject to accelerated methods and favorable depreciation rates under the guideline, Asset Depreciation Range (ADR) System and Class Life System (CLS).^{1/}

The impact of incentive allowances under the income tax produce tax liability effects which are sometimes viewed as conflicting with commonsense equity standards. But, whatever their acceptability under the regular income tax, the extension of these incentive-justified differentials to the special realm of TIP would be especially dubious from the standpoint of equity as well as comprehensive effectiveness in discouraging inflationary wage settlements.

^{1/}For a brief summary of the present depreciation structure and its historical development, see 1975 Depreciation Guide, Commerce Clearing House, para. 1, pp. 7-8..

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c. Debt financing, leveraging, and leasing

The income tax adjustment penalty approach would penalize capital intensive industries, other things being equal. However, capital intensiveness might be offset by heavy debt financing, reflecting either established financial practices of the firm or industry or special efforts on the part of the firm or industry to increase their debt-equity ratios, and by leasing rather than owning capital assets.

The corporate income tax structure particularly is now biased in favor of debt as against equity financing. The income tax adjustment approach would accentuate this bias, including the leasing aspects, possibly quite strongly in a situation in which substantial tax penalties attached to wage settlements which the affected industries could not otherwise resist.

(d) Small business and unincorporated enterprise

The penalty adjustment to income tax rates would involve a number of special problems in its application to small corporate enterprise and to unincorporated enterprises.

In the case of small corporations, in which taxable net earnings are sometimes kept small by payment of salaries to owner-officers and sometimes artificially increased by keeping salaries of owner-officers low (so as to enhance retained earnings subject only to a single low corporate tax

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rate), the penalty adjustment approach would have erratic results and stimulate reorientation of corporate salary policy vis a vis owner-officers.

In the case of unincorporated businesses, including proprietorships, partnerships, and Subchapter S corporations electing to be taxed like partnerships, the penalty tax adjustment approach would apparently require special sets of rules, including the imputation of proprietors' wages and salaries, limitations on partners' and corporate officers' compensation, and the allocation of the TIP penalty tax liability to partners and electing shareholders.^{1/}

e. Coordination of corporate and individual tax adjustments

If the penalty tax adjustment were purely additive, that is, consisted of an addition of a calculated number of percentage points to otherwise applicable corporate or income tax rates, it would be uniform, regardless of the income level or the form of business organization of the taxpayer. Uniformity might involve policy issues, but little technical difficulty. Special attention might need to be given in formulating any limitation required to avoid a confiscatory combination of tax and penalty tax.

If the penalty tax adjustment were applied as a percentage of the applicable corporate or individual tax rate, the penalty would vary as between individuals and corporations and would depend upon the income level and tax.

^{1/}Ibid., p. 10.

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bracket. Highly diverse penalties would thus result for corporations large and small and for individuals in varying tax brackets. Different penalties would apply to different partners in the same enterprise, depending upon their over-all income position. Again policy issues would predominate, but attention would have to be given to designing limitations to avoid confiscatory impacts.

f. Deficit companies

One of the problems which the income adjustment approach would share to some extent with its nearest competitor, the disallowance of excess wage deductions, is its ineffectiveness in reaching enterprises with no current net earnings.

The corporate population embraces a substantial group, including some large and even giant enterprises, which have no net income for tax purposes, owing to business and economic circumstances as well as special features of the tax law. In 1974, for example, out of a total of 1,978,059 active corporation returns, 1,224,131 or 61.9 percent reported net income. Thus, 753,928 or 38.1 percent had no net income.^{1/} Some of the latter group circulate in and out of the deficit category. Some are new enterprises not yet having attained a net profits position. Others are declining business, about to fade out. Still others may be in a chronic deficit posture but may continue in business for a protracted period particularly if their cash flow position is positive, although capital recovery allowances wipe out an overall net profit.

^{1/} Statistics of Income 1974, Preliminary, Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 159 (1-77), Table 1, n. 4.

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g. Low shiftability of corporate income tax adjustment

As part of the corporate (and individual) income tax, the penalty adjustment for excess compensation would be difficult to shift in the short run. The tax is assessed on profits, but the level of assessment is geared to employment and payroll events. Still, the selective, uncertain, and aleatory nature of the adjustment would make it difficult to shift, possibly more so than the regular corporate tax itself. This would mean that the burden of penalty adjustment would tend to rest upon the owners of the business in the short run. This generalization has to be qualified in light of the possibility of a general price increasing reaction by business to the hazards of a Tip penalty. By contrast a TIP penalty tax based on payrolls (as has been suggested by some) would tend to be incorporated in the costs determining the marginal cost curve and also be reflected in mark-up pricing in the short run.

In the longer run, during which capital investment could adjust to the existence of TIP, equity capital exposed to the hazard of penalty-subject wage settlements would move out of the more hazardous into less exposed areas. New capital would tend to be diverted from them. These capital adjustments or flows in response to the potential penalty tax would lower rates of return in less exposed type of investment and increase them in corporate equities in some proportion to the perceived degree of exposure to the chance of incurring the added tax.

In some terminologies, the neo-classic capital adjustment mechanism just described would be called shifting.

In others, stress would be placed upon the absorption of the added tax by capital generally, rather than on the differential which would be developed as a result of the tax between pre-tax rates of return in corporate equities and other forms of investment.

h. Damage to investment

Because of the damage the tax penalty might do to the whole investment process, in which corporate equity of highly "exposed" types would play a complementary role vis a vis other types of investment, investment as a whole may sag (and therefore income and saving) unless this negative element were counteracted or compensated by other, investment-stimulating measures in the fiscal, monetary, or other arsenals of macro-economic expansionist techniques. How the damage done by the income tax rate adjustment would compare with that under alternative tax forms will be examined later.

2. Disallowance of excess wage deductions

An alternative which appears to be technically and economically superior to the rate adjustment approach is one which would disallow deductions for excess employee compensation for purposes of computing taxable income.

a. Conceptual compatibility with existing disallowance of illegal payments

This approach would be in the tradition of past and

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present income tax sanctions on deduction of payments of any kind in contravention of law or sound public policy

Section 162 of the Internal Revenue Code, which sets forth the basic general provisions for the allowance as a deduction of all the ordinary and necessary trade or business expenses, including reasonable salaries or other compensation for personal services, incurred in carrying on any trade or business also contains specific prohibitions against the deduction of "illegal bribes, kickbacks and other illegal payments"^{1/} Related general provisions deny deductions for fines and penalties.^{2/}

In denying status as deductible business expenses for fines and penalties paid to a government for the violation of any law, the Congress has codified the position of the courts in this area.

Under the provisions of sec. 162(c) any bribe or illegal kickback paid to a public official or government employee is nondeductible. This prohibition includes payments to foreign government officials and employees if the payment would be unlawful under the laws of the United States if applicable to such payment or recipient.

No deduction is allowed for any payment made directly or indirectly to any person if the payment is an illegal bribe, illegal kickback, or other illegal payment under any law of the United States or any State, provided such State law is enforced, which subjects the payor to a criminal penalty or

^{1/}IRC secs. 162 (c) (1) and (2).

^{2/}IRC sec. 162 (f).

the loss of license or privilege to engage in a trade or business. In any proceeding involving the issue of whether a payment is an illegal bribe, illegal kickback, or other illegal payment, the burden of proof is placed upon the Commissioner to the same extent as under IRC sec. 7454 concerning the burden of proof when the issue relates to fraud.^{1/} ^{2/}

b. How it would work

(1) Basic penalty effects

If this approach were implemented with a straightforward disallowance of all excess compensation, without regard to the degree of excess, the resulting basic penalty would vary with the applicable bracket rate of tax, as follows:

<u>Corporations</u>	<u>Applicable bracket rate</u>	<u>Penalty per \$1,000 of excess compensation</u>
Income 0-25,000	20%	\$200
Income 25,000-50,000	22	220
Income over 50,000	48	480
<u>Individuals</u>		
Lowest applicable rate above 0 bracket	14	140*
Top bracket rate	70	700

* 14 percent bracket is actually less than \$1,000 wide.

^{1/} IRC sec. 162(e)(2)

^{2/} The summary contained in this paragraph borrows in part from Federal Tax Return Manual 1977, Commerce Clearing House, para. 2440, p.2420.

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(2) Possible additional penalty effects

In addition to the penalty involved in loss of deductions under the regular individual and corporate income tax rates, for which illustrative calculations are shown above, tax penalties might arise under other individual corporate levies based on income in the absence of explicit statutory directives limiting these ancillary effects of the disallowance of excess compensation. The major examples follow.

Individuals

A disallowance of deductions increasing taxable income might, other things being equal, increase some individuals' self-employment tax on business and partnership income. For 1977, the self-employment tax is imposed at a rate of 7.9 percent on the first \$16,500 of self-employment income; for 1978, the rate is 8.1 percent on the first \$17,700. The loss of \$1,000 of deductions for excess wages would increase self-employment tax by an additional \$79 at 1977 levels and \$81 at 1978 levels.

Corporations

Corporations subject to the accumulated earnings tax might incur substantial additional penalties from the increase in income due to the disallowance of excess wages, as indicated here.

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Accumulated earnings tax	Applicable rate	Penalty per \$1,000 of additional income due to excess wage disallowance
First \$100,000 above \$150,000 accumulated earnings credit	27½%	\$275
Over \$100,000	38½	385

(3) Possible scaling factor

The amount of excess wages disallowed in computing taxable income might be made equal to the entire excess wage, as previously illustrated. Or, if that penalty were deemed too severe, a fractional disallowance might be provided, i.e., 50 percent, 40 percent, or 25 percent, or less of the excess wage. This modification would reduce the penalty for a corporation in the 48 percent bracket as follows:

Fractional disallowance (percent)	Penalty per \$1,000 of excess compensation
75%	\$360
50	240
40	192
25	120
10	48

Similarly, the percentage of excess wages denied deductibility might be made to vary with the degree of excessiveness. The following scales A and B serve to illustrate this variant:

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Amount of wages equal to specified percentage above guideline	Percent disallowed Scale A	Percent disallowed Scale B
First one percent	10	25
Second	20	30
Third	30	35
Fourth	40	40
Fifth	50	45
Sixth	60	50
Seventh	70	55
Seventh to tenth	.80	60
Above the tenth	100	80
Above the fifteenth		100

It would be possible to provide a disallowance in excess of 100 percent, but questions of equity and even legality would arise.

c. Problems and difficulties

The disallowance of deductions approach would be subject to some of the weaknesses of the penalty adjustment of rates previously discussed.

(1) Non-taxable because unprofitable firms

It would fail to reach firms (and possibly whole industries) which had substantial chronic operating losses and were not in position to utilize loss carrybacks or carryovers. In some cases, firms which showed zero or negative earnings after ordinary deductions would be made taxable on

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earnings reflecting a portion of excess compensation as a result of its disallowance. Or their loss carrybacks (or carryforwards) would be reduced with resulting tax detriment. However, the effectiveness of the plan would be reduced to the extent that unprofitable firms are considered a significant portion of the compensation-push inflation problem.

(2) Tax haven industries

Like the rate adjustment approach, but in somewhat lesser degree, the disallowance of deductions method would be ineffective and uneven in its approach because of the significant areas of the economy receiving favorable capital recovery allowance and other incentive provisions. There would be some differences in favor of the disallowance of deductions method since it would not uniformly favor businesses with relatively low taxable income bases as would the rate adjustment approach. If the tax-favored firm or industry had zero or merely low earnings, the disallowance of deductions would be fully reflected in the new tax base. Even if there were existing operating losses for tax purposes, the disallowance of excess wage deductions might eliminate the loss and be reflected partially in the new positive earnings position, so the disallowance would have marginal incentive impact. Even if there was a current net operating loss but past years' income was available for application of operating loss carrybacks, the disallowance of deductions method would immediately reduce these tax benefits to firms transgressing the noninflationary compensation standard.

(3) Variation of penalty effects with applicable tax rate

The disallowance of deductions approach would produce a wide variety of tax penalties, varying with the applicable tax bracket of the particular taxpayer, as shown in the preceding tabular analysis. The question is raised whether this particular structure of resulting tax penalties is in accordance with the concept and purposes of the plan. The structure would be progressive or adjusted in accordance with taxable capacity as gauged by the tax rate schedules of past legislation. It is not unreasonable to suggest that a structure of penalties bearing a uniform relationship to existing tax burdens is prima facie fair as well as in keeping with the spirit and the practical effect of legislative and judicial sanctions of the past on payments determined to be illegal and in contravention of sound public policy. On the other hand, in some situations fairly steep penalties on excess compensation might be needed to make the TIP plan effective, and these would not be implemented by a disallowance of deductions under a 14 percent rate (starting rate for individuals) or a 20 to 22 percent rate (rate for small corporations).

(d) Quantitative comparison of approaches

It is worthwhile to compare the penalty rate adjustment and the disallowance of deduction approaches in terms of their dollar burden effects. Without making a lengthy or detailed analysis it is possible to gain useful perspective from the following illustrative calculations.

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(1) Incremental or marginal impact

The disallowance of deductions approach produces a simple, readily predictable impact, increasing the tax bill by an amount equal to the applicable marginal or bracket tax rate times the disallowed excess compensation. The adjustment of rate approach produces a less predictable impact on tax liability since the net income for the year is involved in the determination.

Assume the following relationships:

1) Formula $A = (I-C) \frac{I}{G}$ without further scaling factor for the adjustment approach

2) Straightforward disallowance of excess compensation under a 48 percent corporate tax rate for the deduction disallowance approach

3) $I=.10$
 $C=.05$

4) Gross receipts	= 10,000
Wages	= 6,667
Other expenses	= 2,733
Net income before tax prior to disallowance of excess compensation deduction	= 6061 ^{1/2}
Excess compensation	= 303 ^{1/2}

^{1/2} 6 percent of gross receipts = average for all manufacturing in 1974.

^{2/} Based on $I=.10$ relative to $C=.05$ for one entire year; $6061 \times 1.1 = 6,667$, $6061 \times 1.05 = 6364$, and $6667 - 6364 = 303$.

The increase in tax under the adjustment of rate approach would be \$60, i.e., 10 percent of net income and 19.8 percent of the excess compensation.

The increase in tax under the disallowance of deduction

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approach would be about \$145, for a corporation subject to the top rate, i.e., 48 percent of the excess compensation and 24 percent of net income as computed prior to the disallowance.

Unless scaled up substantially, the adjustment of tax would produce a lower dollar tax effect than the disallowance of deductions. The difference between 48 percent of the excess compensation and 19.8 percent would be marked.

(2) "Effective" rate effect

The comparative effective rate effect depends of course upon the net earnings position of the taxpayer. Under the circumstances assumed here, the formula adjustment would increase the effective tax rate on net income (as computed prior to any disallowance of deductions) by 10 percent versus 24 percent under the disallowance approach.

Since the dollar effect under the stated assumption is 2.42 times greater under the disallowance approach than under the rate adjustment method, the impact is also 2.42 times greater in terms of both an increment of the excess compensation and an increment in the effective corporate tax rate on net earnings.

3. Special penalty tax on excess compensation

To deal with some of the characteristics of the previously outlined approaches which may be considered unsatisfactory, alternatives are available that would:

-- apply a penalty tax to businesses paying excess compensation regardless of their net earnings position

-- assess the penalty on a "predictable" flat rate or scheduled basis not affected by net earnings, capital intensiveness, applicable income tax rate, or other "extraneous" factors

a. Excise tax on inflationary excess compensation

One method would be to impose an excise tax, regulatory in character and in the spirit of the equalization tax (in effect from July 19, 1963 through June 30, 1974), on compensation payments in excess of the non-inflationary guideline standard.

The interest equalization tax was originally enacted under the Interest Equalization Tax Act (P.L. 88-563) Sept. 2, 1964 and extended by subsequent laws. It was designed to tax acquisitions of certain foreign securities in order to equalize costs of longer term financing in the United States and in markets abroad, and thus to aid the Nation's balance-of-payments position by restraining the demand on our capital market from other industrialized countries.^{1/}

The rate could be set at the desired level or levels and could be made to be varied, as was the interest equalization excise tax by the President pursuant

^{1/}For summary of provisions and purposes, see 1975 U.S. Excise Tax Guide, Commerce Clearing House, paras. 1250-1275, pp. 320-335.

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to Executive Order.^{2/} This approach would avoid the inaccessibility of deficit businesses, if that was desired. It could be made applicable to organizations not subject to income tax.

b. Implementation of penalty through a special gross income type tax

Another method of applying a tax penalty on excess compensation in a way that would be neutral with respect to net profitability, capital intensivity, or equity-debt ratio, would be to impose a gross income tax which would permit the deduction of all cost and capital return items except excess compensation. In effect, the tax base of the special gross income tax would be excess compensation.

The base of the special gross income tax would be:

(1) Gross receipts from all sources as now defined for income tax purposes adjusted downward by the amount of net income, if any, or upward by the amount of net operating losses, if any, less

(2) All deduction items now allowed for income tax purposes, except compensation in excess of the non-inflationary guideline standard.

This would accomplish the same substantive result as the excise tax on excess compensation, but would incorporate the tax penalty directly into the

^{1/}See Internal Revenue Code section 4911 (b).

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compliance and administrative procedures of the income tax. On the negative side, this approach might appear to follow an involved, roundabout subterfuge in order to accomplish the same result as an excise approach. Questions of semantics and public attitudes are important in the development and presentation of such a gross income tax since it might well arouse the anxieties and controversies associated with a potential broad-based tax whether of the gross receipts, turnover, or value-added type.

On the question of shiftability, it would appear that the existence of either an excise tax on excess compensation or a "gross" income tax which single out such excess would have about the same "long-term" effects on prices, wages, capital investment behavior, and equity investment returns as the income tax approaches previously discussed, subject to certain qualifications: the penalty tax here would be more uniform and predictable; would not exclude deficit companies as would both income tax methods; and would not reward debt financing as would the rate adjustment approach in particular.

Certainty and comprehensiveness or universality might seem to facilitate shifting. However, the fact that the tax penalty on excess compensation would presumably not be universal and possibly quite limited, variable, and even spotty in its application would militate against the triggering of systematic shifting mechanisms. The greater uniformity and "fairness" of a penalty

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based on excess compensation regardless of net earnings, capital intensivity, and debt-equity ratio might do less damage to equity investment than other options.

The application of the penalty on excess compensation to deficit companies is a significant consideration here. The "exemption" of deficit businesses has been tentatively treated as a kind of technical defect in the previous discussion. However, it may be argued that (1) deficit organizations are a less important factor in inflationary wage settlements, (2) taxing them when they are forced to accept such wage settlements smacks of hitting them when they are down and being forced further downward, and (3) shiftability is possibly reduced if this exempt area is retained in the economy. It may also be persuasively argued that the chief danger that the penalty tax (in whatever form) will be shifted forward into higher prices is the reaction to it by large oligopolistic corporations with market power which they feel can be exploited further in the new situation posed by an extensive if not universal tax cost factor.

4. "Carrot versus stick" and variant TIP plans

An alternative to the tax penalty for excess compensation payments is an approach which would extend a tax bonus for guideline compliance. One variant would allow business tax reduction for business generally but deny part or all of the reduction to those who did not comply with compensation guidelines, and possibly in proportion to

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the degree of non-compliance. Other variant "carrot" approaches would offer a specific bonus (tax relief) only for firms observing restraint in their wage policies. This approach could be implemented effectively only in a fiscal environment of tax reduction. Otherwise it would call for additional taxes to pay for the bonus program. A number of plans of this type are cited in the following section.

a. Considerations raised by the generic tax carrot plan

In general, the question of the carrot versus the stick approach to fiscal incentives for wage restraint presents several aspects reviewed briefly below.

- 1) There are problems in providing a general tax cut large enough to make a sufficient carrot to reward non-inflationary wage behavior.
- 2) In contrast with the TIP penalty as proposed by Wallich and Weintraub, which would be graded smoothly according to the degree of excessiveness in the wage settlement, the carrot or bonus approach as generally advanced is an "all or nothing" affair. Large amounts of potential tax reduction would ride upon small differences of opinion or definition.^{1/}
- 3) While a grading-in system would moderate the impact on small excesses, it would leave a weak disincentive or deterrent to large inflationary excesses.

In examining these questions it is important to bear in mind some of the typical relationships between wages/salaries and employee compensation generally, on the one hand, and corporate profits and a tax reduction thereon, on the other.

In 1975, total corporate income subject to tax for all active corporations was roughly \$145 billion, or nearly

^{1/}Differences in the guideline, at the bargaining table, in the carrot plan design, and/or in the tax administrator's determination.

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5 percent of total corporate receipts of \$3,196 billion, of which \$2,962 billion were classified as business receipts. Total payroll was approximately \$523 billion or 17.65 percent of business receipts. Wage supplements amounted to about \$90 billion or 3 percent of business receipts. Thus total employee compensation amounted to about \$613 billion or some 20.7 percent of total business receipts.^{1/} ^{2/}

Within this set of relationships, a tax reduction of 3 percentage points across the board in the corporate rate, equivalent to a reduction of 6 percent for larger corporations and 15 percent for the smallest, would lose about \$4.35 billion of revenue at 1975 levels. At the higher profit levels likely to prevail in 1978-79 the revenue cost would be in the vicinity of \$5 to \$6 billion.

The 3 percentage point tax reduction (which would be taken away in the event of non-conformity with the guideline

^{1/} Data on payroll and supplements obtained from Bureau of Labor Statistics, U.S. Department of Labor. Corporate income and receipts data shown here are from Statistics of Income 1975, Preliminary, Department of the Treasury, Internal Revenue Service, Publication 159 (1-78), Table, 1, p. 9.

^{2/} While wages constitute about 75 percent of the national income, they represent a much smaller percentage of the total receipts of businesses, owing to the substantial volume of interbusiness transactions which have the familiar effect of increasing total costs and total receipts relative to the value added of a particular business or aggregate of businesses. In many large businesses the ratio of wages and employee compensation to business receipts is higher than the 20.7 percent figure developed here for all active corporations in 1975. For example, in 1977 employee compensation for General Motors Corporation was 33.5 percent of sales; for General Electric Company the figure was 37.4 percent. For unincorporated businesses as reported in Statistics of Income 1974, Business Income Tax Returns, payroll and wage supplements averaged 9.4 percent of sales for sole proprietorships and 11.8 percent for partnerships.

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under the typical carrot plan) would thus amount to about 0.7 percent of employee compensation including various wage supplements and employee benefits (4.35 + 613) or .83 percent of wages/salaries (4.35 + 523), assuming 1975 aggregate relationships.

If the entire penalty in the form of denial of the 3 percentage point corporate rate reduction were regarded as focussed on a 1 percent excess compensation figure, it would amount to a crushing 71 percent of the offending compensation increase (4.35 + 6.13 or 1 percent of 613) again assuming the relationships observed in the aggregate corporate data for 1975. The degree of severity would vary with the amount of the excess, rising to astronomical percentage figures for very small excess compensation increases above the guideline.

These considerations point up the fact that some kind of grading-in system would seem required under the carrot or bonus system to make its impact more "gradual" rather than an "all or nothing" matter.

One crude method would be to phase out the bonus on a schedule such as the following:

<u>Percentage points above guideline</u>	<u>Percent of tax bonus allowed</u>
Above 0, less than 1	75
1 - 2	50
2 - 3	25
Above 3	0

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Such a schedule would ameliorate some of the crudities, discontinuities, and "notch" effects of the bonus approach, but it would still leave sizeable amounts of bonus at stake at the various breaking points. Narrower brackets would reduce the amount of bonus at stake for each bracket boundary but would increase the number of boundaries at which an abrupt change occurred.

A smoother, more gradual phase-out of the bonus would be possible. Thus a formula might be applied which would reduce the bonus by a percentage equal to the ratio of the number of percentage points (calculated to several decimal places) by which compensation increases exceeded the guideline to, say, 3, thus wiping out the bonus at an 8 percent wage increase in relation to a 5 percent guideline. This would apply a constant penalty equal to 23.65 percent of the excess compensation. The 23.65 percent is equal to $4.35 + 18.39$ where 4.35 represents a tax bonus of 3 percent of corporate profits of 145 and 18.39 equals 3 percent of compensation of 613 on the basis of the 1975 aggregate relationships outlined earlier.^{1/}

Above the 8 percent wage increase or 3 percent excess compensation point, the bonus would be a constant amount equal to the assumed percentage points of tax on corporate profits. It would thus become a decreasing percentage of excess earnings as the excess increased above that point. The incremental penalty: zero.

By contrast with this "loss of bonus" behavior, the Wallich-Weintraub T1^{1/} approach would continue to increase the penalty on inflationary wage increases, making the penalty

^{1/} The 23.65 percent incremental penalty rate calculated here compares with a 48 percent incremental penalty under the deduction disallowance method for a large corporation. For a corporation with total employee compensation equal to, say, 41.3 percent of receipts or twice as high in relation to profits as assumed here, the carrot plan penalty would be half that shown here.

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greater the larger the excess up to any desired designated limit.

The essential problem of adjusting the incentive involved in the tax bonus or carrot approach as generally proposed, even with a smooth phase-out, is that it hinges upon allowing or not allowing a fixed reward. Once the carrot was taken away, there would be no further proportioning of the disincentive to inflationary wage excesses to the extent of the excess. Indeed, the incremental loss of bonus would be zero.

The carrot approach involves granting tax reduction to a presumptive majority of businesses conforming with the noninflationary guideline. This involves massive tax reductions. The minority of non-conformers with the guideline would receive a smaller tax reduction or no tax reduction. The penalty of losing the bonus would lack incrementality above the upper boundary of the phase-out zone. The penalty would be made steeper for the offending minority only at the cost of further costly tax reductions for the majority.

b. Okun proposal for tax relief for price-wage restraint

Arthur M. Okun has, as part of a larger anti-stagflation package, proposed a tax relief incentive for workers and businessmen who enlist in a cooperative anti-inflationary effort. In its wage restraint aspects the Okun plan would grant businesses pledging, at the beginning of 1978, to hold the average rate of wage increase below 6 percent a

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tax rebate equal to 5 percent of its income tax liabilities on domestic operating profits. Participating employees would also be rewarded in the form of a rebate of 1½ percent of wage or salary incomes up to \$225 per person. The revenue cost of this feature of the plan is estimated at up to \$15 billion annually.^{1/}

This plan would involve the usual problems and burdens of measuring wage increases relative to a guideline, discussed later in this report. It would involve very wide application of the measurement process. Considerable accuracy would be required at the 6 percent margin. On this measurement would ride a potentially universal tax rebate both for business and participating employees who established satisfactory (below the 6 percent norm) wage behavior. Pricing behavior would also be a factor in qualifying for the rebate.

c. Seidman plan for business payroll tax decreases for wage increases below norm

Lawrence S. Seidman has proposed progressive rebates on the payroll tax -- the greater, the further the average wage increase is below the norm. This would enhance the efficiency of the Wallach-Weintraub TIT plan by providing a marginal incentive discouraging all wage increases, not just those penetrating the guideline ceiling, according to its proponents.

The administrative-compliance aspects peculiar to this plan would be similar to those of the Okun proposal

^{1/}Arthur M. Okun (Senior fellow, The Brookings Institution), "The Great Stagflation Swamp", Address before the Economic Club of Chicago, Oct. 6, 1977, pp. 17-18.

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since all business would be required to measure wage restraint success. Great accuracy would be required in measuring wage increases not merely for those in the vicinity of the norm but for all businesses in establishing the amount of the payroll tax rebate. The plan would not incrementally discourage wage increases once the guideline ceiling was breached by a firm.^{1/}

^{1/}See description of Seidman plan in Abba P. Lerner, "Stagflation - Its Cause and Cure", Challenge, Vol. 20, No. 4, Sept.-Oct. 1977) p. 17.

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d. Abba P. Lerner anti-stagflation package^{1/}

Lerner has proposed (as an intellectually second choice to sale of wage-increase permits in the manner of plans for the auctioning off of licenses to pollute) a package plan limited to the thousand largest corporation including these features:

--a "consolidation" of the Wallich-Weintraub plan and the Seidman proposal which would give each participating corporation a lump sum grant, possibly in the form of tax reduction, less a tax/charge per unit of every wage increase. There would be no need for a norm for measuring excess wages. The intent would be to make the plan revenue neutral by balancing grants and taxes/charges,

--the grant (or tax relief) as well as the tax/charge to be based not on net profits but on a previous wage bill,

--the tax/charge to be geared proportionally to the average wage rate increase times the base figure. The exact formula required for the tax/charge is not furnished by Lerner.

This complex plan would involve calculations of all wage rate increases for the thousand largest corporations only. The duration of the charge/tax like that of the grant in any year would be limited to that year only. The procedure would be "peated annually.

A formidable estimating task would be required to balance grants and tax/charge levels and to adjust these figures annually. Lerner estimates that owing to the limitation of the plan to a relatively few large

^{1/}See Abba P. Lerner "Stagflation - Its Cause and Cure" Challenge, previously cited, pp. 14-19 especially pp. 17-19.

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corporations administration costs would be only "a few million dollars" annually (versus a national product gain in the tens of billions of dollars).

* * *

Denying income tax rate reduction to non-compliers with wage guidelines would present the same characteristics and technical problems as the penalty upward adjustment of rates previously discussed. It would superimpose new special technical problems associated with a dual level of tax rates which would entail a differential against non-compliers. Future tax rate adjustments up and down would have to take into consideration means of maintaining or altering as desired the original differential penalty on non-compliance.

B. Area of application

One of the critical policy decisions to be made in the design of TIP is its area of application. This area would be defined (or limited) chiefly in terms of type and size of business organization.

The practical issues (decisions on which technical and administrative problems are involved) seem to boil down to the following:

- (1) Should proprietorships and partnerships be exempted from the tax penalty on non-compliance with compensation guidelines? How should subchapter S corporations be treated?
- (2) Should an exclusion or exemption based on size (income level, net worth, assets, number of employees, sales, or other characteristic) be applied to otherwise eligible business categories?

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(3) Should the scope of the tax be limited to domestic activities of enterprises?

(4) Should "new" firms - defined either as genuinely newly organized or as inclusive of "new" combinations of preexisting firms or their assets - be temporarily excluded or given special treatment tantamount to temporary exemption?

(5) Should "tax-exempt" or non-profit organizations be included in some form of penalty or non-compliance with anti-inflationary wage guidelines?

Technical and administrative factors enter into the decisions on these issues in two ways:

--the practical implementation of an exemption

--the technical and administrative problems avoided by creating an exempt area or demanding attention if no exemption is created.

1. Unincorporated enterprise

There are those who contend that there would be "no logical basis for distinguishing categories of business tax payers who might be exempted from the additional tax". Also, it is contended that "Size classifications always end up being highly arbitrary and discriminatory between firms in different markets whether the criterion is total assets, net worth, or numbers of employees. And there would be unintentional ambiguity introduced by exempting proprietorships and partnerships when approximately 300,000 corporations qualify under

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Subchapter S and elect to be taxed as partnerships".^{1/}

a. Blanket exemption

There is however considerable economic and administrative logic in exempting unincorporated enterprises. Their role is small in the process of compensation-push inflation reflecting wage increases in excess of productivity gains pressed upon large, strategically positioned corporate employers by powerful labor unions. Their role in wage increases is largely passive. The application of the tax to them would chiefly be in the interest of uniformity and equity. Avoidance of an area of wage settlement free of the proposed tax restraint which might exert upward pressure on the labor market for penalty-tax subject corporate employers might be a pertinent consideration.

Exemption of unincorporated enterprise would involve little or no administrative complication and would save a substantial amount of administrative and compliance cost with little sacrifice of overall effectiveness of TIP.

The administrative saving would be chiefly in

^{1/}Ibid. It should be noted that at 1971 levels there were 330,411 active small business corporation returns, Form 1120 S, of which 193,161 reported net income totaling about .5.7 billion. *Statistics of Income 1974, Preliminary, Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 159 (1-77) Table 3, p. 1).*

the form of the cost of designing, printing, distributing, processing, monitoring, and tabulating the special tax forms or schedules. It seems likely that there would be relatively few cases of compensation increases above the guideline norm in the unincorporated business area, except in severe inflationary spirals completely beyond the control of small employers. Actual audit of borderline or actual cases involving penalty tax would probably be minimal in this area, except under severe inflation. The costs or cost savings involved, probably in the order of \$5 million would probably not be significantly different under any of the four alternative forms of penalty tax discussed earlier.

The economic and administrative magnitudes involved in blanketing out the unincorporated enterprise sector are evidenced by the following key figures.

For 1974, these were:^{1/}

--10,873,822 proprietorships in all industries with net profits (less losses) of \$45.9 billion

--7,695,666 proprietorships in nonfarm industries with net profits (less losses) of \$39.0 billion

--1,062,268 partnerships with 4,620,439 partners (an average of 4 1/3 partners per firm) in all industries with net profit (less loss) of \$8.9 billion

--952,655 partnerships with 4,298,129 partners (an average of 4 1/3 partners per firm) in nonfarm industries with net profit (less loss) of \$7.8 billion

^{1/}Data taken from Statistics of Income 1974, Business Income Tax Returns, Sole Proprietorships and Partnerships, Department of the Treasury, Internal Revenue Service, Publication 438 (7-77) Tables 1.1 and 2.1, pp. 4 and 119.

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Average profits (less losses) per firm and per partner were as follows:

Proprietorships

All industries	\$ 4217
Nonfarm industries	5067

Partnerships

	<u>Per firm</u>	<u>Per partner</u>
All industries	\$ 8345	\$ 1919
Nonfarm industries	8240	1826

Payroll constitutes a considerably smaller percentage of the receipts of unincorporated enterprise than in the case of corporations. The following percentage calculations for sole proprietorships and partnerships highlight the facts:

		<u>Payroll</u>	<u>Percent of Business Receipts</u>
	<u>Business Receipts</u>	<u>Amount</u>	<u>Business Receipts</u>
Sole Proprietorships			(dollar amounts in thousands)
All industries	\$ 328,262,352	\$ 30,733,400	9.4%
Nonfarm industries	264,892,250	27,402,129	10.3%
Partnerships			
All industries	137,155,870	15,804,080	11.5
Nonfarm industries	125,936,783	14,973,452	11.9

While exactly comparable tax data are not available for corporations, Commerce data show that in the past 30 years or so total compensation of employees of nonfinancial corporate business has ranged around 62 to 67 percent of the gross domestic product of this particular business sector.^{1/} Employees' share of national income rose to

^{1/}See, for example, Economic Report of the President, January 1976, Table B-6, p. 1.

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three-fourths in the 1970's from the two-thirds level prevailing in the period 1935-68. The 9 to 12 percent payroll ratio to business receipts of noncorporate business cited above based on tax return data is not exactly comparable, since the wage component of interbusiness sales is excluded. But even making an approximate adjustment for this difference, it is evident that employee compensation is a smaller percentage of product for noncorporate enterprise. Implicit owner service income is a factor in this differential.

While the majority of sole proprietorships are small, they include a substantial area of sizeable operations. In the partnership area, the scope of business operations with sizeable net profit is still more important, as summarized in the following size distributions.^{1/}

^{1/} Data taken from Statistics of Income 1974, Business Income Tax Returns, previously cited, Tables 1.6 and 2.3, pp. 96 and 145.

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Sole proprietorships 1974

Size of adjusted gross income	Number of businesses	Business receipts	Net profit (less loss)
Returns with or without adjusted gross income, total	10,873,822	\$328,262,352	\$45,855,023
Returns with ad- justed gross in- come, total	10,397,205	306,902,060	49,322,063
\$1 - 5,000	2,215,259	31,241,575	1,562,077
5,000 - 10,000	2,373,562	46,411,347	4,841,986
10,000 - 20,000	3,516,255	81,558,226	11,948,213
20,000 - 50,000	1,936,194	99,518,942	20,197,059
50,000 - 100,000	285,264	33,089,647	7,903,840
100,000 - 500,000	68,122	13,754,433	2,664,200
500,000 - 1,000,000	1,784	706,167	85,129
1,000,000 and over	.765	621,723	119,559
Returns with no adjusted gross income	476,617	21,360,292	3,467,040

Note; Except in size class column dollar amounts in thousands.

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Partnerships 1974

<u>Size of business receipts</u>	<u>Number of partnerships</u>	<u>Business receipts</u>	<u>Payroll</u>	<u>Net profit (less loss)</u>
Total	1,062,268	\$137,155,870	\$15,804,080	\$8,864,873
Under \$5,000, total	277,336	422,325	98,971	-3,398,962
No receipts reported	70,495	-	56,942	-2,490,210
\$1 - 5,000	206,841	422,325	42,029	-908,752
5,000 - 10,000	98,507	721,580	32,357	-218,962
10,000 - 25,000	161,986	2,698,822	153,490	-56,546
25,000 - 50,000	139,009	5,002,002	398,525	495,668
50,000 - 100,000	136,846	9,854,780	939,237	1,310,824
100,000 - 200,000	117,234	16,688,473	1,837,965	2,160,190
200,000 - 500,000	88,940	27,010,922	3,154,369	2,945,237
500,000 - 1,000,000	25,778	17,291,742	2,152,694	1,305,475
1,000,000 - 2,000,000	10,380	14,278,936	1,686,900	834,965
2,000,000 - 5,000,000	4,884	14,677,388	1,693,069	1,073,926
5,000,000 - 10,000,000	1,169	7,969,944	958,121	528,107
10,000,000 and over	699	20,538,956	2,698,382	1,884,951

Note: Except in size class column, dollar amounts in thousands.

In light of the above data showing a considerable area of sizeable business operations in the unincorporated enterprise area, and an appreciable "overlap" of unincorporated and corporate enterprise in the small and medium-sized business area, it is difficult to accept a blanket exemption for sole proprietorships and partnerships.

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A specific exemption of unincorporated enterprise income of about \$10,000 before the additional tax is applied has been suggested, on the grounds that proprietorship income is always gross of the proprietor's own service income. This is apparently intended as a technical adjustment of the penalty tax base of the unincorporated enterprise or its owners to bring it into comparability with that of the owner-officer salary net figure for corporations. It is not intended as a size exemption for proprietorships and partnerships as such.

b. Size exemption

To avoid a blanket non-corporate exemption with its discriminatory sweeping aside of a considerable area of small and medium sized business comparable with corresponding corporate operations, and yet to save the compliance and administrative burden associated with the penalty tax reporting and processing procedures for numerous truly small farm and commercial enterprises, it seems desirable to consider an exemption feature, applicable to corporate and unincorporated enterprises alike. This exemption might be based on payroll business receipts or similar gross measure of size of operations. The exact level of the exemption would need to be set on the basis of detailed study in the light of policy objectives, including coordination with the related exemption in the corporate enterprise area.

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2. Corporate area.

a. Design options

In the corporate area there are several design options with respect to coverage in which administrative and compliance burdens are a determining factor.

One possibility is to limit the penalty on excess compensation to large corporations only. This would remove the numerous returns reflecting both compliance costs and substantial processing activity with a relatively small payoff in terms of penalty tax and anti-inflationary restraint. This approach would be reasonably consistent with a blanket exemption for unincorporated business.

Another variant would be to apply the penalty tax to corporations generally with a small business exemption. Depending in part on the level of the small business exemption, this might be substantially consistent conceptually with a blanket exemption for unincorporated enterprise. If, however, the exemption were set quite low for corporations, this might call for applying the penalty tax system consistently to unincorporated businesses above the specified exemption level in terms of receipts, payroll, or other measure of operations size. Otherwise the disparity in treatment between overlapping large proprietorships and partnerships on the one hand and small or medium-sized corporations would be conspicuous and a potential factor in inducing tax-inspired

disincorporation.

A third possibility would be universal corporate area of application. This would entail maximum compliance and administrative implementation and processing costs, particularly if it dictated, as it would tend to do, similar universal application to large and small unincorporated enterprises.

b. Universal corporate application

Universal corporate application would bring within the ambit of the penalty tax administration and compliance procedures some 1,978,059 active corporations, based on preliminary 1974 Statistics of Income data. Of this total, some 1,153,292 or 58.3 percent would have assets under \$100,000. Some 1,521,645 or 76.9 percent would have assets under \$50,000. The 58.3 percent with assets under \$100,000 in 1974 accounted for total net income (less deficit) of about \$851.7 million or less than $\frac{6}{10}$ of 1 percent of the \$146 billion total net income reported by corporations in that year. The 76.9 percent with assets under \$250,000 in 1974 accounted for total net income of about \$4.1 billion or 2.8 percent of the \$146 billion total for all corporations in 1974.

c. Universal corporate application subject to small business exemption

As the foregoing size distribution data indicate, a small business exemption could be provided in the corporate

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area which would remove some 58 to 77 percent of the corporate population from the application of the excess wage penalty provisions. This would effectuate very substantial compliance and administrative cost savings. This could be done at a cost in terms of the potential base and comprehensiveness of the anti-inflationary restraint which would be only a small fraction of the total potential. The $\frac{6}{10}$ of 1 percent to 2.8 percent figure just cited as the smaller corporations' share of the total net income (less loss) almost certainly overstates the significance of the exemption in terms of the area of active contribution to inflationary compensation increases.

A small business exemption would provide only a partial justification on equity grounds for a blanket exemption of unincorporated business. A better balance between the corporate and unincorporated sectors would probably be struck by applying a similar exemption to both.

d. Application of TIP to large corporations only

Very large savings of compliance and administrative cost could be obtained if the TIP plan was restricted to large corporations only. The exemption of all but large or very large corporations in implementing TIP could thus capitalize on (1) the familiar, pervasive factor of economic concentration and (2) the apparently strategic role of large, especially giant, corporations in the wage negotiation process in many if not most industrial categories.

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In 1974, 1759 corporations with assets of \$250 million or more accounted for:

--46.3 percent of the total receipts of all active corporations

--64.3 percent of the total assets

--63.8 percent of the total net income (less deficit)

--63.2 percent of the total corporate income tax before credits

--84.3 percent of the total corporate additional tax for tax preferences

--97.3 percent of the total foreign tax credit

--65.7 percent of the total investment credit

--74.3 percent of total dividend distribution (other than in stock) to stockholders.^{1/}

These 1759 corporations constituted less than 9/100 of 1 percent of all active corporations filing 1974 corporate income tax returns.

The aggregate coverage of these giants in terms of most business measures is impressive. If the degree and pattern of concentration were uniform in all major industrial classifications, it would be a simple matter to establish a uniform exception based on receipts, assets payroll, or similar factor. Such an exemption could exclude hundreds of thousands of smaller corporations and stave the implementation of

^{1/}The series of percentages presented here are computed from data appearing in Statistics of Income 1974, preliminary, Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 159 (1-77) Table 3, p. vi.

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TIP on a relative handful (less than 2000) of corporate giants accounting for two-thirds or more of the corporate sector, which in turn accounts for 86.8 percent of the total receipts of all U.S. business enterprise as of 1974.^{1/}

The degree of concentration varies, however, and the conditioning described by the aggregate data do not prevail in a number of industries in which wage settlements play an important role in the macroeconomy. Thus degree of concentration characteristic of the corporate aggregate does not prevail in the following major industrial divisions:

- 1) Agriculture, forestry, and fishing,
- 2) Construction,
- 3) Wholesale and retail trade, and
- 4) Services

Moreover, the pattern of distribution of receipts and other measures of activity by asset size in these major industry divisions is such that an exemption in the interest of compliance/administrative economies would have to go at least as low as \$1,000,000 assets, and

^{1/} Compiled and computed from Statistics of Income 1974, previously cited, as follows:

	Total receipts (billions)	Percent
Corporations	3059.1	86.8%
Sole proprietorships	328.3	9.3
Partnerships	137.2	3.9
Total	3524.6	100.0

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considerably lower in most cases, to achieve TIP coverage for two-thirds of business receipts (and presumably compensation payments).

Unless, therefore, the plan were to jettison effective coverage of these industrial categories and focus chiefly on mining, manufacturing, transport and public utilities, and the financial sector, it would be impossible to achieve acceptable coverage with a uniform exemption geared to exclude all corporations except those in the giant or near-giant size class.

The following set of calculations, based on 1974 Statistics of Income data, indicate the varying asset size exemption levels required to include two-thirds of corporate receipts in the four relatively non-concentrated major industrial decisions, with associated figures in numbers and percentages of exempted corporations.

<u>Major industrial division</u>	Approximate exemption level, based on asset size, needed for two-thirds coverage of receipts	Corporations exempted	
		Number	Percent
Agriculture, forestry, and fishing	\$ 396,000	43,500	80
Construction	451,000	161,267	86
Wholesale and retail trade	956,000	526,375	94
Service	143,000	323,572	83

Source: Calculated with rough interpretations from asset size distributions for all active corporation returns, Statistics of Income 1974, Preliminary, Treasury - IRS Publication 159 (1977) and p. 3, pp. 14-15.

These figures are merely illustrative. Further variations in the pattern of concentration would emerge from finer analysis. The difficulties these data point up do not, however, conclusively veto any attempt to introduce into TIP an exemption designed to save compliance and administrative costs for government and numerous smaller businesses. These difficulties, together with the consideration that a problem of inflationary compensation push may in fact exist in areas of so-called small business, suggest that the exemption approach calls for close study in formulating a detailed TIP proposal.

e. Subchapter S (tax option) corporations

The design of TIP with respect to area of application, particularly if consideration is given to excluding sole proprietorships and partnerships, must confront the issue of what to do with subchapter S corporations, which elect, pursuant to the provisions of Internal Revenue Code sections 1371 - 1379, to file on Form 1120-S and receive partnership-like treatment for themselves and their stockholders.

These corporations do not pay corporate income tax on their income, but instead have their shareholders pay taxes on it, even though the income is not actually distributed to the shareholders. Unlike a partnership, however, a subchapter S corporation is not treated

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as a conduit for tax purposes. That is, individual items of income and deduction are not as a general rule passed through to the shareholders so as to retain the same character in the hands of the shareholders as they had in the hands of the corporation. Instead, taxable income is computed at the corporate level in about the same way as it is for corporations generally. The shareholders are then taxed directly on the taxable income (or loss) thus attributed to them, whether or not the corporation actually makes any distribution of funds to them.

One exception to the "no conduit" rule just described: the net capital gain of Subchapter S corporations is attributed to them and is treated as long-term capital gain of individuals on their individual income tax returns.^{1/}

In 1974, there were 330,418 returns of active small business corporation on Form 1120-S, of which 193,161 or 58.5 percent reported net income. Total receipts of subchapter S corporations in 1974 amounted to \$122.4 billion, of which \$98.6 billion was received by those with net income. Total net income (less deficit of this group of corporations amounted to about \$3.6 billion, representing about 2½ percent of the net

^{1/}The preceding summary relies upon 1977 U.S. Master Tax Guide, Commerce Clearing House, para. 244, pp. 91-92.

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income (less deficit) of all corporations but nevertheless a substantial area of corporate business operation.

To exclude this area of partnership-like tax entities as an ancillary feature of an exemption of unincorporated business would seem to go too far in weakening the coverage of TIF as part of an attempt to achieve uniform treatment of actual and "tax-option" partnerships. If both unincorporated and corporate business were treated alike under TIF, the issue would automatically be resolved. The only remaining issue, a minor one, would be how to apply the income tax rate adjustment approach in the case of subchapter S corporations and their shareholders. The presumption would be that they would be taxed like partnerships - at the owner level under the applicable individual income tax.

f. "Deficit" corporations

From time to time in the preceding discussion, references have been made to the issue raised by "deficit" corporations. It would seem that exclusion of these enterprises from the application of TIF would weaken the effective scope of the anti-inflationary wage restraint. On the other hand, it might seem like hitting a loss corporation when it was down to impose a TIF penalty on top of an inflationary wage increase thrust upon it by forces beyond its control.

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Deficit corporations in 1974 numbered 753,928 out of a total active corporate population of 1,978,059, or 38.1 percent. Their net losses totalled about \$24.4 billion; their total receipts were about \$436.7 or 14.3 percent of the \$3059.1 billion corporate total.^{1/} Exclusion of such a large business sector for the effective scope of TIP, either by an explicit exemption based on net income or by an implicit exemption based on use of a tax penalty related to net taxable income would seem objectionable

On balance, it would seem that consideration would need to be given reaching the deficit group more effectively than by disallowing deductions which had repercussions in reducing their loss carrybacks and carryforwards. If this were done, however, the tax would have to be based on excess wages directly or a gross income equivalent.

g. Technical problems of exemption

The narrowing of the scope of TIP through an outright exemption based on size characteristics raises certain technical problems.

(1) Notch problem

One is the notch problem: the triggering of a tax penalty greater than, and possibly a large multiple of, a small size increment based on receipts, earnings, assets, or similar measure which puts the

^{1/}Comparable data for 1975: deficit corporations numbered 795,534 or 39.3 percent of total active corporations numbering 2,021,778. Net losses of the deficit group were \$26.4 billion; total receipts were \$486.6 billion or 15.2 percent of the \$3,198.1 billion corporate total. Statistics of Income 1975, Preliminary, Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, Publication 159 (1-78) Tables 1 and 2, pp. 9 and 14.

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firm within the ambit of TIF. The usual remedy for a notch problem of this type would be to limit the penalty tax to some fraction of the increment in size that triggered the tax. Without such a remedy, the forewarned business will go through various tax-pressured contortions to keep under the critical size limit, including refusing business, shifting business, contracting out in lieu of employment, and business reorganization.

(2) Multiple incorporation and other business reorganization

Business response to an exemption based on either size or form of organization would include:

--split-ups and multiple incorporation to keep under the critical size and avoid TIF

--disincorporation to take advantage of an exemption of unincorporated business

These problems argue both for (1) avoiding an exemption or keeping it small to minimize the feasible and significant area of TIF avoidance and (2) developing safeguards against TIF avoidance through obvious maneuvers, as discussed later in this report.

C. Duration of TIF penalty

The formulation of TIF immediately raises the question: How long should the additional tax triggered

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by excess compensation in a particular year persist, in the absence of any obvious correction of the excess payment position?

For example, suppose a business increases its wages by an average of, say, 7 percent in year 1, when the noninflationary guideline is 5 percent, and continues the 7 percent increase into years 2 and 3 on top of annual new increases equal to the guideline percentage in the subsequent years. Should the TIP penalty apply only in year 1 and the slate be wiped clean in year 2 and subsequent periods? Or should the TIP penalty be continued as long as the cumulative wage increases over the period since the inception of TIP are in excess of the cumulative total of the noninflationary guideline percentages? Or should the penalty tax be made subject to some arbitrary cut-off period of, say, 2, 3, or 5 years application following the initial excess compensation arrangement?

The payment of excess wages may be regarded as a one-time transgression against stability and thus taxed only in the first year or first full year. Taxation beyond that may be regarded as punitive, since inflation becomes a fait accompli after the initial creation of the excess. On the other hand, it may be contended that the tax helps contain inflation once the wage increase has occurred and removal of the tax

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after the first year may lead to further inflationary release of purchasing power.

Beyond a few years, however, it may be held that it would be best to let bygones be bygones. The drag of cumulative penalty taxes would favor "new" businesses which could start with a clean slate, and compel discontinuance of older heavily burdened operations.

The mechanics of alternative approaches to "duration" are examined under the headings that follow.

1. One year only approach

The simplest approach might at first glance appear to be to impose the TIP penalty for one year only, i.e., the year for which average compensation increases over the preceding (base) year were determined to be in excess of the applicable non-inflationary guideline standard. To illustrate in simplest terms, suppose the guideline for the year 1979 permitted an average compensation increase of 5 percent in 1979 over 1978. If an employer's wages were \$1,000,000 in 1978 and \$1,070,000 in 1979, and the \$1,070,000 was found to represent an increase of 7 percent over the prior year base, the excess of \$1,070,000 over 1,050,000 or \$20,000 would be subject to the annual penalty tax.^{1/}

^{1/}In this simplified illustration, the actual wage bill for 1978 is treated as the base from which the 7 percent average wage increase in 1979 is measured. This relationship between the current and prior year wage bills would not necessarily exist.

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In the following year 1980, if actual wages are again increased 7 percent as compared with a 5 percent guideline, the new excess wage figure would become \$21,400 (.02 x 1,070,000, i.e. 1.07 x 1,070,000 minus 1.05 x 1,070,000 or 1,144,900 - 1,123,500).

The \$20,000 excess of 1979 in effect would be expunged from the record as far as the computation of the excess wage tax base in 1980 is concerned. This would simplify record-keeping but weaken the pressure on chronic transgressors of the guideline. Thus, this approach would tend to impose a relatively mild annual penalty based on the current year excess, even though the employer had a cumulative build-up of wage increases in excess of the non-inflationary norm far greater than the current year TIP penalty tax base.

2. Cumulative excess or carryover approach

To bring continuing pressure in proportion to the employer's cumulative excess of wage increases over the guideline standard, a cumulative approach might be followed which would carry forward the excess in one year to be added to the excess if any in the succeeding year or years, until corrected or expunged by the terms of the TIP penalty tax plan.

The cumulative approach is illustrated and compared with the annual approach in the following simplified example. This example assumes a continuing

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7 percent annual increase in the average wage rate, as against a 5 percent guideline. For purpose of clarifying the continuity of developments the actual wage bill for one year is treated as equal to the base wage in computing the excess compensation in the following years, a condition which would not necessarily prevail.

Illustration 1. Comparison of cumulative and annual approaches, assuming constant annual rate of excess over guideline^{1/}

	1978	1979	1980	1981
Guideline increases	\$ 1,000,000	\$ 1,050,000	\$ 1,102,500	\$1,157,625
Employer experience	1,000,000	1,070,000	1,144,900	1,225,043
Excess wages, cumulative basis	--	20,000	42,400	67,418
Excess wages, annual basis	--	20,000	21,400	22,898
Difference between cumulative and annual basis	--	0	21,000	44,520

^{1/}Guideline = 5 percent; average annual percentage rate of wage increases = 7 percent; average annual rate of excess over guideline = 2 percent.

Suppose that the pattern of wage increases in excess of guideline was interrupted. The cumulative system would give the employer credit for this improvement in his status as illustrated below.

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Illustration 2. Operation of cumulative excess approach when excess over guideline in early years is followed by conformity or reversed.

	1978	1979	1980	1981	1982
Guideline increases (5 percent)	\$1,000,000	\$1,050,000	\$1,102,500	\$1,157,625	\$1,215,506 ¹
Employer experience	1,000,000	1,070,000	1,123,500 ^{1/}	1,179,675 ^{2/}	1,215,506 ³
Excess wages, annual basis		20,000	0	0	0
Excess wages cumulative basis		20,000	21,000	22,050	0

^{1/}Increase 5 percent over 1979.

^{2/}Increase 5 percent over 1980.

^{3/}Increase about 3 percent over 1981 (actual percentage increase required to eliminate TIP tax penalty under cumulative approach = 3.03736 percent).

Under the cumulative approach and the circumstances assumed in Illustration 2, mere conformity with the guideline in 1982 would not have purged the employer of any TIP tax liability in that year. Rather the excess would have been \$23153, i.e. $(\$1,179,675 \times 1.05)$ or $\$1,238,659$ minus $\$1,215,506$. It will be noted that mere conformity following a period of excess wage payments continues the excess wage base, increased by the annual growth rate of the wage bill. Thus the \$22,050 excess under the cumulative approach shown in Illustration 2 for 1981 is 1.05 times the \$21,000 excess for 1980. Similarly, the \$23,153 excess for 1982 cited above

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under an alternative assumption for 1982 would be 1.05 times the \$22,050 excess for 1981.

This formulation of the cumulative approach would bring continuing pressure for the employer who has exceeded the guideline in prior years not only to get into conformity on a current basis but also to dip below the guideline rate of increase sufficiently to wipe out the excess established in a prior year as now increased in dollar terms by the overall rate of growth in compensation.

It is assumed that the design of the cumulative approach would not permit negative TIP tax bases to develop, as might mathematically occur if the cumulative rate of wage increase fell below the cumulative guideline level, and that such a "negative" could not be applied to recoup TIP tax liability previously incurred in years of excess. However, a year in which wage increases were below the guideline, possibly producing a technical negative, might be used as a carryforward to be credited in a future year in which the wage increase exceeded the current guideline, possibly as a result of a catch-up type of wage adjustment.

The carryforward of credit for restrained wage behavior would automatically occur under the cumulative approach as outlined. This operation of the carryforward effect under the cumulative approach (as compared with the annual basis approach with no carryforward) is shown in illustration 3 below..

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Illustration 3. Carryforward of credit for below guideline increases against years of excess.

	1978	1979	1980
<u>Guideline increases (5 percent)</u>	\$ 1,000,000	\$ 1,050,000	\$ 1,102,500
<u>Employer experience</u>	1,000,000	1,030,000 ^{1/}	1,102,100 ^{2/}
<u>Excess wages, annual basis</u>		0	20,600
<u>Excess wages, cumulative basis</u>		-20,000	-400

^{1/}3 percent increase over 1978.

^{2/}7 percent increase over 1979.

As Illustration 3 demonstrates, the payment of a 7 percent increase in wages in 1980 following a 3 percent increase in 1979 would result in a substantial TIP tax base under the annual method in 1980 and prevent TIP tax penalty in that year under the facts assumed. Provision could be made for a limited carryover under the annual method to prevent the apparent hardship in catch-up wage settlements.

The complexity of the cumulative approach, particularly over a considerable period of years under the system in which the identity of particular employers may be altered in various ways, would be substantial.

Labor groups would of course particularly oppose a carryforward feature of the plan which had the

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effect of additional encouragement to employers to go below the guideline in order to wipe out a previous record of above-guideline wage payments and their continuing tax penalty effects .

One possible variant of the cumulative approach would entail a periodic wipeout of prior guideline experience, permitting the employer and employees to start anew without the complexities and overhanging pressures of prior above guideline or below guideline wage settlement experience.

3. Further problems in the carryover approach

It should be borne in mind that the operation of the cumulative basis or carryover approach as illustrated in the preceding section is substantially simplified by the use of a continuing wage bill on which the sequence of assumed wage increases takes effect and no other growth changes occur. In practice, the wage bill will reflect growth or decline due to causes other than productivity or inflation. Under these conditions, the cumulative or carryover process would take the form of accumulating and carrying over percentages or index figures reflecting excess wage experience of the past.

Should these percentages representing inflationary excess wage experience of the past be applied to the current wage bill without adjustment? This may be conceptually appealing; it would involve applying an x

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percent excess wage determination to wage layers which may be much larger (or smaller) due to expansion (or decline) of the business or the economic sector of which it is a part. Thus a portion of the TIF penalty tax originating in a wage settlement involving, say, \$50,000 excess wages in 1978 may be applied to a much larger amount 5 years or more later.

This may be harmonious with the economic logic of penalizing inflated wage rate increases for a lengthy if not indefinite period, including all the growth element in the current wage. But it may be difficult to justify to the ordinary observer who perceives a TIF penalty tax applied to a determined percentage of a wage bill of \$2 million, for example, in 1983 when the original wage bill from which the penalty arose amounted to only \$1,000,000. With growth due to all factors of 15 percent annually a TIF penalty tax of, say, \$50,000 based on a 1979 noncompliance becomes \$100,568 five years later in 1984 at a 15 percent annual growth rate (compounded annually); \$124,416 at a 20 percent annual growth rate; and \$224,202 at a 35 percent annual growth rate. This effect would be further compounded if there were intervening inflationary wage increases embodied in the expansion process above guideline in the years 1980 - 1984.

Some might question the propriety of a policy of applying a TIF penalty originating in an excess wage settlement in, say, 1979 to the wages of an addition to the firm's staff in, say, 1983. "Layering" or separate treatment of different vintages of an expanding staff would be complex.

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Technical problems associated with a cumulative computation under an indexing procedure are mentioned in connection with that topic in a later section of this report.

4. Fixed period of years

In the interest of simplification, achieving more impact than a 1-year penalty only, but keeping the combined TIP penalty tax within more moderate limits than under the cumulative method, a compromise approach is possible which would continue the penalty tax liability arising from a particular year for, say, 3 years, then drop that portion of the TIP penalty assessment.

This would result in a gradual build up of the penalty from a 1-year assessment in year 1 to a 3-year assessment in year 3. Thereafter a new year of assessment would be added each year and an old year dropped. The 3-year wage experience span upon which the current combined penalty would be based would be a moving period, reflecting the wage settlement experiences relative to the guidelines over the most recent prior three years.

Two different approaches are possible in applying a fixed period of years technique. The simplest would subject the excess wages as determined in year 1 to the TIP penalty tax for the next 3 (or whatever) number of years. In effect, this would merely triple the tax for one year and spread it over a 3-year period. The base in years 2 and 3 would not change in response to expansion or contraction of the previously determined layer of excess

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wages.

The other would be to apply the penalty tax in the same ways as under the cumulative approach but terminate the inclusion in the tax base with respect to any particular layer of excess wages after 3 years.

The TIP penalty tax base or "measure" under two alternative 3-year period approaches are illustrated below over a 4-year build-up period.

	Year 1	Year 2	Year 3	Year 4
Wage bill	\$1,000,000	\$1,090,000	\$1,200,000	\$1,300,000
Excess wages (percent)	2	3	1	0
(1) Simplified 3-year period approach	20,000	20,000 <u>32,700</u> ^{1/} <u>52,700</u> ^{1/}	20,000 <u>32,700</u> <u>12,000</u> ^{2/} <u>64,700</u> ^{2/}	32,700 <u>12,000</u> ^{3/} <u>44,700</u> ^{3/}
(2) Cumulative approach, 3-year cut-off	20,000	54,500 ^{4/}	72,000 ^{5/}	52,000 ^{6/}

^{1/} 2% of \$1,000,000 (from year 1) plus 3% of \$1,090,000.

^{2/} year 2 total plus 1% of \$1,200,000.

^{3/} year 2 and year 3 components of year 3 total plus nil percent of year 4 wage bill.

^{4/} 2 plus 3 or 5% of \$1,090,000.

^{5/} 2 plus 3 plus 1 or 6% of \$1,200,000.

^{6/} 3 plus 1 plus 0 or 4% of \$1,300,000.

The impact of the TIP penalty tax under the

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fixed period method would be amplified as compared with a one-year only method. The 3-year method would be milder than full cumulation but would tend, other things being equal, to call for a lower tax rate than under the one-year only method.

The question is posed whether the prospect of 3 years of application of a lower penalty rate would be as effective a deterrent to excessive wage increases as a higher rate of a single year's duration. Would it stimulate closing of business operations to escape the over-hanging TIP tax burden?

The additional penalty imposed under the three-years' duration system is less certain, although prospectively greater in a firm with a growing wage bill, under the cumulative system shown as Alternative 2 in the preceding illustration in which excess wage layers are "elastic" portions of the changing wage bill.

III. Definitional and measurement matters

This section discusses a number of central problems and issues involved in the definition and measurement of the TIP tax base and taxable unit.

A. Definition and measurement of wages/salaries/compensation and increases thereof

The definition of compensation and its various components would be expected to be comprehensive in order to ward off obvious escape hatches from the TIP tax. These definitional questions and the related compliance and administrative tasks confront virtually all forms of the TIP approach, including those which (like

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the Abba P. Lerner package) impose taxes on all wage increases without regard to excessiveness in relation to any norm.

1. Identification and valuation of compensation items

The definition and valuation of wages/salaries/compensation should include, in the absence of policy considerations to the contrary, not only money compensation payments and conventional payments in kind, but the whole range of presently known and potential new wage supplements and fringe benefits. The various pay components and factors which are to be varied and changes in which may contribute to increases in compensation rates would include, but not necessarily be limited to:

- pension and retirement benefits
- health, dental, and legal service or insurance protection
- life insurance
- paid vacations
- recreational facilities and travel
- in-house food services
- deferred compensation and deferred pay increases
- commuter travel or other transportation or moving allowances
- commission and piece rate compensation or bonus and incentive pay arrangements
- profit sharing benefits

--bargain purchase of stock, commodities, or services
--guaranteed wage arrangements
--shorter work periods
--improvement in the work environment and working conditions, and
--other compensation-equivalent or hard-to-value employee benefits.

Some of these items might prove difficult to measure and subject to considerable controversy. Specialized study and detailed regulations might be required for their valuation.

Conceptual problems would arise in the approach to certain items, such as deferred compensation or deferred pay increases.

2. Deferred compensation and deferred pay increases

Deferred compensation valued at its present discounted value might be regarded as current pay. Its receipt would not swell the flow of current compensation dollars, but it would affect the employee's attitude and spending-saving inclinations towards current pay.

Deferred pay increases differ in character from deferred compensation in that they do not become owing to the employees until work is performed in a later period in which the increases become effective. Nevertheless, they may take the place of current pay increases and loosen up spending by employees in anticipation

of future improvement in their earnings status. If the TIP tax penalty plan were to operate for an indefinite period, the deferred pay increases would be taken account of, in any event, when actually received. Thus, on balance, while the prescription would seem to be that deferred compensation should be currently recognized at present discounted value, deferred pay increases should be recognized as part of the compensation measure only when they actually materialize as current pay.

3. Allocation of group-type compensation among different components of the work force

In cases where group benefits, presumably measured on the basis of cost to the employer, are not directly attributable to a particular category of labor, some allocation or apportionment would need to be provided in calculating weighted average rates of wage-salary-compensation increase. This apportionment might be based, for example, on the ratio of other, directly allocable pay for that class of employees to the total. Or an initial apportionment on such basis might be modified in the light of the actual experience in the sharing of the flow of the employee benefits.

Since the calculation of average rates of pay increase is a vital factor in determining conformity with guidelines and the degree of excess, if any, specific attention would need to be given to this question in

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the detailed formulation and implementation of TIP. This might call for specific statutory guidance and specific statutory delegation of regulation-making authority to spell out detailed provisions for allocation and apportionment of benefits among employee classes.

4. Convenience of employer rule

The pressures of a TIP penalty tax system may bring into question some of the existing rules for determining taxable compensation, or their applicability for purposes of TIP.

One example is the existing provision that the value of meals and lodging furnished for the convenience of the employer is not income if, in the case of meals, they are furnished on the business premises of the employer and if, in the case of lodging, the employee is required to accept the lodging on the business premises of the employer as a condition of his employment.^{1/} Escape from TIF via the "convenience of employer" rule is a possibility that would need to be dealt with.

5. Travel, entertainment, personal expenses of employees, gifts, and similar items

The whole complex of present provisions relating to the deductibility to the employer and status in

^{1/} Internal Revenue Code sec. 119

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the hands of the employee of travel and entertainment expenditures, club dues, local travel, other personal expenses, gifts, and other items may need to be reexamined for purposes of measuring compensation under TIP.

Items now excluded from the definition of compensation to employees might need to be treated as compensation for TIP purposes. Excessive salaries, not now deductible by the employer but taxable to the employee as something else, might need to be examined in the light of TIP. Present rules excluding from taxable compensation the cost of the first \$50,000 of group term life insurance might call for review for TIP purposes.

The status of interest-free loans to employees in connection with fixed, periodic bonus payments, for example, would need to be explored, since the benefit from such loans is apparently not now considered taxable gain and offers a route for paying employees tax-free incentive compensation.^{1/}

Present rules permitting some bargain purchases to be treated as gifts or good will promotional expenses, not compensation, also would require review for TIP purposes.^{2/}

This brief treatment illustrates possible

^{1/}See 1977 Federal Tax Return Manual, Commerce Clearing House, para. 732, pp. 708-709.

^{2/}Ibid., para. 738, p. 709.

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technical problems. Full examination of this area is beyond the scope of this report.

6. Exclusion of non-domestic compensation

Since the scope of TIF would presumably be limited to domestic activities of enterprises, special rules would need to be developed for the segregation of wages, salaries, and other compensation related to domestic and foreign activities. These definitional rules would need to be consistent with the determination of U.S. or domestic net income to which the TIP tax penalty would apply under some formulations of the plan.

7. Measurement of certain elements of wage increase

The preceding list illustrates problems of achieving comprehensiveness in identifying and measuring compensation, allocating certain items among work force categories, and dealing with low-visibility types of compensation increase. Before moving on to the key question of calculating average rate of pay increase by indexation or otherwise, brief attention should be given to questions of valuation of certain types of compensation or increases in compensation.

a. Valuation of compensation other than in cash

The general rule of the tax law is that where services are paid for in property, the fair market value

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at the time of receipt must be included in the employee's gross income. A note received in payment for services, and not merely as security for such payment, comes within this rule.^{1/}

From the employee's standpoint, rental value of living quarters and fair market value of meals are the measure of these forms of compensation in kind (now excluded from the employee's gross income if furnished for the convenience of the employer). It is the cost to the employer, however, not the value which is deductible by him as a business expense.^{2/} This technical disparity would need to be handled in the determination of wage levels and wage increases.

If deferred compensation were treated as a current compensation increase, valuation would presumably be on a present discounted value basis, as indicated earlier. The weight thrust upon the rate of discount used and related calculation procedures by TIS would call for precise specifications.

Similar problems arise in the measurement of compensation increases involving actuarial estimates, forecasts of retirement experience, pension fund earnings

^{1/}See 1977 U.S. Master Tax Guide, Commerce Clearing House, para. 724, pp. 226-227.

^{2/}1977 Federal Tax Return Manual, Commerce Clearing House, para. 2411, p. 2109.

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and similar factors. As has been pointed out by a proponent of TIP, these questions are gradually ironed out in the process of wage negotiations. The "two sides' interpretations of the cost of a given claim or offer frequently diverge widely" in the early stages. "When the settlement is reached, the differing interpretations tend to be closer and often are in agreement. Nevertheless, these calculations contain a high degree of arbitrariness. They may involve assumptions as to future labor turnover, retirements, incidence and cost of illness, pension fund performance, and the like. They may be adequate for purposes of policing the verdicts of the Pay Board. Typically, they are not adequate as a basis for assessments of a surtax which must be capable of being audited and if necessary taken to court".^{1/}

B. Measurement of excess compensation for TIP purposes

A basic task in the measurement of excess compensation for TIP purposes is the determination of the percentage increase in the average rate of compensation. This percentage may then be compared with the guideline percentage (presumably reflecting the nationwide average increase in labor productivity) to determine conformity or non-conformity with the non inflationary norm and the extent the employer's departure (above or below)

^{1/}See Henry C. Wallich, "Phase II and the Proposal for a Tax Oriented Incomes Policy", Review of Social Economy, Vol. XII, No. 1 (March 1972), p. 3.

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from the noninflationary norm.

This discussion takes the determination of the guideline percentage as given, i.e. determined chiefly on the basis of nationwide data measuring the increase in later productivity, essentially the rate of growth of real output per person-hour or other unit of labor input. It is therefore concerned almost entirely with the procedure for measuring the particular employer's average percentage increase in rates of compensation.

1. Brief review of alternatives

The following review of alternative methods of measuring average rates of pay increase includes a number which are obviously crude or defective, chiefly as a step in clarifying the problems and defects which the more refined procedures are designed to avoid.

a. Reliance solely on percentage pay increase in union wage settlements

The simplest although not necessarily the crudest approach would be possible if the FLSI penalty tax were confined to excessive wage settlements between labor unions and typically large employers. The calculation of the percentage increase in pay in these settlements could be refined and subjected to standardizing definitions and rules. The excess of the percentage increase over a guideline standard could then be fed

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into the profits penalty tax formula, with technical adjustments called for where the compensation segment involved was only a part of the work force; used in determining and scaling the disallowance of deductions; or used in identifying and measuring the base of a special excise or payroll tax on excess pay increases. If the wage settlement involved only one category of workers, the TIP penalty tax would then be confined to this category of pay or corresponding portion of profits. Allowance would be made for increases under multi-year as against annual contracts.

b. Wage bill

The calculation of percentage pay increases based on the overall change in the wage bill from one year to another is the simplest and crudest technique. It would work well only in situations where the work force remained the same in numbers and composition from one year to another. Where growth (or decline) occurred in the work force, the percentage increase in pay would be correspondingly overstated (or understated). Similarly, the wage bill method would fail to take account of changes in the skill and pay rate mix, which would distort the result and invite tax avoidance by manipulation of the skill mix within the firm.

c. Overall average annual pay per employee

Another measure of average pay increase - one suggested by Professor Reintraub - would be based

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on the percentage change from one year to another in the annual payroll (wage bill) divided by the number of employees, or possibly by the number of man hours. This would avoid the crudities and distortions in the wage bill or total payroll method described above due to failure to take account of increases in the number of employees or similar measure of labor input. However, relying as it does on an unweighted average wage or salary, this method would register the effect of an increase in the proportion of more skilled to less skilled employees as an average pay increase; of an increase in the less skilled relatively to the more skilled, as an average pay decrease factor.

The result would be an obvious distortion, unintended inequities and penalties on firms employing an increased proportion of skilled workers, and "invitations to tax avoidance by manipulating the number of employees and the mix of skills (and therefore of average wage levels) within the firm's labor force."^{1/}

d. Weighted average or indexin' procedures

The only exact and fair method would be to measure the average annual percentage increase in pay on the basis of an average of compensation increases in appropriate employee or compensation categories,

^{1/}Wallich "Phase II and III: A proposal for a tax-oriented income policy," *Final Budgetary Statement*, previously cited, p. 8.

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appropriately weighted by man hours or other suitable units of labor input.^{1/} This approach is tantamount to an indexing procedure. Except for whatever additional complication is involved in pay and labor categorization and the related weighting procedure, this correct approach is no more complex for the standpoint of administration and compliance than the crude unweighted average annual pay method, described under the preceding heading.

The labor category, labor input, and wage data for this weighted average or indexing method is available or could readily be obtained by a rearrangement of cost data the taxpayer must prepare for income and payroll tax purposes and for its own payroll purposes.

The procedure may seem laborious on a start-up basis. Initial problems of classification on a consistent basis would arise and call for administrative clarification. However, once in operation with the assistance of automatic and electronic payroll accounting methods it should not be unduly burdensome for business to prepare or for the government to monitor and audit.

Some analysts observe that:

"any specific way of measuring the firm's average wage would undoubtedly leave 'loop-holes' or generate side effects. If the index were simply the firm's total wage bill for the year divided by its average labour force during the year the firm might shift its skill mix towards lower paid workers, since by reducing the average wage this would enable it to raise wages all around without incurring tax. But the Wallach-Heintzraub suggestion of an index aggregated from separate wage

1/ibid.

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indices for separate skill classes might induce spurious upgrading of workers".^{1/}

(1) Illustration and analysis of alternative measures

Alternative weighted average procedures are compared with each other and with the cruder measures of percentage changes in compensation in the accompanying Tables 1 and 2.^{2/}

Table 1 sets forth an example of a firm's experience in terms of total pay, labor input, and average pay, broken down by four different employee categories (hourly paid personnel and salaried: supervisory, technical-professional, and executive) for each of 3 years. The table thus provides an illustrative analysis of the measurement of changes from year 1 to year 2 (an expansionary period with substantial pay increases) and from year 2 to year 3 (marked by contraction and a reduction in rate of pay increase).

Table 2 summarizes the percentage pay increases, by employee category for year 2 over year 1 and for year 3 over year 2 shown in Table 1 and gives the results of different methods especially weighting procedures, in calculating average percentage pay increases. For convenience of reference, the average pay increase calculations in Table 2 are repeated in the lower bank of Table 1.

1/ Yehuda Schwartz and Richard Portes, "The Effect on Wage Inequality", *Review of Economics and Statistics*, Vol. 53, No. 4 (1971), North-Holland Publishing Company, p. 423, note 4.

2/ See, e.g., *Wage Indexes and Their Use*, pp. 11-12, "Weighted Average Pay Increases and their Use in Comparing Compensation in Manufacturing Industries", U.S. Bureau of the Census, Current Population Reports, Series P-60, No. 124, December 1969, p. 10, for a brief discussion.

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(1) Illustration and analysis of alternative measures

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1/Yehuda Kotwitz and Richard Portes, "The Tax on Wage Increases", *Review of Economics and Statistics*, Vol. 52 (1970), North-Holland Publishing Company, p. 177, note 4.

2/ *ibid.* p. 177, note 4. The 1970 data for the first two years were obtained from the U.S. Bureau of the Census, *Current Population Reports, Series P-60, No. 104, Income in 1970 by Age, Sex, Race, and Family Size for Families and Persons in the United States*.

Table 1. Illustration of selected alternative methods
of determining average rates of compensation increase

Classes of employ- ees	Year 0			Year 1			Year 2		
	Total pay (\$ thou)	Employee yrs (hrs) (hr)(3)	Ave pay per yr	Total pay (\$ thou)	Employee yrs (hrs) (hr)(3)	Ave pay per yr	Total pay (\$ thou)	Employee yrs (hrs) (hr)(3)	Ave pay per yr
hourly paid per- sonnel	9,000	750	12,000	10,593.0	825	12,040	10,200.5	775	12,340
salaried:	(1,500,000)	(0)	(0)	(1,650,000)	(0)	(0)	(1,550,000)	(0)	(0)
Supervisory	450	30	15,000	492.9	31	15,900	404.0	29	16,800
Tech-prof	400	20	20,000	416.0	20	20,200	309.5	19	21,700
Exec	250	5	50,000	275.0	5	55,000	332.00	5	60,000
etc.1	10,100	805	12,547	11,776.9	881	13,368	11,402	823	13,379

Selected percentage changes in given year over preceding year

total payroll	----	16.60	-2.42	-6.12
total number of employee years		9.44		3.82
average pay per employee		6.54		
average increase in pay of 4 classes of employees:				
1. Unweighted average		6.75		3.81
Index equivalent	100	106.75		110.00
2. Average wage relatives weighted by				
total pay, current year		6.92		3.71
Index equivalent	100	106.92		110.00
3. Average weighted by number of				
employees preceding year		6.91		3.68
Index equivalent	100	106.91		110.04

Note: For further detail on pay rate changes in this example and additional alternative methods of determining average increases, see Table 2.

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Table 2
 Percentage pay increases by class of employees
 (shown in Table 1 example)
 together with
 Summary of results under alternative index methods

Class of employees	Percentage pay increase year 1 over year 0	Percentage pay increase year 2 over year 1
Hourly paid personnel	7	3.89
Salaried:		
Supervisory	6	.63
Technical-professional	4	-1.44
Executive	10	9.09
1. Average pay all employees	6.54	3.82
Index equivalent	106.54	110.61
Average of four classes of employees:		
2. Unweighted average	6.75	3.04
Index equivalent	106.75	110.00
3. Average of relatives weighted by total pay, current year	6.92	3.71
Index equivalent	106.92	110.89
4. Average of relatives weighted by employee years, current year	6.91	3.685
Index equivalent (Laspeyres type)	106.91	110.85
5. Average of relatives weighted by employee years, preceding year (Laspeyres type)	6.91	3.68
Index equivalent	106.91	110.84
6. Fisher's Ideal average of relatives	6.91	3.69
Index equivalent	106.91	110.85

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Table 2 continued

Class of employees	Percentage pay increase year 1 over year 0	Percentage pay increase year 2 over year 1
7. "True" Paasche ^{1/}	6.92	3.69
Current year quantity weights	106.92	110.87
8. "True" Laspeyres ^{1/}	6.91	3.68
Base year quantity weights	106.91	110.84

^{1/}Note: Percentage change numbers for all alternatives except "true" Paasche and Laspeyres methods are, as indicated, calculated for current year over preceding year. Corresponding index figures are constructed by "chaining" back to year 0. True Paasche and Laspeyres aggregative index calculations with the year 0 base, without "chaining," are shown for comparison. The Fisher's Ideal Index is the same, due to rounding, whether computed on the basis of the Paasche-Laspeyres-type numbers or on the basis of the "true" number.

For purpose of obtaining a common denominator in computing pay per employee and the weighted averages based on amount of labor in the current year, preceding year, or both, hours of hourly paid employees were converted into employee years on the basis of 2000 hours = 1 employee year.^{1/}

The calculations underlying the results shown in Tables 1 and 2 abstract from two technical problems discussed later under separate headings: (1) apportionment of the costs of not specifically allocable employee benefits, and (more important) (2) the treatment of overtime pay.

(2) What the results show

From a technical standpoint, all the weighted average systems of calculating the average percentage increase in compensation rates give similar results both in the expansion and contraction years. In addition, since there was no marked change in the distribution of the work force among the four employee classifications, the average pay per employee (once favored by Weintraub) performed reasonably well in alignment with the more refined weighted averages. Even the unweighted average produced a result approximately in line with that of the 3 standard weighting systems and the more recherche Fisher's Ideal Index for the expansion year, but it

^{1/} 2000 hours assumes 250 working days of eight hours in the year.

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fell down in overresponding to the negative change for one employee category (technical-professional) and the very low increase for another (supervisory), not untypical events of a contraction year.

The results shown were, understandably and properly, governed primarily by the pay experience of the hourly paid personnel, who accounted for the bulk of the payroll (90 percent in year 1) and an even higher percent (94 percent) of the number of employee years, factors used as weights.

Over-all, the averaging system seems reliable as a measuring device. The choice among averaging or weighting systems would not seem to be a critical issue. The average percentage pay rise would not be especially difficult to compute once the data were assembled and organized. The data assemblage and organization tasks do not seem burdensome.

(3) Highlights of Treasury staff study of 1970

A Treasury staff study on the subject in 1970 went through the various operations involved in the determination of a compensation index for purposes of a TIP approach. The Treasury study procedure assumed only 2 categories of employees: hourly paid personnel

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and salaried personnel. It concluded that the determination of a suitable compensation index would then call for "four parts or schedules in any given return": one (A) for the determination of hourly compensation of hourly paid personnel; one (B) for the determination of per salaried personnel compensation; one (C) for allocating non-directly allocable compensation deductions between the salaried and hourly paid personnel; and one (D) for calculation of the compensation index. The Treasury staff illustration of "Schedule A" for hourly paid personnel took 2 half pages of typescript, i.e., $\frac{1}{2}$ page each for the current year and the preceding year (together the equivalent of about 1 full page). The illustration of Schedule B on salaried employees for the 2 years involved called for 2 typescript pages, each about $\frac{1}{3}$ page, and less than 1 full page together. The other two schedules C and D, required about $\frac{1}{3}$ of a typescript page each or less than 1 full page altogether. The greater length of "Schedule A" for hourly paid personnel as compared with the others was attributable to the distinction between regular hours and overtime hours worked and the calculation of a regular time equivalent of overtime at a 3 to 2 ratio assuming time and one-half for overtime, together with the apportionment of non-directly allocable benefit costs. (the latter a procedure is also called for in the processing of the salaried personnel schedule).

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The Treasury staff study determined the compensation index by means of a weighted average of the percentage pay increases for hourly paid and salaried personnel, the weighting being based on the total compensation of each broad category of personnel as a percent of the total compensation (payroll, "fringes", and all employee benefit costs for which the employer would take income tax deductions).

There is no indication in the Treasury staff study of 1970 that the procedure would be infeasible, unduly burdensome, or impracticable. This would seem to include the mechanics of data gathering and processing and related compliance tasks by the firm, such as the apportionment of non-directly allocable benefit costs and merging of regular time and overtime compensation figures. All apportionment and weighting procedures in the Treasury study were based upon the ratio of compensation (or allocable compensation) for the particular employee classification and the total compensation (or allocable compensation). Other weights or apportionment factors were not entertained.

The resulting average percentage increase in compensation was termed the firm's "compensation index", and this index was to be compared with the guideline index in determining the TIP penalty tax.^{1/}

^{1/}As will be pointed out later in this report, percentage changes computed in this way are not literally an index; they may be converted into an index by " chaining" the resulting time series of relatives to form indexes expressed as a percentage of a base reference period.

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Other Treasury staff work on the subject of TIP of the period 1970-71 seems to have been concerned primarily with the economic concept and effects of TII, including the economic aspects of design options. Specific attention, however, was given to:

--the preferability of the deduction-disallowance method over a penalty adjustment of income tax rates

--the scope of the TIP tax

--"miscellaneous measurement" problems, i.e., the need for a reasonable index construction procedure, and timing problems in the introduction and transitional phases of TIP.

(4) Apportionment of non-directly allocable employee-benefit costs

The calculation of alternative measures of average pay increases illustrated in tables 1 and 2 above assumed that the compensation figures fed into the calculation included all fringe benefits and wage supplements, including those directly allocable to the employee classification used in the averaging system. The attribution of items not directly allocable to particular employee categories necessarily involves an apportionment procedure.

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The non-directly allocable items, like others, are to be generally measured by the income tax deductions taken by the employer for these items. In some exceptional cases, part of the compensation element may be reflected in values for which there is no current cost deduction counterpart, a point discussed briefly under a subsequent heading.

The chief technical issue in the apportionment of non-directly allocable items is the selection of the basis of apportionment, i.e., the apportionment factors. The Treasury staff work on this subject relied solely on the ratio of the sum of the hourly pay or salary plus directly allocable compensation employment benefit costs for a particular employee category to the corresponding total for all employee categories. This would tend to assign more of the non-directly allocable items to the more highly paid classifications and less to the lower-pay groups. An obvious alternative would be to apportion on the basis of numbers of employees (or calculated employee years where the group includes a numerous changing population due to labor turnover).

It should be recalled that the choice of method does not affect the income tax of the employee, so no conventional question of tax progressivity vs. regressivity is involved. What is involved is the determination of the average annual percentage pay increase for the firm, affecting its TIP liability. Apportioning would tend to increase TIP liability if it attributed more to an employee group with a

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large percentage pay increase and decrease TIR liability if it attributed more to a group with a low percentage pay increase in a particular year.

The mechanics and impact considerations of alternative apportionment bases are illustrated by the following. We start with the situation shown below.

"Compensation structure and changes, excluding non-directly allocable items

Classes of employees	Year 1			Year 2		
	Number	Total compensation ^{1/} Amount	Total compensation ^{1/} Percent dist.	Number	Total compensation ^{1/} Amount	Total compensation ^{1/} Percent dist.
Hourly paid	90	810	81%	95	907	77.7%
Supervisory	5	60	6	6	75	6.4
Technical-professional	3	50	5	4	85	7.3
Executive	<u>2</u>	<u>80</u>	<u>8</u>	<u>2</u>	<u>100</u>	<u>8.6</u>
Total	100	1,000	100	107	1,167	100.0

^{1/}Total compensation excluding non-directly allocable items equal to \$40 thousand in year 1 and \$50 thousand in year 2.

The revised pay structure including the non-directly allocable items under two alternative apportionment procedures for the two years is shown below.

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A. Apportionment based on total compensation

	Year 1			Year 2		
	Allocable allocable	Non-directly allocable	Total	Allocable allocable	Non-directly allocable	Total
Hourly paid	810	32.4	842.4	907	38.85	945.85
Supervisory	60	2.4	62.4	75	3.20	78.20
Technical- professional	50	2.0	52.0	85	3.65	88.65
Executive	80	3.2	83.2	100	4.30	104.30
Total	1,000	40.0	1,040.0	1,167	50.00	1,217.00

B. Apportionment based on numbers of employees

	Year 1			Year 2		
	Allocable allocable	Non-directly allocable	Total	Allocable allocable	Non-directly allocable	Total
Hourly paid	810	36	846	907	44.39	951.39
Supervisory	60	2	62	75	2.80	77.80
Technical- professional	50	1.2	51.2	85	1.87	86.87
Executive	80	.8	80.8	100	.94	100.94
Total	1,000	40.0	1,040.0	1,167	50.00	1,217.00

C. Apportionment based on:**Total compensation**

	Total compensation			Number of employees		
	Average pay Year 1	Average pay Year 2	Percentage increase	Average pay Year 1	Average pay Year 2	Percentage increase
Hourly paid	9,360	9,956	6.368	9,400	10,015	6.543
Supervisory	12,480	13,033	4.431	12,400	12,967	4.573
Technical- professional	17,333	22,163	27.866	17,067	21,718	27.251
Executive	41,600	52,150	25.361	40,400	50,470	24.926
Total	10,400	11,374	9.365	10,400	11,374	9.365

Average percentage increase in compensation:

Unweighted average	16.007	15.823
Weighted by total compensation current year	0.436	.9.499
Weighted by number of employees, current year	7.419	7.551

(a) What the illustration shows about apportionment factors

As this series of illustrative calculations shows, the apportionment of non-directly allocable employee benefit costs on the basis of numbers of employees may produce minor but appreciable differences in impact on average rate of pay increase as compared with apportionment based on total compensation. Under the not untypical circumstances assumed in these illustrations, apportionment by numbers increased the percentage pay increase in the hourly paid category more than apportionment by total compensation. An opposite effect occurred in the higher paid classes where numbers do not weigh as heavily as total compensation. As a result, the weighted average pay increase percentage was slightly higher under the numbers apportionment method, whether the weighting was by total compensation or by numbers of employees. By contrast, the unweighted average percentage pay increase was lower by using numbers apportionment, because this apportionment reduced percentage increases for the highly paid categories more in terms of percentage points than it increased the percentage increase for the hourly paid.

It may be argued that whether the non-directly allocable benefit costs should be apportioned among employee categories on the basis of numbers of employees or on the basis of total compensation should depend in part on the nature of the benefit, whom it was intended for, who gets it, and whose compensation is implicitly enhanced by it. If the benefit tends to be greater for highly paid employees, the compensation formula

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seem more in accord with the facts. If the benefit goes more to the rank and file, the numbers formula would seem preferable. If benefits seem clearly greater for a particular category than any practicable formula would apportion to it, some allocation on the basis of facts and circumstances may be called for, the remainder being subject to formula apportionment. Perhaps different types of benefits should be apportioned by different formulas, although that would complicate the applicable rules and procedures.

In any event, the above illustration shows that some potential tax effects ride upon the method of apportioning the non-directly allocable, and the merits and demerits of the options need to be considered.

(b) Sidelight on choice of averaging method

The lengthy illustration also serves to bring out another more basic point relating to the relative effects of the averaging method. Under the set of facts and circumstances assumed here, unlike those of Tables 1 and 2, there is a substantial disparity between the average percentage increase in pay as computed under the compensation weighting and number of employees weighting system.

This disparity results from the wide differences between the percentage pay increase for hourly paid personnel, in particular, and the increases for the technical-professional and executive categories. Under a weighting system based on numbers the high percentage compensation rises for the less

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numerous but higher-paid categories were reflected less in the weighted average than under the compensation weighting system.

It is evident that the choice of weighted average as between numbers and compensation weighting may have very substantial tax consequences. The numbers weighting system is:

-- more favorable than compensation weighting to businesses with relatively high executive pay increases (or in an economic environment in which such increases predominate) and

-- less favorable than compensation weighting to businesses with relatively high pay rises for the majority of workers and lower percentage increases for relatively few but highly paid executive and near-executive personnel (or in an economic environment in which the latter pattern predominates).

(5) Treatment of overtime pay

One of the neglected issues in the detailed formulation of the TIP tax penalty is how overtime pay is to be handled in the numerator and denominator of the fraction which determines average pay for a given classification of employees.

(a) BLS - ECI Index

Overtime pay is excluded from the measurement of changes in the price of labor in the Employment Cost Index developed by the Bureau of Labor Statistics. This index measures only "straight-line" hourly earnings, including production bonuses, commissions, and cost-of-living allowances, but excluding premium payments for overtime, weekend, and late-shift

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work, also payments in kind, room and board, and tips.^{1/}

(b) Treasury staff study of 1970

Of more direct interest as a "precedent" for TIP design is a method followed in illustrating the Wallich TIP plan in the Treasury staff study of 1970. The Treasury procedure is highlighted in pertinent part below:

<u>Hourly paid personnel</u>	<u>Year 1</u>	<u>Year 2</u>
a. Total hourly wage pay	\$9,000,000	\$11,000,000
b. Regular hours worked	1,500,000	1,850,000
c. Overtime hours worked	200,000	100,000
d. Regular hour equivalent of overtime (time + $\frac{1}{2}$ assumed)	300,000	150,000
e. Total "regular" hours worked	1,800,000	2,000,000
f. Hourly wage	\$5.00/hr.	\$5.50/hr.
g. Non-wage "deductions" allocable to hourly paid personnel	1,800,000	2,200,000
h. Non-wage "deductions" per employee hour	\$1.00/hr.	\$1.10/hr.
i. Non-directly allocable deductions apportioned to hourly paid personnel	90,000	100,000
j. Apportioned wage equivalent per employee hour	.05/hr.	.05/hr.
k. Total hourly compensation (f+h+j)	6.05/hr.	6.65/hr.

^{1/}BLS Handbook of Methods, U. S. Dept. of Labor, Bureau of Labor Statistics, 1970, Bulletin 1910, p. 184.

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(c) Should overtime be neutralized as a TIP factor?

The treatment illustrated above removes overtime as a factor influencing hourly wage rates unless there is a change in the role of overtime allowance. An increase in the amount of overtime worked is offset by the adjustment in "regular" hours. This treatment would substantially remove higher wage bills and higher annual rates of pay due to increases in overtime worked from the application of TIP. Conversely, it would remove a decline in the prevalence of overtime as a factor decreasing effective rates of annual pay. By using total compensation, including dollars received for overtime, as a weighting factor attached to the "muted" percentage change in the hourly wage rate, the method illustrated compounds its effect in toning down possible application of TIP in a strongly expanding labor market.

The percentage increase in work pay in a situation involving increased overtime under different methods of calculation are illustrated below.

	Year 1	Year 2	<u>Percentage increase Year 2 over year</u>
Regular hours worked	1,000	1,000	0%
Overtime hours	0	250	
Total actual hours	1,000	1,250	25.
Total hours equivalent for pay purposes	1,000	1,375	37.5
Hourly pay	5.00	5.25	5.0
Total pay	5,000	7,218.75	44.375
Average pay per hour actually worked	5.00	5.775	15.5
Average pay per "regular" hour as computed in Treasury Study	5.00	5.25	5.0

The absence of TIP penalty on overtime as a pay increase factor may seem fair or only properly generous to the employer who pays a fixed schedule of rising hourly rates with expanded operations. On the other hand, a TIP penalty on substantial amounts of overtime raising pay above productivity-matching levels may help increase the number of employed persons and decrease unemployment by spreading the hours of work. In a situation in which a real labor scarcity existed, the TIP penalty on overtime might be a disincentive to the expansion of the effective labor supply. Overtime creates more goods and services but at a somewhat higher marginal cost; while this is one aspect of a shortage situation, the price of goods and services involved would rise less with the supply created by overtime than in its absence.

C. Indexation

This section briefly examines the question of the merits of indexation vs. more direct methods of calculating the average rate of compensation increases. It reviews some standard statistical procedures for measuring compensation levels and changes.^{1/}

1. Indexation vs. average rate of compensation increase

In the preceding discussion, the calculation of average rates of increase in employee compensation for a firm and indexation have been used almost interchangeably (subject to a footnote caveat that there is a technical difference).

^{1/}Note: The reader is referred to the additional discussion of information in Appendix A of Part I of this report.

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This manner of speaking is understandable since a mere technicality is involved. The Treasury study of 1970 referred to the calculation of a compensation-weighted average of percentage increases in pay for hourly paid and salaried employees over the preceding year as indexation. The Bureau of Labor Statistics currently publishes its Employment Cost Index "as quarterly percentage changes rather than in index form to avoid confusion caused by shifts of the reference base as the index is expanded in scope."^{1/} The BLS expects to publish these data in index form when the expansion is complete. The ECI is described as "a fixed employment, base-weighted average of changes in the rate of compensation expressed as a relative of average rates in a reference base period."^{2/}

The familiar fact is that an index number is a figure which reflects the relative change, if any, of prices, wages, costs or other variable between one period of time and another, referenced to a time period selected as the base, to which is usually assigned the index number 100. Thus, if average percentage increases in compensation are computed by a consistent, reasonable method from year to year, they are easily translatable into actual index form to a specified base year as follows:

^{1/} BLS Measures of Compensation, U. S. Dept. of Labor, Bureau of Statistics, 1977, Bulletin 1941, p. 74.

^{2/} Ibid.

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	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>	<u>Year 5</u>
Average percentage change in compensa- tion over preceding year		7	4	6	
Corresponding index (year 1=100)	100	107 ^{1/}	111.28 ^{2/}	117.96	121.50
^{1/} 1.07x100					
^{2/} 1.04x107					

Indexes are usually computed only for large aggregates such as general price or wage levels, but they may be employed by a particular firm. The chances that classification problems and any weighting system other than current year quantities or compensation totals may need to be periodically revised are greater for a particular firm, particularly a small or medium-sized one, than for the economy.

2. Would actual indexation be appropriate in applying TIP?

a. Structuring

Indexation in the liberal sense would not seem to provide any more "discipline", uniformity, or structuring in the compliance procedures of the firm than a prescribed system of calculating the average percentage increase in rates of pay in the current year over the preceding year.

b. Roundaboutness

The calculation of the average percentage increase

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in compensation rates would directly provide the figure which the firm would compare with the guideline (or feed into a tax penalty formula) to determine TIF liability. If the procedure first involved calculation of an index number referenced to a remote initial year base for the firm, the average percentage increase in compensation rates would then have to be derived from the index by the familiar translating procedure illustrated below. The index would then seem to be merely a superfluous step, making for a less convenient, roundabout procedure for getting the practical operating result, unless of course the base year was moved forward each year, so that the reference base was always the preceding year.

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>
Index	100	107	115.56
Derived percentage increase in compensation rates for current year over preceding year	-	1/ 107 100	8.02/ 107

1/
107-100
100

2/
115.56-107
107

An index number such as the consumer price index which is used for various purposes involving historical perspective and long-range comparisons between periods calls for referencing to an historical base period. This increases its understandability and convenience for most users. However, in the case of implementing TIF, the focus is primarily on the current year percentage increase in compensation rates

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which is to be compared with a conceptually compatible annual percentage rise in labor productivity furnished to the taxpayer.

c. Cumulative or carryover approach

Special considerations may arise in the implementation of a cumulative or carryover approach (as distinguished from the annual approach) in determining the application of a TIP tax penalty. If the TIP tax was based solely on one year's excess compensation (presumably then to apply for a year or period of years) without regard to the excess compensation experience of other, preceding or succeeding, years, there would be no apparent need for the historical perspective or running record that an index number affords.^{1/} If, however, the TIP tax liability is to take account of previous or subsequent years' as well as the current year's experience, would this make a difference? Would the record provided by actual indexation be more useful than the equivalent information provided by the series of annual compensation rate increases (which are after all an alternative to, and the raw material for, a true index).

Suppose, for example, the TIP specifications called for the carryover of below-guideline pay increase experience for 3 years, in order to relieve wage catch-up adjustments in a particular year that merely made up for several prior years of no increase or low rate of increase caused by an outmoded 3-year contract (or whatever). The pay rate increase percentages

^{1/} Duration of the TIP penalty tax is essentially distinct from, and independent of, the specification with regard to accumulation or carryover which has to do with crediting deferrals for prior year below guideline wages.

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for a 4 year period for a particular firm relative to the guideline are shown in the first bank of the tabular presentation below. Application of a cumulative guideline and a compensation index for the firm is shown in the second bank.

	Year			
	1	2	3	4
Average percentage increase in compensation rates over preceding year	4	3	2	10
Guideline				5
Excess:				
Annual	-1	-2	-2	5
Cumulative	-1	-3	-5	0
<hr/>				
Compensation index to year base=100	104	107.12	109.26	120.19
Cumulative guideline expressed as index	105	110.25	114.66	120.39
Excess	-1	-3.13	-5.40	-.20

The 3-year carryover of unused guideline leeway would permit the firm to be exempt from TIP liability in year 4 because the cumulative deficiency of -5 percent for the years 1-3 (-1, -2, -2) would offset the excess of 5 percent in year 4. Would the availability of a conventional index number make the implementation of the carryover principle any easier? The answer seems to be no. The carryover would be effectuated essentially by adding up algebraically the annual figures for "Excess" (guideline minus firm's average percentage increase in pay rates).

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If the index number were the starting point for implementing the carryover, it would merely have to be translated back into annual percentage figures for the average pay rate rise. Or the ceiling on pay rises in year 4, for example, would have to be expressed in terms of a cumulative rise in the firm's index over the period beginning with the earliest carryover year (year 1). The latter procedure would seem to be somewhat cumbersome and less understandable than the annual rate method. It would also give slightly different numerical results since the result of compounding growth rates which add up to a given sum will vary with their order of occurrence.

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d. Interplay of "long-play TIP penalty tax and carryover principle

How would an index serve under more complex carryover and tax duration rules? Although duration of TIP tax and the carryover principle are essentially separate concepts, there would be an important interplay if the TIP specification, for example, called for a long or indefinite duration of tax with respect to a layer of excess arising in a particular year and also a carryover of credit for years when wage increases were below the guideline. Assume the following sequence of compensation increases in relation to guideline standards:

	<u>Year 1</u>	<u>Year 2</u>	<u>Year 3</u>	<u>Year 4</u>
Firm's percentage increase	6	6	5	3
Guideline	5	5	5	5
Excess for year	1	1	0	-2
Cumulative excess (TIP penalty tax base)	1	2	2	0

In the circumstances shown above, the firm would incur TIP penalty tax based on an excess of 1 percent of payroll in year 1; 2 percent, in year 2; 2 percent again, in year 3. In year 4 its current below-guideline wage experience of 2 would wipe out the previous cumulative excess of 2 and exempt it from TIP tax in year 4 (and thereafter until a new

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excess developed.

The same experience, applying cumulative guideline and compensation indexes is shown below:

	Year 1	Year 2	Year 3	Year 4
Firm's compensation index	106	112.36	117.98	121.52
Guideline (cumulative, expressed as index)	105	110.25	115.76	121.55
Excess (cumulative)	1	2.11	2.22	-.03

Again, there seems to be no particular advantage in the case of a true index figure as against a cumulation of successive annual disparities, positive or negative, between the firm's average percentage pay rise and the guideline.

This brief analysis illustrates the operation of a possible set of TIP specifications the policy implications of which go beyond the compliance and administrative merits of indexation versus simple annual measurements of percentage pay rate increases. One effect of these specifications is relief for catch-up wage settlements. The other is both (a) relief from continued duration of a "long-play" TIP tax penalty based on cumulative alignment of wage policy with guideline objectives and (b) continuing pressure on the firm which has exceeded the guideline not merely to get in line with the current guideline but also to compensate for past excesses with below-guideline wage adjustments.

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3. Some official compensation indexes

A review of possible methods of computing average percentage increases in pay rates or constructing index numbers is outside the scope of this report. The selection of the TIP specification in this regard would call for a review of the considerable range of averaging, weighting, and indexing procedures now in use or described in the extensive technical literature. Nevertheless, a quick review of some of the existing

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compensation indexes is instructive.

a. BLS compensation indexes emphasizing measurement of change

There are a number of official BLS measures of compensation which suggest possible procedures or variations for use in a TIP program. The BLS compensation series include some 12 measures (or groups of measures) concerned with pay levels or pay changes. Of these 12, 5 place emphasis on levels of compensation; 3 are concerned with both levels and change; and 4 place emphasis on measuring change in compensation rates.^{1/} The four which emphasize measurement of change are:

- 1) Hourly compensation measures of the Office of Productivity and Technology,
- 2) Developments in major collective bargaining units,
- 3) Wage developments in manufacturing, and
- 4) Employment Cost Index (ECI), now published and in process of expansion.

None of these measures is tailor-made to provide exactly the data gathering format apparently needed on an employer basis for a TIP initiative. However, ECI is described by BLS as meeting a need "for a comprehensive measure of change in the price of labor (defined as the rate of compensation) comparable to the measure of change in the price of commodities provided by the Consumer Price Index." The BLS further indicates that "The attempt to understand and cope with inflation in the late 1960's provided the immediate stimulus to fill this gap in our national statistics."^{2/}

^{1/}See BLS Measures of Compensation, U. S. Department of Labor, Bureau of Labor Statistics, 1977, Bulletin 1941, especially Table 1, pp. 4-5.

^{2/}Ibid., Chapter 12, p. 73.

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The BLS indicates that the ECI "will provide, for the first time, a comprehensive and timely measure of changes in the rate of employment compensation, free of much of the influence of employment shifts." In addition to uses in economic trend analysis and forecasting, the BLS feels the ECI "may be of use in the formation of wage decisions by parties to collective bargaining and in contract cost escalation, as well as for those presently unforeseen uses which inevitably arise from the ingenuity of users."^{1/}

The compliance tasks which the collection of the ECI compensation data on a quarterly basis imposes on a sampling group consisting (at time of description) of some 2,000 establishments seem to be greater than those involved in compliance with TIF, chiefly because of its quarterly reporting requirement and the detailed occupational coding it calls for: some 417 occupational categories.^{2/}

b. Employee classification issue

It appears that the ECI is designed as a Laspeyres, fixed-weight index at the occupational level in order to eliminate the effects of employment shifts among occupations. The index weights remain fixed from period to period pending a major index revision, next scheduled to occur when the 1980

^{1/} Both quotations in this paragraph are from BLS Measures of Compensation, previously cited, Chapter 12, p. 75.

^{2/} See BLS Handbook of Methods, U. S. Dept. of Labor, Bureau of Labor Statistics, 1976, Bulletin 1610, Chapter 25, especially pp. 185-187.

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Census results become available.

This prompts the question whether and to what extent the use of "moving" current year (or preceding year) weights based on compensation or numbers of employees under the TIP plan, with or without fairly numerous occupational categories, would give rise to significant distortion due to shifts in occupation or classification by employers.

Table 3 below reports the results of an exploration of the effects of different employee classifications -- equivalent to an occupational shift of employees from one period to another -- on average percentage increases in compensation as computed under different averaging procedures. This simplified illustration shows that the same overall payroll, the same number of employees, and the same percentage increase in total payroll and average compensation per employee from year 1 to year 2 will be reflected in different measured average increases in the rate of compensation merely as a result of using a different method of classification of employees. The exception shown is the weighted average of relatives method using year 1 (base year) compensation^{1/} weights. Where the quantity (employee years) are constant, as assumed in the Table 3 illustration, this method merely reflects the percentage increase in total payroll.

^{1/}The reason for the classification neutrality of the year (base year) compensation weighted average of relatives is evident: the numerator of the averaging fraction calculated and the sum of the class compensation figures each multiplied by the percentage pay increase in the particular class is always equal to the total pay increase no matter what the classification method. The denominator is also the same, the base year payroll.

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The differences in the measured average percentage increase in compensation rules are not absolutely large in this example by ordinary standards. But they would have a significant impact on TIF liabilities. The difference between Classifications A and B would result in a .023 percentage point difference using year 2 compensation weights -- equivalent to a 1.6 percent impact on the TIF tax base. The difference is larger using numbers of employees as weights in this example.

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Table 3 Illustration of effects of employee classification
on average percentage pay increase

Class of employees	Employee years	Classification A		Classification B		percentage increase in pay yr 2 over yr 1
		Average pay	Total pay (thou)	Average pay	Total pay (thou)	
Hourly paid	50	\$8,800	740	\$9,680	454	10.00%
Supervisory	30	12,000	360	12,300	372	5.00
Technical-professional	10	20,000	200	20,800	200	4.00
Executive	2	50,000	100	51,500	103	3.00
Total	92	11,957	1,100	12,750	1,173	6.636
		(average)		(average)		(total pay) 6.636
Hourly paid	30	8,000	240	9,000	270	12.50
Custodial-maintenance	20	10,000	200	10,700	214	7.00
Supervisory	30	12,000	360	12,600	372	5.00
Technical-professional	10	20,000	200	20,800	200	4.00
Executive	2	50,000	100	51,500	103	3.00
Total	92	11,957	1,100	12,750	1,173	6.636
		(average)		(average)		(total pay)

Summary of results: Percentage increases

1. Average pay per employee 6.636%
2. Payroll (total pay) 6.636
3. Unweighted average pay increase

Classification A	5.500
Classification B	6.300
Excess B over A	.800
4. Weighted average of relatives

(a) Compensation year 1 weights	
Classification A	6.636
Classification B	6.636
Excess B over A	0
(b) Compensation year 2 weights	
Classification A	6.710
Classification B	6.738
Excess B over A	.028
5. Weighted average of relatives

Employee-year weights	
Classification A	7.565
Classification B	7.728
Excess B over A	.163

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Thus the increase in compensation rates from year 1 to year 2 under the average weighted by numbers of employees is 7.728 percent using the 5-class system of employee classification as against 7.565 percent using a 4-class system. The difference of .163 percentage point is equivalent to some 6 to 6.4 percent of the potential TIP tax base as determined by the differential between a 7.728 or 7.565 percent increase and a 5 percent guideline.^{1/}

c. Lessons drawn

This example shows the possibility of an employer's utilizing the classification of employees for TIP purposes to reduce his TIP tax liability. Under either the current year compensation weighting or numbers of employees weighting systems (but not the prior year compensation weighting system) as shown here, the employer could reduce his TIP tax liability by reclassifying custodial-maintenance into the hourly paid category of employees, i.e., by switching de facto from Classification B to Classification A.

In more general terms those results with respect to classification effects (not to be confused with upgrading or downgrading) indicate:

-- possible erratic results depending upon employee classification

-- inequities as between firms depending upon the classification system used and the configuration of shifts in employee composition

-- potential rewards to manipulation of employee classification for tax avoidance purposes

^{1/}.163*(7.728-5) = 6.0 percent and .163*(7.565-5) = 6.4 percent.

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-- the need for careful study of the classification issue in formulating indexation methods for a TIP initiative

-- the need for careful monitoring of firms' classification rules and practices in the administration of TIP.

-- use of the weighted average of relatives system with prior year compensation weights (or equivalent aggregative) would avoid this source of distortion, but might not be otherwise satisfactory.

D. Methods of pay increase measurement followed in past episodes of wage stabilization

Anything resembling a full review of the various historical episodes of wage stabilization and the methodology involved is necessarily beyond the scope of this report.

A study of the experience under the guidepost efforts of the 1960's has been published by The Brookings Institution.^{1/} This study, which includes a selected bibliography, reviews and appraises the guidepost concept, its evolution, and its implementation from a broad policy standpoint.

A particular practical aspect of the experience under wage-price guideposts of the 1960's in the Kennedy-Johnson Administrations and the subsequent guidelines and controls of the Nixon Administration of special pertinence for purposes of this report is embraced by the questions: How were wages (or total employee compensation) measured and rates of increase determined in applying the guideline benchmark to a particular firm or industry? What mechanisms were used in getting the required data? What were the data sources, Have new data since been developed which would better serve a TIP initiative?

^{1/}John Sheahan, The Wage-Price Guideposts, The Brookings Institution, Washington, 1967.

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In answering these questions, we leave aside the productivity measurement aspects which do not directly impinge on the tasks laid out for this report. Nor is this report directly concerned with such ancillary matters as the measurement of increases in real versus value productivity of labor in an inflationary economy or the merits and implementation of a cost of living (COLA) adjustment.

From the best sources immediately available it appears that no single DLS data series was used. Wage settlements were approached on a case-by-case basis and with a certain amount of flexibility, possibly in implicit recognition of differences in labor productivity between firms and industries which might theoretically call for individually tailored guidelines. These differences may have been allowed for by flexing the determination of the additional labor cost (compensation rate increase) which was to be compared with an inflexible economy-wide ceiling of some 3 or 3.2 percent.

1. "Costing out" collective bargaining settlements

The task involved in evaluating wage negotiations or proposed settlements was that of a "costing-out" approach, is provided sation increases involved. Information of this type, or which employs the equivalent of "costing-out" approach, is provided in the "Developments in major collective bargaining units" series on employee compensation. This is said to have been the major source relied on in the implementation of the guideposts and guidelines.

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These data, reflecting pay rate changes in cents per hour and percent, are published quarterly by BLS in Current Wage Developments. They relate to wage rates and private supplementary benefits for production and nonsupervisory workers: wages for workers in bargaining units of 1,000 workers or more and wages and benefits combined for units of 5,000 or more workers. The industrial coverage is the private non-farm economy. The BLS data are apparently developed largely from secondary sources. The BLS has described its general procedures but has never published data or formulas used in particular cases.^{1/}

Although not limited to manufacturing and not specifically cited by BLS staff familiar with guideline procedures in the past, the current wage developments series, often used to determine trends in wage and benefit changes, is pertinent.^{2/}

2. Compensation per manhour

Other BLS compensation series, which give an overall view on compensation trends and the performance of wage settlement procedures are the hourly employee compensation measures of the Office of Productivity and Technology and the average hourly and weekly earnings data for nonagricultural establishments.^{3/}

^{1/}This description is based on conversations with BLS staff and the following publications: BLS Measures of Compensation, U. S. Dept. of Labor, Bureau of Labor Statistics, 1977, Bulletin 1941, Tables 1, B-5, and Chapter 1C, pp. 63-67; and BLS Handbook of Methods, 1970, Bulletin 1710, Chapter 21, pp. 151-163.

^{2/}See BLS Measures of Compensation, previously cited, Table 1, p. 5 and BLS Handbook of Methods, Chapter 20, pp. 154-166.

^{3/}BLS Measures of Compensation, Chapter 9, pp. 60 ff. and Chapter 5, pp. 29 ff.

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3. Employment Cost Index (ECI)^{1/}

BLS staff point to the relatively new ECI series, now in process of further development and expansion, as being the best single current measure of the price of labor itself. It was not available during the period the guideposts and guidelines were in operation, but apparently would have done better in expert opinion than the other data available at that time.^{2/}

It should be noted that the ECI method for national indexation purposes involves pricing a fixed "market basket" or "package" of labor over the years and relating that package cost to a fixed base period cost, the package to be updated only at Census-taking intervals. This lengthy retention of a fixed quantity weighting would not seem to be suitable for TIP. Where individual firms' indexes are subject to relatively quick and easily ascertainable changes in the weights with the firm, each preceding year may be a new base year.

E. Definition of the taxpayer unit

The chief technical problem in the definition of the TIP taxpayer is how to treat multi-corporate enterprises in their various manifestations, including (1) ordinary

^{1/} BLS Measures of Compensation, previously cited, Table 1, p. 5 and related references.

^{2/} The ECI is described and discussed briefly earlier in this report.

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controlled corporate groups consisting of parent and affiliates largely operating in a particular industry; (2) conglomerates -- controlled groups embracing affiliates in various essentially different and unrelated industrial activities; (3) changes in corporate ownership of affiliates, including reorganizations, potentially affecting the practical definition of the TIP taxpaying unit; and (4) the exclusion of foreign subsidiaries.

1. Controlled corporate groups

a. Importance in the economy

The bulk of American corporate business activity is conducted by controlled corporate groups. Affiliated groups under common control of 80 percent or more have the privilege of filing consolidated returns under sections 1501 and 1504(b) of the Internal Revenue Code, with the exception of special categories of corporations such as certain insurance companies,^{1/} regulated investment companies and real estate investment trusts, a DISC or former DISC (IRC sec. 992(a)), certain sec. 936 possessions tax credit corporations, and foreign corporations. However, many affiliated groups do not file consolidated returns although they are now denied multiple surtax exemptions whether they file separately or on a consolidated basis.

In 1973, the latest year for which complete data are published, some 31,400 consolidated returns were filed with a total of 155,573 subsidiaries, an average of about 5 subsidiaries per return. Of the 31,400 consolidated returns

^{1/} New rules apply permitting inclusion of insurance companies in a consolidated return beginning in 1981.

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some 21,558 or 68.5 percent had net income, while the remaining 9,932 or 31.5 percent reported deficits.

The total net income of those reporting net income amounted to \$73.5 billion. After deducting the deficit totaling \$6.1 billion for the deficit group, the net income of consolidated groups overall amounted to \$67.4 billion of which some \$66.4 billion was subject to normal tax, surtax, and alternative tax.

Consolidated returns accounted for total receipts of \$1,227 billion, about 48 percent of the \$2,558 billion total for all active corporations in 1973. Consolidated return assets of \$2,080 billion accounted for 57 percent of the total \$3,649 billion assets of all corporations in 1973.^{1/}

b. Potential anomalies and inequalities: TIP tax shelters

Since a corporate group under common control of 80 percent or more is in effect a single, albeit complex and possibly diverse enterprise, the prescription should apparently be, particularly if it is consolidated for corporate income tax purposes, that it should be treated as a single taxpayer for TIP as well. However, there might be difficulties and drawbacks in treating the consolidated return enterprise differently from a non-consolidated group in essentially the same posture with regard to TII. In a large corporate group, excess wages for the whole enterprise might be the result of a large excess

^{1/}Data in this section compiled and computed from information presented in Statistics of Income 1973 Corporation Income Tax Returns, Department of the Treasury, Internal Revenue Service, (Publication 16 (11-77) Table 2, p. 14 and Table 17, p. 145.

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in some parts of the multi-corporate organization only partially offset by small increases (or TIP "negatives") in other parts. On the other hand, situations would exist where large excesses in some of the corporate segments might escape TIP restraint or liability because other segments had small compensation increases.

Affiliated groups may have net income while some corporate members of the group have deficits; on the other hand some members may have net income which would be submerged for tax purposes if offset against deficits of other affiliates.

c. Labor-management strategy

Glaring disparities and anomalies of this character might seem more striking and unjustifiable if the controlled group was conglomerate in character. Upward pressure on wages in a particular industry would not be fully contained by TIP if large units of the industry were part of larger industrial conglomerates which in effect gave them a substantial cushion if not complete shelter. The inequity would appear striking to independent competitors forced to pay TIP as a result of wage settlements forced upon them in part because the conglomerate-held segment of the industry was TIP tax-sheltered and did not have the TIP incentive to resist "excess" wage settlements.

Other possible effects merit attention. Would labor unions follow a strategy of first applying pressure on an industrial unit surrounded and protected by its conglomerate affiliates in other industries, a settlement in this soft spot thus weakening the position of others actually subject to TIP? What other impacts on, and distortions of, labor-

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management economic incentives and strategy would occur under TIP?

d. Interplay with form of tax

Excess wages appearing only in a particular segment or subsidiary of a consolidated group (generally in conformity with the guideline) treated as a single enterprise might result in a penalty tax on the net income of a much larger whole if the TIP tax penalty took the form of an adjustment of the corporate income tax rate. This effect is one aspect of the general problem of potential disparity between excess compensation and the TIP tax base. It would be avoided under TIP plans relying upon disallowance of deductions and similar tax penalties which singled out the excess compensation as the TIP tax base.

3. Discrimination depending upon consolidation versus non-consolidation

If the TIP penalty tax took a form which resulted in a larger penalty on a given excess wage in the hands of a consolidated group than in the hands of a separately filing corporation, there would be a tax incentive to file separate returns, possibly great enough to override existing tax advantages of consolidation. Deconsolidation might result. Or in some situations corporations might arrange to reduce control over certain affected subsidiaries below the critical 30 percent figure in order to segregate their TIP tax problems from the rest of the enterprise.^{1/}

^{1/}See: Opportunities and Incentives of Consolidated Reporting, a paper of technical fact by Robert L. Gitterman, Chairman of the Committee on Reporting, American Accounting Association, 1970. The paper discusses opportunities for consolidated reporting and reporting by affiliated corporate groups for tax purposes.

The reverse type of tax differential might occur where a separate corporate business incurred TIP penalty which would be avoided by achieving "shelter" within a corporate family. This would tend to encourage affiliation and/or consolidation.

f. Possible mandatory consolidation

To combat deconsolidation, relinquishment of troublesome subsidiaries, and discrimination between separate and consolidated filing, it might be possible to make consolidated returns mandatory for TIP purposes. This would seem a rather heavy and cumbersome step, however.

g. Separate filing for TIP purposes

Another alternative to deal with the unintended side effects would be to apply TIF on the basis of each separate corporation, whether filing on a consolidated basis or separately for corporate income tax purposes. This would be easiest if the TIF tax applied to the wage deduction or excess wages as such rather than as an adjustment of the rate on the net income, since separate determination of net income of consolidated subsidiaries is difficult and subject to distortion.

Making the TIP taxpayer unit the corporation would do several things helpful to TIP administration:

-- eliminate discrimination between multi-corporate and unicorporate organizations

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-- remove possible TIP tax incentives to consolidate, deconsolidate, disengage subsidiaries, add subsidiaries, and the like

-- avoid the distortions and side effects previously mentioned owing to the mingling of different businesses in different excess wage postures

-- neutralize the whole issue of the comparative treatment of conglomerate and non-conglomerate multi-corporate enterprises

There would remain a possible problem of TIP tax incentives and distortions due to the possibility of marshalling labor assignments among members of the multi-corporate family. A related problem would be the appearance of inequity or hardship if a particular corporation incurred TIP penalty although the corporate group to which it belonged would not. The claim would be made that the TIP penalty was an accident of disaggregation. The pressures encouraging consolidation or deconsolidation under the consolidated approach might reappear here in the guise of tax choice problems affecting separate incorporation versus disincorporation.

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2. Conglomerate problem

Should an exception from the generally applicable rules for defining the TIP taxpayer unit be made for conglomerates? How should a conglomerate be defined for purposes of such an exception?

It seems superficially attractive to separate out the various non-homogeneous industrial components of multicorporate conglomerates to prevent "hiding" or "sheltering" excess wages in one industrial category under the more moderate wage increases arrived at in other industry components. There are certain obvious answers to this approach:

- 1) There are unicorporate conglomerates or near conglomerates. They would get the same TIP shelter for some components as the multicorporates but would be hard to divide into separate TIP taxpayers.
- 2) Multicorporate corporate conglomerates could escape heavy TIP liabilities by reorganizing on the division basis.
- 3) Multicorporate giants may operate a considerable range of businesses, involving different wage negotiations, although not quite as heterogeneous, variegated, and unrelated as the more recent conglomerate ventures. Traditional parts of the economic landscape, they might avoid or resist a definition as conglomerates for TIP purposes.

The whole problem of sheltering certain wage guideline excesses under the good behavior of other corporate members of a multicorporate conglomerate consolidated for TIP purposes (or of other industry components of a unicorporate heir to a previous multicorporate conglomerate complex) actually stems from the implicit assumption that the TIP tax penalty is determined on a business-wide basis.

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If the conglomerate or near conglomerate problem is deemed serious, the assessment of excess wages could be determined on a sectoral basis, with or without averaging of compensation rate increases for the skill mix of a particular sector. The penalty could be applied directly to, or based on, the excess for that sector. There would be no "spillover" of penalty on the entire earnings of the whole enterprise. The application of this rule as an exception to the general averaging system of calculating compensation increases could be narrowed down further, if desired, by limiting the separate-sector approach to conditions in which there was both:

-- substantial industry code disparity between the industry components involved

-- a marked difference between the rate of compensation increase in one industry component as compared with the rates of increase in the rest of the business.

The remedial approach suggested would not necessarily be limited to multicorporate conglomerates. It could be applied on an establishment or division basis for the unicorporates.

Problems of achieving consistency between current year and preceding year (base year) experience could be resolved if necessary by using current year labor quantity or total compensation weights in arriving at the average increase in compensation rates over the prior year.

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3. Changes of corporate ownership of affiliates.

Changes in the composition of the affiliated corporate group due to acquisition or divestment of control of of subsidiaries presents several possible problems:

-- acquisition of affiliates with "good" wage settlement experience to average against, and wipe out, excess compensation in others,

-- acquisition of affiliates confronted by a substantial TIP liability by a corporate group with a margin of wage increases below guideline level in order to offset the new affiliate's excess

-- disposition of shares below a controlling interest level, of affiliates which might subject the enterprise to a TIP tax penalty that might be avoided or reduced if the affiliates were segregated for TIP definitional purposes, and

-- possible difficulties in establishing consistency in the definition of an enterprise as between current and preceding years.¹

Most of these "problems" may be dismissed as part of the inevitable process of economic adjustment to a changing tax environment and not seriously damaging to the essential integrity of TIP.

Some may be dismissed as non-existent or dependent upon a particular formulation of the TIP tax. For example, disposition of "control" of an affiliate with an impending excess wage situation would not necessarily reduce the economy-wide TIP tax liability except under specific structural assumptions, e.g., that the TIP tax is imposed as an adjustment of tax rate on net income and the affiliate has little or no net income. If the TIP tax were imposed on each corporation rather than on the multicorporate controlled group and on the excess

¹/note: The reader is referred to the discussion of technical factors affecting TIP liability under Appendix B, combined report for affiliates in Exhibit 1, pp. 101-11 of this report.

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as such, the "problems" of acquisition and disaffiliation would disappear.

Assuming the TIP tax formulation to be related to the multicorporate controlled group as the taxpayer unit and the tax to be applied as a rate adjustment on net income (i.e., assumptions making the system most vulnerable to this kind of manipulation), measures could still be developed dealing with all of these taxpayer maneuvers if this were considered important. For example, a multicorporate entity in year 1 might be considered to remain intact for TIP tax purposes in year 2, disregarding acquisitions and divestments for the next year or two.

If the legalities prevented this remedial approach, special tax sanctions might be imposed on corporate acquisitions or divestments to avoid tax. For example, a TIP tax supplement might be imposed equal to the TIP tax avoided by the corporate reconfiguration. Such a rule might be extended to cover property transfers between corporations which entailed corresponding shifts in employment. A precedent for the latter approach is the present section 269 of the Internal Revenue Code which disallows deductions, credits, or other allowances obtained as a result of acquisitions of corporate control or property of another corporation made, directly or indirectly, to evade or avoid income tax.

Still another approach would be to raise the percentage ownership and control test from, say, 30 to 100 percent in the

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case of acquisition and lower it from 80 to, say, 60 or even 50 in the case of divestments which substantially affect TIP liability. Such adjustments of the control test for TIP purposes would be temporary - effective for two or three years following the initial change of ownership. This would not remove the possibility of acquisition and disposition of corporate subsidiaries to manipulate the TIF tax base, but it would make it more difficult or impracticable by ruling out transactions involving a small margin of control around a preexisting percentage such as the present 80 percent test for consolidated returns.

4. Foreign subsidiaries and branches

a. Subsidiaries

The treatment of foreign subsidiaries for purposes of TIP should not be difficult. They would be excluded since they represent a segment of the corporate groups business which is outside the U.S. domestic economy, the stability of which is the concern of TIP and with reference to which the TIP guideline would be developed. No technical or administrative problems seem to be involved in this specification, except for minor ones such as (1) the policing of possible payroll switches at the executive level between foreign and domestic subsidiaries,

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and the (2) semi-technical question whether dividends representing repatriated earnings of foreign subsidiaries should form part of the TIP tax base, if the base were corporate net income.

b. Branches

Exclusion of foreign subsidiaries from the corporate group for purposes of TIP presents the issue of comparable treatment of foreign branches of U.S. enterprises. The familiar general rule of U.S. income tax law is that a domestic corporation is taxed on its worldwide income. In this treatment, no distinction is made between income from sources inside and income from sources outside the United States. U.S. tax on foreign income may be reduced by the foreign tax credit (for foreign income tax paid on foreign branch earnings).

Within the spirit and concept of the exclusion of the segment of foreign economic activity represented by foreign subsidiaries, there should be a similar exclusion of the branch activities, payroll, and income from the determination of TIP. Since a foreign branch is more of an integral part of the domestic corporation for accounting and tax purposes, there might be some difficulty in such a disaggregation. However, the problem does not appear to be substantial, particularly since the major focus of the disaggregation would be jobs and

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payroll.

c. Western Hemisphere trade corporations

At least part exemption would also seem to be appropriate for Western Hemisphere trade corporations, which - although domestic corporations - do all of their business, other than incidental purchases, in North, Central, or South America, or in the West Indies and, among other tests, derive 95 percent of their gross income over a given 3-year period preceding the taxable year from sources outside the United States.

To the extent these corporations have payrolls for employees located outside the United States, they should be exempt for TIP. Whatever employment base they have in the United States should apparently be subject to the usual TIP restraints on economic compensation increases.

d. Constructive taxable income from related foreign corporations

"Constructive taxable income from related foreign corporations", a portion of the net income base of domestic corporations presumably should not be a part of an income base to which a TIP tax adjustment should apply. Such income amounted to \$3.1 billion in 1973.^{1/}

^{1/}The published figure consists of the sum of (1) includable income from Controlled Foreign Corporations and (2) foreign dividend income resulting from foreign taxes paid. See Publication 14, 1973 Corporation Income Tax Returns, Dept. of the Treasury, Internal Revenue Service, Publication 1C (1977) pp. 14, 157, 162-163, and related refs.

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F. Timing problems

The formulation and implementation of a TIP plan entails a variety of technical design and administrative issues that come under the general rubric of "timing". These include provisions for (1) start-up and transition questions, (2) nonconterminous tax and wage contract years, (3) preexisting and multi-year contracts, (4) new firms and defunct firms, (5) catch-up wage settlements, and (6) coordination of guideline determination, measurement of compensation increases, and the timing of tax payment.

1. Start-up and transition problems

This discussion first outlines the problems and unvarnished criticisms, then offers constructive solution approaches.

a. Effective date of plan

A TIP plan, like certain other tax proposals which are likely to elicit advance adaptive behavior by affected taxpayers once they are put on notice, involves the problem of the "effective date." Unless the effective date is actually set as of the time the proposal is submitted to, or at least when introduced in, the Congress, business and labor representatives may take advantage of the delay to work out anticipatory wage settlements. If all wage payments or increases are treated alike for TIP purposes, regardless of the date of the wage settlement or contract, the problem of preadaptive behavior would not be serious

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unless there were protracted Congressional consideration which permitted wage increases to be put into the initial base year. Thus, the main design issue here -- one of importance to the immediate effectiveness of TIP -- is whether compensation increases pursuant to one-year, two-year, or even three-year wage contracts (sometimes with scheduled year-to-year pay rises) entered into prior to the actual effective date should be given blanket exemption in the determination of excess compensation for purposes of TIP.

b. Preexisting contracts and "catch-up" settlements

Apart from the problem of anticipating wage settlements designed to "jump the gun," whenever a TIP plan is introduced it will of necessity make its debut in the midst of pre-existing labor contracts. Taxpayer firms will have no control over scheduled pay increases under contracts entered into prior to the effective date of TIP.

Would it be fair and legally acceptable to treat wage increases pursuant to prior contracts in the same way as others? Would it be feasible to distinguish on the basis of date or the facts and circumstances between (a) contracts entered into technically before the effective date of TIP but actually consummated in contemplation of the legislation and (b) those entered into before TIP was publicly presented and discussed?

Where preexisting contracts cover a number of years, their renewal would often tend to involve some

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belated recognition of prior years' inflationary impact.

The renewals would thus embody "catch-up" increases both to put the new wage schedule on track and possibly to recoup some of the accumulated deficiency of the run-out period under the old contract.

As a matter of prudent strategy it would appear appropriate to minimize exclusions on the basis of equity for corrective catch-ups or lack of notice to prior commitments and to resist provisions for special administrative or discretionary relief. The number of hardship cases would not justify opening the door to claims for relief based on unwritten agreements, implicit understandings, and the like.

c. Start-up data requirements

Even if a prompt effective date is secured so that taxpayers cannot claim they were not put on notice, some analysts have suggested there may be the problem of having insufficient information from tax returns or internal business payroll accounts to put the plan into immediate operation. Some argue that ordinary accounting data on total compensation and corresponding numbers of hours or equivalent employee years may not be enough to permit systematic, consistent calculation of rates of compensation and the resulting weighted average or index figure.^{1/}

Some lapse of time would occur, they contend, before the data collection system required could be mounted and put into reliable operation. Data for the year prior

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to the first taxable year would be needed on a reliable basis to measure the first increase. Unless the first "prior" year data were obtained for a period with respect to which the taxpayer and labor did not have an opportunity to "jump the gun", the plan could start handicapped and bearing the onus of actually accelerating wage increases that otherwise would not have materialized so early and under such artificial tax stimulus both to get increases in early without penalty and to establish a high initial base.

Such critics contend that unless a preemptively-early effective date and relatively simple data requirements are made part of the plan a wave of large wage settlements may be made during the anticipatory start-up period.

d. New companies

Critical analysts point out that start-up problems of the type described for the initiation of the system will be renewed in part (and with variations) on a small scale every time a new firm is born. The new firm would not have a payroll or payscale record. It would almost automatically seem to enjoy a first year of exemption from TIP tax. The advantages of "newness" under TIP might thus encourage the formation of pseudo-new firms that would emerge as the result of mergers, reorganizations, transfers and reincorporation of

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chunks of operating properties of old firms, and similar types of occurrences. Effective administration of a TIP tax penalty plan would call for a method of identifying the false or old-new firms and applying suitable TIP tax restraints in these situations.

e. Defunct companies

In the case of companies going out of business, the technical problems do not appear significant. The payroll, payscale, and earnings records would be available for use in applying TIP in the same way as for ongoing enterprises. There may be deterioration of the continuity and general discipline of operations, including accounting, however. There may be low or negative earnings.

If, however, the wage increase experience of the outgoing firm is taxable under TIP - indeed the excess wage adjustments may be a factor in its demise - the major technical problem would seem to be how to assure collection of the overhanging TIP tax liability. The collection task would probably be more difficult if there were no concomitant income tax liability, but the collection problem would not seem essentially different from that encountered in collecting manufacturers excise tax or payroll tax from defunct enterprises, except for the fact that final TIP tax determination may lag (like income tax calculation) until after the taxable

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year is closed.

f. Coordination of guideline determination, excess compensation calculations, and timing of tax payment

Some attention should be paid to the relatively straightforward and readily soluble questions involving the sequential timing of guideline formulation, excess wage calculation, TJP liability determination, and TIP tax payment.

1. Prompt availability of guideline standard

The initial task of timely determination and promulgation of a guideline for a particular year or time period should not impose much of a burden on the government. Guidelines based on productivity would tend to change only slowly and slightly in any year. If a COLA adjustment were to be embodied in the guideline, somewhat greater suspense might be involved in the periodic declaration of a guideline figure for use in the ensuing year.

2. Provision of guidelines for "straddle" periods

There should be no problem in the fact that tax years of various non-calendar year basis taxpayer would straddle any promulgation date designed for the calendar year return. Guidelines for a particular 12-month period during which different guidelines were in

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effect would be readily constructed by proration. For example, if a 4 percent guideline applied for one calendar year and a 5 percent guideline the next calendar year, a fiscal year taxpayer whose year ended June 30 would calculate his guideline at 4½ percent ($6/12 \times 4 + 6/12 \times 5$).

Non-conterminousness of tax years and wage contract years should not constitute a compliance or administrative problem. TIP would apply to compensation payments within a tax year, regardless of the contract period, as noted later.

3. Current Tip tax payment

a. Avoiding lagged and perverse timing

The TIP tax penalty would probably be most effective if paid concurrently with the excess compensation payments themselves. The penalty for above-guideline wage contracts would seem to be brought home with greater force and reality if not delayed or obscured by a mere accounting accrual procedure. Periodic payment rather than a lump-sum payment system would seem more orderly and less disturbing to the firm's cash-flow planning and the financial economy at large. The desired incentive effects would be weakened and an apparently perverse timing of the TIP penalty tax would occur if a year of inflationary wage behavior went by untaxed only to be followed by a year of noninflationary compensation during which a lagged TIP tax bill came due.

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b. Integrating TIP with income tax current payment system

To achieve concurrent payment and avoid perverse and disorderly lagging, the firm might be called upon to estimate TIP tax liability, if any, early in the tax year. Declaration and payment of estimated TIP tax might be integrated with the current payment system for corporate income tax. This would in general require that at least 80 percent of the tax be paid on four quarterly payment dates, followed by a clean-up payment at time of filing the corporate income tax return. The usual penalties for underestimation, which are moderate but sufficient to exercise a salutary incentive for accurate estimate and timely payment, might cover TIP tax as well as income tax.

2. Evaluation and constructive solutions

The litany of problems and issues in the area of timing, particularly those relating to data availability, new firms, and non-conterminousness of wage contract and tax years, may support the impression that TIP would be an "administrative nightmare", that it would put an "already overworked" Internal Revenue Service in the position of having to administer a complex and difficult form of wage control.

Such an impression would be incorrect. Some of the problems listed prove on examination to be minor. The TIP tax structure, including its start-up and timing phases, is quite workable. Although it has its incremental and base period features, traditionally anathema

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to old-line tax administrators and theorist, TIP would be considerably easier to formulate, comply with, and administer than other special forms of taxation such as the corporation excess profits tax. Yet TIP would perform a substantive anti-inflationary incentive function with little or no damage to the economy while the essentially symbolic excess profits tax tends to create incentives to waste which palpably aggravate inflation.

a. Simplified operation in start-up year

If the start-up year presents problems because available prior base year data are not exactly in line with the employee classifications and comprehensive definitions of compensation required in full operation, provision may be made for measurement of average rates of increase in compensation on a simplified basis, consistent as between base and current years, until collection and retrieval of data on the standard basis becomes feasible.

b. New companies

Specific relief for new companies could be extended by methods roughly analogous to those provided under the excess profits tax of the Korean war period (Excess Profit Tax Act of 1950). The concept underlying this relief was to compensate for new companies' lack of an earnings base by giving them a liberalized

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alternative invested capital return base.

In brief compass, the relief in question included:

-- a special liberalized allowance for new capital generally (for old and new corporations) at a rate of 12 percent in computing the invested capital base (limited in its practical scope to corporations with invested capital above \$ 5 million since 12 percent was allowed anyway on the first \$ 5 million of invested capital), and more specifically,

--an industry average rate of return for use in developing an alternative base period net income available to new corporations only, including corporations which began business during the base period and to corporations which began at a later date.

The excess profits tax legislation took care to exclude from the average rate of return alternative:

--corporations which merely acquired the assets of an old corporation in reorganization transactions and which therefore had a base-period earnings record made up of the combined experience of the predecessor and successor corporation

--certain "ineligible corporations" whose assets were presumed to have been transferred from an old to a new new corporation in order to obtain the benefits of a ^{1/} comparatively large industry average rate of return.

The analogous approach to provide new companies with a base by which to measure excess compensation even in the first year of operation under TIP would be to allow them an industry average pay scale with which to construct their base period average rate of pay (using weights related to their current year employment or payroll).

^{1/}See Dan Throop Smith, "Role of Invested Capital Base in Excess Profits Taxation," in "Symposium on the Excess Profits Tax," National Tax Journal, Vol. IV, No. 3 (Sept. 1951) pp. 210-211; and Eugene E. Oakes, "General Relief under the Excess Profits Tax," ibid., pp. 230-231.

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Unlike the situation under the excess profits tax relief described, the application of this industry average pay approach under TIP is not relief but the provision of a fair alternative to effective exemption from TIP in the first year. Absence of such a feature might open the floodgates to formation of old-new businesses.

Even with the application of an average payscale base for new companies under TIP, it might be desirable to exclude (1) companies formed from reorganization which actually had a previous payroll experience and (2) the "ineligible" businesses whose assets were transferred from an old to a new corporation in order to obtain the benefits of a comparatively high industry average rate of pay. The pressure on new company rules of this type would probably be less than that on the excess profits tax safeguards of the early 1950's. On the other hand, absence of this whole sub-structure of rules designed to serve in lieu of a de facto exemption of new companies would constitute a severe weakness in the TIP plan.

c. Making non-contiguous wage contract and tax years compatible

The fact that wage contract and tax years are not conterminous does not seem to be a serious stumbling block. Tip would not apply to wage contracts as such. Rather it would rest upon a comparison of actual average

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rates of compensation increase with a specified productivity-based guideline percentage. If a wage contract affects wage levels or increases for only part of a year, its results will nevertheless be recorded in the wage experience for the year in the same way as would the results of any other factor influencing wage levels during only a fraction of the year. The average rate of pay increase under TIP would be calculated from the facts, as shown by the company's records, not by the percentage increase figured in announcing the terms of a wage settlement.

d. Relief for predetermined pay increases and catch-up wage settlements

Relief for predetermined pay increases is a policy issue. It may well be argued that predetermined pay increases like any other should be part of the TIP tax framework. Particularly if a cumulative approach was followed in applying TIP on the basis not only of the current year but also of the prior record over a considerable period of years, it would seem inappropriate to ease the pressure in favor of a long-range noninflationary compensation policy by creating a predetermined pay increase as though it had not happened.

Catch-up wage settlements are in a different category, since they would represent the consequence of a current wage settlement reached in full knowledge of the existence of TIP. The conclusion seems unavoidable

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that such settlements should constitute a recognized pay increase for TIP purposes, even spreading them over a forward period equal, say, to the previous contract period for which they are supposed to represent a kind of retroactive adjustment, has relatively little appeal and merely adds a conceptually simple but moderately burdensome complication.

IV. Specific problems of administration and economic impact

The discussion in this section touches very briefly on a list of potential problem areas, including avoidance/evasion, hardship, and adverse economic impact. The analysis seeks to avoid excessive overlap with the previous treatment of these topical areas in section III and to emphasize constructive solutions. The discussion will sometimes merely demonstrate that certain so-called problem areas are in fact minuscule or are automatically handled by preferred design options.

A. Tax avoidance and evasion

1. Concealment of fringe Benefits

One form of avoidance or evasion is the creation or concealment of fringe benefits in forms that:

- tend to escape notice
- lend themselves to undervaluation
- involve tax deductions that are ostensibly for other types of business expense

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-- are based on private contracts with employers that involve no current tax deduction for cash payment or accrual of employer liability but are valuable compensation, e.g., deferred compensation or deferred compensation increases.

This form of escape may range from crude under-reporting of pay or disguising it as something else to more sophisticated methods of providing invisible or undervalued fringe benefits, e.g., travel and entertainment that is more for the benefit of employees than for customers or working conditions, health care, recreational facilities, improvements in the terms of retirement, working rules, etc.

Those that affect executives or owner-officers may call for sophisticated scrutiny of the firm's operations and accounts. Those that affect large numbers of employees, such as health insurance or retirement benefit sweeteners or shortening of hours for the same pay, would seem less susceptible to concealment.

2. Upgrading of employees

One of the most commonly employed methods of avoiding pay freezes and similar controls is to upgrade employees. Pay scales remain constant, but employees move from lower into higher paid classifications without corresponding changes in their duties or work performance. If these changes are challenged, personnel officials may argue that the previous classification was in error and the new classification merely gives the employees affected the higher pay they were entitled to in the first place.

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It is possible that upgrading in terms of real pay may occur in cases of nominal downgrading of employee classification, so that overtime computation, for example, and other factors may actually give the employee a higher paycheck without increasing the calculated average rate of pay for TIP purposes.^{1/}

There is no easy answer to upgrading as an evasion technique. Detection of its occurrence on a significant scale may be assisted by symptoms such as increase in average pay per employee or unexplained changes in the relative numbers of employees in the various classifications without corresponding changes in operations.

Conceivably there may be situations in which employees are downgraded, for example, to correct or reverse previous upgrading or to achieve adjustment to economic pressures calling for retrenchment. With a weighted averaging system, the substantial pay decreases would not be reflected in computed averages or index figures. The policy question is posed whether relief should be provided. Factual evidence the reverse of that used to detect upgrading might be used to qualify for relief.

3. Fictitious overtime and manipulation of differential shift pay

One possible escape technique would be to pay for overtime that was not performed. If average pay per hour was the measure of pay rates, the average pay might be

^{1/}In the case of overtime pay, the result for TIP purposes would depend upon the adjustment or lack of adjustment of hours worked for the overtime factor in calculating the average hourly compensation, as discussed earlier in this report.

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affected by the real increase in compensation. By this device would be reflected in increases in average pay per employee, especially in the employee classification involved. Audit techniques could be systematized to identify this kind of avoidance by watching increases in pay per employee and increases in pay in relation to physical output.

Manipulation of differential shift pay (night pay, late shift, etc.) might offer similar opportunities for camouflaging pay increases that would call for similar audit and detection techniques.

4. Corporate reorganizations and transfers into "new" businesses

If no reasonable basis was provided for calculating a constructive average percentage increase in compensation for new companies, they would in effect be exempt from TIP until their second year of operation. The constructive base period wage for implementing TIP in the first year of operation of bona fide new companies would almost necessarily be calculated with reference to an industry average pay scale developed by regulations pursuant to statutory directive and authorization.

Allowing one year of effective exemption from TIP would of course encourage a spate of "new" company formation through reorganization of old companies or incorporation of property transferred out of old companies. Even a constructive base period compensation calculation such as that described above might lead to formation of "new" companies whose actual

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pay levels had been lower than the constructive base, who were faced with TIP liability, and who could reduce or eliminate TIP liability by substitution of a constructive first-year pay scale.

Suggested solutions:

- 1) Exclude or restrict companies formed by reorganization of old from full use of the constructive base period pay scale for new companies
- 2) Require such companies to employ their actual base as carried over from their prior history.
- 3) Apply similar restrictions to new companies formed substantially on the basis of transfer of productive properties from old companies.

5. Sale or transfer of a subsidiary between multicorporate groups (or acquisition of independent corporations)

TIP tax considerations may motivate sale of subsidiaries from one corporate complex to another (or acquisition of independent corporations) where the over-all excess compensation computation by the acquiring corporation would permit absorbing the subsidiary's compensation excess otherwise taxable under its former ownership. This statement of the problem implicitly assures that the affiliated group is the TIP tax computation unit, since the offsetting of a subsidiary's excess against a group's margin of safety under TII would not occur if the particular corporate entity were made the TII calculation unit. This particular problem is of course quite separate and distinct from that of the old-new company, since it does not involve taking advantage of new company treatment but rather exploits

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the advantages of averaging within the framework of a corporate group with over-all favorable compensation guideline performance.

It would seem the better part of valor to tolerate this relatively harmless form of TIP tax avoidance. If preventive action were deemed desirable, a possible approach would be to place individual corporations transferred into an affiliated group on a separate TIP taxpayer basis for the first year. Thereafter, the new affiliate might be merged, along with its post-acquisition compensation experience, with the group for TIP purposes.

6. Switches of employment to "deficit" subsidiaries

The problem might arise of switches of jobs to "deficit" subsidiaries. The TIP tax advantage would depend upon two conditions: (1) the application of the TIP tax penalty in the form of either an adjustment of the corporate rate or a disallowance of excess compensation deductions, and (2) the application of TIP on the basis of the particular corporation as the TIP computation unit. If TIP were applied either as a direct tax on excess compensation as such or on the affiliated group as the TIP computation and taxpayer unit, the problem would not arise.

If the transfer took the form of actual physical and legal transfer of labor and production operations to the location and payroll of the deficit subsidiary, it might be appropriate to acquiesce in whatever TIP tax saving consequences occurred within the prevailing rules for defining the TIP computation unit. Mandatory consolidation would remove the problem. If the transfer took place on paper only, by switching productive facilities from one subsidiary to another

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it might be set aside for TIP purposes as a transparent tax avoidance maneuver.

7. "Contracting out."

It is conceivable that, confronted with a substantial TIP tax liability situation -- possibly for a prospective period of more than one or two years -- the company and its labor force might both be motivated to "contract out" their labor services. The former employer would pay a fee for the delivery of labor service. The former employees might serve as partners in the new enterprise, receiving distributions from their own firm in lieu of their former employee compensation.

This may seem farfetched but should not be overlooked.

Simpler "contracting out" deals would be possible, in which employers with special skills and in a strong bargaining position might convert their relationship with the employing firm to an independent contractor arrangement. The legal aspects of this type of development would need to be explored.

The chief safeguard against such arrangements where they threatened significant sabotage of the TIP plan would be to provide statutorily for a "lookthrough" power to permit administrators to identify the substance of such transactions as disquising an essential employer-employee relationship and treat their contractual fees as employee compensation.

8. Capital Maladjustment

Design of the TIP tax structure may call for

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recognition of certain hardship situations which would not be automatically ironed out by the basic TIP tax specifications. In some instances, as will be noted, whether the particular situation constitutes genuine hardship of the type that should be granted exception or alleviated within the spirit of the TIP tax penalty may be open to question.

1. Renewal of multi-year contracts including a "first year catch-up" increase

In some instances renewal of contracts entered into before the effective date of TIP, particularly contracts of more than one year's duration, may include not only a portion of the new settlement in recognition of prior years' inflationary erosion of the buying power of the money wages but also a special "first year catch-up increase." After the first year "catch-up," the wage rates may resume a level more consonant with the guideline productivity standard.

Such a one-year catch-up may be penalized under TIP, even though the over-all average annual wage settlement may be below the guideline. The hardship here is not that the contract was entered into without knowledge of TIP; the assumption is that the application of TIP was known. Rather, the hardship (or distortion) may be argued on the grounds that:

- the prior multiyear contract that precipitated the need for a catch-up at renewal time was entered into in the pre-TIP announcement period
- the one-year catch-up follows standard wage settlement practice

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-- if the one-year catch-up is not employed and the settlement is forced into a stretch-out type of arrangement which would avoid TIP, there may be less equity for the workers affected, since delay in the face of a changing work force may in effect deny recompense for a considerable group.

If a relief feature is deemed desirable, it could be provided, subject to fairly restrictive qualifying conditions, that the one-year catch-up element might be averaged over the period of the contract. This would entail minor complication and require rather exact formulations. It would also unfortunately represent tolerance of an inflationary one-year bulge in pay that should normally be discouraged by TIP. The policy decision on this point would rest upon a balancing of the somewhat tenuous equity considerations against the cost in terms of inflationary slippage and statutory/administrative complexity.

2. New labor classifications

The appearance of new types of labor altering the skill mix and calling for a new classification for purposes of calculating the average pay increase presents problems akin to, but different from, those of the treatment of the new firm. Both potential hardship and tax avoidance possibilities are present.

The appearance of a new more highly paid labor element within a standard labor classification would be reflected in the pay average as an increase in the average pay rate. If the new labor element is genuine, its placement

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in a new labor classification for TIP purposes would avoid the appearance of a computed increase in the average rate of pay, except for possible minor deviations due to the mathematics of indexation.

Two specific problems arise here:

- 1) How is the base year pay rate to be provided in calculating the pay increase for the new category in the first year? Or should the new classification in effect be exempted or excluded from average pay increase calculations the first year?
- 2) What safeguards are necessary and feasible in identifying and ruling out resort to new labor classifications in order to disguise substantive pay increases?

The answer to the first question seems to be that an industry average might be granted as a presumptive pay rate for the new labor classification in the constructive base period. If data are not available the reality of the new classification might be questioned, unless the firm could prove (1) that it pioneered in the creation and use of this particular skill and pay category and (2) that use of the new classification was not a veiled special pay increase for the component of the regular labor classification. If data are not available but the classification is accepted as real, the new labor category might be assigned a pay rate in the base (prior) year equal to its current year rate discounted by the overall guideline productivity percentage. The insertion of this dummy figure in the new average increase in pay would seem less distorting (and less unduly liberal) than merely excluding this labor category.

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3. "Upward drift" in the skill mix

A potential hardship problem similar in character to that of the appearance of a new skill/pay classification might arise where a firm could plausibly argue a substantial upward drift in its skill mix. Such a drift, arising due to the more or less gradual appearance of more and more elite, highly paid employees in one or more of its employee classifications, might be reflected in the average pay increase, with possible TIF liability as a consequence. Yet the firm might contend that its pay increases were not in fact inflationary, above-guideline payments but merely the reflection of a significant genuine change in the composition of its work force.

It might be desirable to allow reclassification of certain types of workers in this situation or a revision of the whole classification system of the firm, provided there was a clear showing that genuine upgrading of its skill mix had occurred, such that the previous classification resulted in overstatement of the average pay increase for TIF purposes. This relief approach would require setting up administrative machinery pursuant to a specific statutory directive. Its provisions would be subject to some abuse and proliferation of claims for adjustment.

4. "Fandom relationships"/catch-up problem

Previous discussion above dealt with possible relief

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for catch-up wage settlements representing one-year increases to compensate for lag in recognition of inflationary erosion over a prior multi-year contract. A similar type of relief problem arises in connection with so-called tandem wage relationships, for which relief is reported to have been provided at times under the wage contracts of the Korean War periods. Thus in some cases, a wage rate in one industry might be historically related to the wage rate in another industry. As of the base date, one of these rates may have already changed and the catch-up necessary to reestablish the historic tandem relationship or parity might be too large to be covered by the applicable ceiling or guideline. The Korean War wage control system apparently provided a set of regulations defining situations where this extra catch-up to maintain tandem parity would be permitted.

The primary issue here is a policy question whether TIP should endeavor to recognize and allow adjustments to exempt above guideline wage increases because they arise from such tandem parity relationships. If the policy decision is affirmative, the statute might include such situations in a statutory relief feature which would spell out tandem wage changes and provide for their exclusion in specified quantitative amounts in the computation of the average percentage increase in pay rates. The administrative task of identification and measurement for this type of relief should be delegated to a special board in IRS or elsewhere, rather than

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left to the administrative discretion of a particular IRS agent.

5. COLA adjustments

This report does not examine technical or policy questions involved in possible cost-of-living (COLA) adjustments in the implementation and administration of TIF. It would appear that if accepted, COLA adjustments would be uniform on a nationwide basis like the productivity measure embodied in the guideline and thus be added to the productivity percentage embodied in the guideline. No special technical or administrative problems would appear to be involved in applying TIF under a guideline embodying COLA as well as productivity factors. The 5 percent guideline figure used illustratively at several points in this report implicitly assumes a partial COLA adjustment supplementing productivity increase of 3 percent or possibly less.

6. Inter-firm, inter-industry, and inter-regional competitive pay adjustments

The question is sometimes raised whether administrative machinery and related statutory directives should be included in TIF which would provide exemption or relief for abnormally high wage increases made to keep abreast of individual firm, industry, or regional competition for scarce labor to meet expanding demand.

The identification and quantification problems involved in such an adjustment would be more complex than in the one-time catch-up situations previously mentioned. It is

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true that a TIP tax penalty in these situations might seem to operate as an obstacle to normal and salutary wage and labor supply-demand adjustments which are part of the market mechanism and help allocate resources in optimum fashion. It is apparently also true that the Korean War wage control system made an effort to permit at least some types of wage increase in this general category.

This approach for TIP, however, would seem to be a seriously compromising step since it would tend to introduce all the bureaucratic paraphernalia of regulatory controls. The merit of TIP is that it would be largely automatic, self-operating, and administratively economical. TIP can ignore some rough edges because it does not involve obsolete prohibitions, but only a tax penalty which will discourage or moderate inflationary wage rises, whatever their immediate economic excuse or motivation.

C. Undesirable economic impacts: export of jobs

The economic impact of TIP might well take certain forms that would have negative effects on the U. S. economy and employment opportunities and would be obvious targets of public criticism.

The exclusion of foreign subsidiaries and foreign branch operations would open the way to expansion of foreign operations in lieu of payment of higher U. S. wages subject to TIP tax penalties. Conceivably this might take the form

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of expansion in contiguous countries, with movement of U. S. workers across the border on a daily or periodic basis to perform work that might be excluded on the basis of situs from the scope of TIP.

This kind of development poses two specific problems:

- 1) How should foreign operations or employment be defined for purposes of the TIP exemption? Should the definition be modified to exclude the exemption of above-guideline wage payments to U. S. residents who merely cross the border to work?
- 2) How should the design of TIP be shaped to minimize the "export of jobs" aspects that result from confining TIP to the segments of U. S. business operating within U. S. borders?

D. Accounting problems of small business

Some critics have expressed concern that millions of small firms (retail stores, physicians' offices, and farm enterprises) mostly unincorporated and having extremely rudimentary accounting might have difficulty in complying with TIP. Thus, they might be denied an opportunity to qualify for tax benefits under those versions of the TIP approach which reward guideline-conforming firms or be unable to absolve themselves from direct penalties under the more standard TIP proposals for imposing a specific tax increment on excess compensation, apportioned proportionately to the excess.

The problem of the very small firm under the type of TIP program discussed in the report would be minor. Small and even moderately large firms may well be excluded from

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TIP under an exception based on size, noncorporate form of organization, or both. Even if not excluded by such an exemption, it is difficult to conceive of a firm with employees whose wages are subject to withholding and the Form W-2 wage reporting procedures, which could not calculate its average percentage increase in the rate of compensation from one year to another. The basic information needed is the amount of compensation paid by class of employee and the number of employee hours or employee years for which the compensation was paid.

If a firm's books of account, tax accounts, and tax reporting procedures under modern conditions are so rudimentary that it cannot determine the average percentage increase in its pay rates over the preceding year, following prescribed procedures set forth in an official tax reporting form, there would appear to be some question as to its conformity with present tax accounting rules. Some further development of its accounting procedures might be salutary both for tax accounting and business and financial management purposes.

B. Problems of principle and detailed articulation of standards and procedures

Another type of criticism raised against current TIP initiatives is to the effect that the award of tax rebates (or tax relief) or the imposition of a tax penalty (or its

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avoidance) requires that standards and procedures must be precisely definable in the tax law, and able to withstand court review of their fairness. This criticism is based in part on the experiences in designing and administering price controls during World War II, and the development of restraints on wage and price increases during the Korean War. This report indicates the basic specifications and procedures which might be embodied in the TIP statute. This statutory base in turn would be amplified and detailed in regulations, as all modern tax laws must be.

These criticisms imply that the detailed application of TIP might fill endless volumes of the Federal Register with fine print, subject to constant revisions, exceptions, and adjustments necessary to cover special situations that would never have been dreamed of in advance by the most imaginative economists, accountants, and lawyers.

Every tax law requires regulations and rulings to put it into effect. These are subject to the usual Federal procedural requirement for permitting public hearing and comment. Regulations on particular features of the income tax law sometimes take years to formulate and put into final form. Nevertheless, the tax law is administered in acceptable although frequently in admittedly imperfect fashion.

There is no indication that the statute, regulations, or rulings under a TIP initiative would be more onerous or

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susceptible to continuing controversial revision than those embodying the provisions of the income tax law with respect to depreciation, depletion, corporate reorganization, the treatment of travel and entertainment expenditures, taxation of foreign income, and the like.

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Appendix A: A Primer of Index Number Construction for TIP

Index numbers are devices for measuring differences in the magnitude of a group of related variables over a period of time (or as between places).^{1/} The most common type of index is one which, like the measure required for applying TIP, reflects a change in average prices over time -- in the case of TIP, a change in the price of labor employed by a firm or TIP taxpayer unit.

Among the five problems/tasks which a statistician typically encounters in the construction of an index (selection of series for inclusion in the index, selection of source of data, selection of base, method of combining data, and system of weighting), the first two and to a lesser extent, the third, are automatically resolved by the specifications of the TIP tax initiative. The remaining two (method of combining data and system of weighting) are therefore the essence of indexation for TIP purposes.

A. Base period considerations

The base for TIP is in a sense the first available wage experience year. However, since the essence of the TIP tax procedure is the measurement of the average wage increase for a particular firm or TIP unit over the prior year, the focus of indexation procedure may be on the averaging of current over prior year price relatives. Thus the base may be

^{1/} This primer relies heavily upon Frederick L. Gossman and Bussey, Cost of Living Indexes (Princeton University Press, 1951), Chapter III, especially pp. 375-377.

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said to move from year to year. The initial or starting base year may be retained in the sense of "chaining" average wage relatives back to it or by continuing to use the same base year weights.

In standard index number construction, a particular base may be satisfactory for a number of years but "becomes less meaningful as time passes, and it eventually becomes desirable to shift to a more recent period."^{1/} Why the outmoding of a particular fixed base? The factors are:

- dispersion of individual wage relatives to such an extent that no average is reliable
- change in the pattern equivalent to "market basket" or "job package" of employment to such an extent that no aggregate of labor classifications can be found which includes the major payroll components common to both periods
- progressive change in the quality of labor classifications, nominally the same, due to their rise or decline in the labor hierarchy due to skill and market changes

Since overall historical analysis and comparisons are probably less important in TIP implementation than in national or industry-wide index number constructions, these considerations are only of secondary importance for TIP.

B. Alternate methods of constructing wage index numbers

There are two basic alternative methods of constructing index numbers for wages (or other prices):

- by computing aggregative values and calculating the ratio of the aggregate in the current year to a base figure (the aggregative index method)

^{1/}Ibid, p. 505.

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-- by computing averages of wage (price) relatives (ratios of current year to base year figures).

These two methods are briefly discussed in the following sections of this appendix.

B. Aggregative wage index numbers

Aggregative index numbers of wages measure the changing value of a fixed aggregate ("market basket" or "package") of labor. If the total value changes but the labor components do not, changes in value must be due to changes in rates of compensation.

1. Simple or "unweighted" aggregates

The simplest, crudest form of aggregative index of wages is one arrived at by adding up the wage rates (per hour or other unit of labor) for the different classes of employees in the current year and dividing that sum by the corresponding aggregate for the base year. For example if there are three categories of labor, l_1 , l_2 , l_3 , paid wages of .80, 1.20, and 1.50, respectively in the base year and .90, 1.40, and 1.70 in the current year, the calculation of the simple or "unweighted" aggregative index is as follows

	year ₀ = 100	year ₁
l_1	.80	.90
l_2	1.20	1.40
l_3	<u>1.50</u>	<u>1.70</u>
Aggregate	3.50	4.00
Index (year ₁)	<u>.11420</u>	= <u>114.20</u> or multiplied by 100 = 114.20

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The standard formula for this kind of index, treating p as the price wage for a given class of labor is:^{1/}

$$P = \frac{Sp_n}{Sp_o}$$

where P = wage or price index

p_n = wage (price) of a particular class of labor
in the given year

p_o = wage (price) of a particular class of labor
in the base year

In the simpler or "unweighted" aggregate each class of labor is in actuality not unweighted but is arbitrarily given equal weight, without regard to its relative importance to labor operations.

2. Weighted aggregates

In order to have each class of labor have an influence on the index corresponding to its relative importance, a quantity (or weight) may be assigned to each and calculations made of the resulting aggregate value in the given and base year. If the quantities (or weights) assigned l_1 , l_2 , and l_3 in the previous example are 200, 300, and 500, the calculation of the weighted aggregative index is as follows:

	Quantity	Year ₀	Year ₁
l_1	200	150	180
l_2	300	360	420
l_3	500	750	850
Aggregate	1,000	1,270	1,450
Index (year ₁)	$\frac{1,450}{1,270} = 1.1417^{1/2}$	multiplied by 100 = 114.17	

^{1/}In this and subsequent index number formulas presented here, the symbol Σ is substituted for the usual sigma summation sign.

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In this case, the change of weighting resulted in only a minor difference between the quantity weighted and "unweighted" aggregative index. Suppose, however, the weights are more disparate than the 2, 3, 5 relationship assumed in the preceding example, as shown below:

	Quantity	Year ₀	Year ₁
l ₁	200	160	180
l ₂	700	840	980
l ₃	<u>100</u>	<u>150</u>	<u>170</u>
Aggregate	1,000	1,150	1,330
Index (year ₁)	= $\frac{1,330}{1,150} = 1.1565$ or multiplied by 100 = 115.65		

The higher index figure which results reflected the heavier weight attached to labor classification l₂ for which the pay increase was 16.67 percent ($\frac{1.40}{1.70} - 1$) as against 12.5 percent for l₁ ($\frac{.90}{.80} - 1$) 13.33 for l₃ ($\frac{1.70}{1.50} - 1$).

The standard formula for this kind of aggregative index is:

$$P = \frac{\sum p_1 q_1}{\sum p_0 q_1}$$

If the base year quantities are used the general formula becomes:

$$P = \frac{\sum p_1 q_0}{\sum p_0 q_0}$$

If given year quantities are used, the formula becomes:

$$P = \frac{\sum p_1 q_1}{\sum p_1 q_0}$$

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Various quantity weighting systems may be and have been used or suggested. A few prominent methods of calculating weighted aggregative price (wage) indexes are listed with brief comment below.

a. Base period quantities as weights

The Laspeyres method

$$\text{Formula: } P = \frac{\sum p_n q_0}{\sum p_0 q_0}$$

Comment: This type of index is generally said to have an upward bias, because of the interplay of price (wage) changes and accompanying opposite quantity changes. Its use in the consumer price field is criticized because it might record an average price (wage) increase even though the increasing relative amounts of consumption of commodities that decline in price might permit an individual to buy the same amount of satisfaction at a lower total cost. This criticism is less applicable to the use of the Laspeyres method for measuring average wage increases. But still it may be said that this method marks an upper limit to the price (wage) change.

b. Given (current year) quantities used as weights

The Paasche method.

$$\text{Formula: } P = \frac{\sum p_n q_n}{\sum p_0 q_n}$$

In the consumer price field, this method is open to the opposite criticism to that levied against the Laspeyres method.

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It is said to have a downward bias and to mark the lower limit of price (wage) change.

c. Average or total quantities of base and given (current) years used as weights

The Marshall-Edgeworth formula: This is a compromise between Laspeyres and Paasche. It has no known general bias in a particular direction. However, like Paasche's method it has shifting weights and what is sometimes termed "lack of comparability" among the different years. Where the focus of interest is the change between two adjacent years as under TII, this lack of comparability seems to carry less weight except possibly where, for some reason, a full series of index numbers is developed covering a lengthy period of a firm's wage experience.

d. Average together the quantities for all (or selected typical) years covered by the index

This type of method would offer a compromise solution for an historical study but is cumbersome and impracticable for purposes of an up-to-date index like TII since it requires continuing (or frequent periodic) revision of weights and re-computation of prior year index numbers.

e. Highest current factor used as weight

The Luyties method: This approach would employ to

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weights the quantities of a particular labor category common to each year, either to the base and given year or to all the years under comparison. This approach tends to use as weights the smallest quantity for any category in any of the years under analysis. Suggested by John Maynard Keynes in his Treatise on Money (1930), it is designed to remove the type of systematic upward or downward bias of the base quantity weighting (Laspeyres) and given year quantity weighting (Paasche) methods outlined previously. However, wide variations in quantities for particular categories could result in the development of abnormally low weights for them, with as much distortion as the other techniques, and possibly a worse type of distortion because it would be more erratic and less predictable.

f. Average of two differently weighted index numbers (usually employing geometric mean)

Irving Fisher's "ideal" index number (geometric mean of base and given year weighting):

Formula for the Fisher's "ideal" version of this type of index number is:

$$f = \text{square root of } \frac{(Sp_{1^o} \times Sp_{1^n})}{(Sp_{o^o} \times Sp_{o^n})}$$

As will be seen, Fisher's "ideal" index is the geometric mean (square root of the cross product) of the base year quantity weighted (Laspeyres) and given year quantity weighted (Paasche) aggregative indexes.

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g. Weighting bias criticisms

While the Fisher's "ideal" avoids the biases of its components and meets behavioral tests he regarded as important, it involves a different set of weights for each year's index computation, so that logically the indexes for any two years (other than the base and given year) are not comparable. This somewhat technical and purist criticism of the Fisher "ideal" may also be raised against the following systems:

- given (current) year weighting
- average of base and given year weights
- highest common factor method when quantities selected are common only to the two years under comparison.

The following methods involving what amount to "fixed" weights for the entire period under analysis are free from this particular technical-statistical criticism:

- base year weights
- average-of-all-years weights
- fixed "typical" year weights
- highest common factor method when quantities common to all years under analysis are used.

The practical importance of different weighting systems is frequently not great even in the field of commodity price indexation where considerable instability of particular prices often without systematic patterns of change is present. It would be of even less importance in the measurement of average increase in wage rates, which are less unstable than commodity prices in the present economy and seem to follow

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a similar common upward trend. Accuracy of measuring wage rates may be more important than the system of averaging employed in the indexation procedure. However, if important changes in the relative importance of particular categories of labor with appreciably varying wage change occur, the matter of weighting becomes quite important. Some updating of a "fixed" weighting system may become necessary.

Automatic continuous updating of the base weighting system, may be achieved by the "link relative" index number system in which each annual index number is expressed not as a percentage of the original base, but as a percentage of the preceding period. Such link relative index numbers may be "chained" back to the original base by a process of successive multiplication (briefly illustrated in the course of the text discussion).

D. Averages of wage (price) relatives

The basic alternatives to aggregative indexation is the construction of index numbers by averaging wage (price) relatives.

Under this approach, the wages (prices) of the given year are each reduced to a percentage of its base period counterpart. The various wage (price) relatives are then averaged for each year separately to obtain a series of index numbers. The averaging may be by means of the arithmetic, harmonic or geometric mean or by determination of the

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median (or even the mode). Various weighting systems are possible. Weighting under the average of wage (price) relatives method permits, and usually relies upon, use of value weights, whereas the aggregative method -- almost as a matter of logical necessity -- relies upon quantity weighting.

A simplified illustration comparing aggregative and average of wage relatives approaches to indexation is shown below.

Required Assumptions				Aggregative		Average of wage rate relatives		
Base rates Quantity Payroll				Yr. 0	Yr. 1	Rel. ¹ x100	Wt. pay- roll	Weighted by payroll
Yr. 0	Yr. 1	Yr. 1	Yr. 1					
1 ₁ .80 .90	200	180		160	180	112.5 x	180 =	20,250
1 ₂ 1.20 1.40	700	900		940	980	116.67 x	980 =	114,336.6
1 ₃ 1.50 1.70	100	170		150	170	113.33 x	170 =	19,289.1
			1,330	1,150	1,330		1,330	153,852.7
Index yr.						115.65 ^{1/}		115.63 ^{2/}

$$1/(1,330 + 1,150) \cdot 100$$

$$2' 153,852.7 + 1,330$$

The illustration shows a close similarity of results obtained using an aggregative method with given year quantity weights and an average of wage relatives method with given year payrolls weights...

Mathematically identical results would have been obtained if base year quantity weights had been employed for

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the aggregative method and base year payroll weights for the average of relatives method. The reason for the identical relationship is demonstrated as follows:

$$\text{Individual labor category } \frac{P_n}{P_o} \frac{P_o q_o}{P_o q_o} = \frac{P_n q_o}{P_o q_o}$$

$$\text{All labor categories used for index} \frac{\sum P_n}{\sum P_o} \frac{P_o q_o}{P_o q_o} = \frac{\sum P_n q_o}{\sum P_o q_o}$$

A further illustration of the identity of results under aggregative and average of wage relatives method, using the base year quantity and payroll weights, respectively, is presented below within a framework of assumptions consistent with those employed in the preceding illustration of aggregative vs. average of wage relations method:

Required assumption			Aggregative		Average of wage rate relatives		
Wage rates Yr. 0	Quantity Yr. 0	Payroll Yr. 0	Yr. 0	Yr. 1	wage relative	Wt. pay- roll	Weighted by pay- roll
.1 .80	.90	190	152	171	1.125 x 152	=	171
.2 1.20	1.40	680	816	952	1.167 x 816	=	952
.3 1.50	1.70	75	112.50	112.50	1.133 x 112.50	=	127.50
Index:			1,080.50	1,080.50	1,250.50		1,250.50
					115.73 ^{1/}		115.73 ^{2/}

$$1/(1,250.50 + 1,080.50) \times 100$$

$$2/(1,250.50 + 1,080.50) \times 100$$

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3. Usefulness of weighted average of wage relatives method vs. aggregative method

The usual assessment is that the weighted average of relatives method is just a roundabout way of doing what may be accomplished more easily by the direct means of the aggregative approach.^{1/} Some also contend that the aggregative method is more understandable to most persons than an average of wage (price) relatives.^{2/} Comparative understandability is, however, a matter of opinion and rather subjective judgment. For many, the concept of a group of wage (price) relatives averaged by a reasonable weighting system is essentially clearer and furnishes a better insight into the components and nature of the statistical processing involved.

It is recognized that the wage (price) relatives themselves provide information of interest from several interrelated standpoints all of which are relevant to TIP implementation:

- the behavior of particular wage (price) relatives and their contribution to index changes of a firm, in comparison with similarly situated firms
- the variability, diffusion, and pattern of the various wage (price) relatives of one firm as compared with others as a test of reasonableness and credibility
- raw material for frequency distributions to obtain insight into average behavior
- the identification and quantification of causative factors (i.e., particular wage relatives and their weights) in unusual over-all changes in a firm's index.

As previously suggested, in a number of cases,

^{1/}Cronon and Cruton, *ibid.*, p. 622.

^{2/}Ibid.

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aggregative and average wage relative methods are equivalent. Excluding the more esoteric field of harmonic averages, there are two basic equivalences:

-- an arithmetic mean of wage relatives weighted by base year values (payroll amounts)^{1/} is the equivalent of an aggregative index weighted with base year quantities

-- an arithmetic mean of wage relatives weighted by the product of base year wages and given year quantities (employees or other labor units)^{2/} is the equivalent of an aggregative index weighted with given year quantities (employees or other labor units).

The average of relatives method has a special advantage for use in connection with TII. It permits averaging of varying types of rates of pay based on different labor units, e.g., those for hourly workers, workers paid weekly wages, and salaries workers without converting them to a common denominator labor unit. The wage relatives for the various categories may then be weighted with a dollar value figure, most plausibly by the amount of payroll payments, thus dealing with the need for a common denominator in the weighting system.

1/ Weighting factor = $p_0 q_0$

2/ Weighting factor = $p_0 q_n$

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Appendix B:

Definition of TIF taxpayer unit in the case of multicorporate entities: effects of separate and consolidated reporting due to interplay of labor skill mix and index method

Possible TIF tax advantages and disadvantages of TIF tax reporting on separate or combined bases by multicorporate entities have been mentioned in the text. These advantages and disadvantages of including or excluding certain corporate affiliates have been recognized chiefly (1) in the case of affiliates which have an "unused" margin of guideline ceiling above the firm average rate of pay increase or a substantive excess of compensation over the guideline and (2) in situations where profits were the base of a TIF tax rate adjustment, making it advantageous to "separate" high profits or "include" low profit affiliates. This appendix briefly illustrates another technical source of TIF tax effects depending upon the inclusion or exclusion of affiliates: the interplay of skill mix and the averaging or index procedure, sometimes complicated by the form of the TIF tax penalty. This may be said to involve the definition of the business unit used in the computation of the average rate of pay increase and its comparison with the guideline to determine excess compensation.

For purposes of the present brief analysis, the following illustrative facts and circumstances are assumed:

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Labor class	Year 0			Year 1			Percent increase yr 1 over yr 0	
	Employee years	Pay	Payroll (thous)	Employee years	Pay	Payroll (thous)		
Affili- ate A	Prod.	100	10	\$1,000	105	11	\$1,155	10.0%
	Adm.	50	12	600	52	13	676	8.33%
	Exec.	10	20	200	9	24	216	20.00%
	Total	160	11.25	1,800	166	12.331	2,047	9.61% (ave pay per employee yr)
Affili- ate B	Prod.	50	9	450	52	9.5	494	5.55%
	Adm.	10	13	130	11	14	154	7.692
	Exec.	2	40	80	3	50	150	25.00%
	Total	62	10.65	660	66	12.09	796	13.52% (ave pay per employee yr)
A and B Combined	Prod.	150	9.667	1,450	157	10.503	1,649	8.651
	Adm.	60	12.167	730	63	13.175	830	8.27
	Exec.	12	23.333	280	12	30.500	356	30.716
	Total	222	11.091	2,460	232	12.263	2,845	10.657 (ave pay per employee yr)

A. Effects of employee compensation

The differences in the average percentage increase in pay rates and the amount of employee compensation computed on separate and combined bases for affiliates A and B, using selected different methods of computing average rates of pay increase or inflation, are tabulated below. A guideline figure of 5 percent is assumed in computing employee compensation.

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1. Average percentage increase in pay rates calculated under separate and combined reporting for TII purposes, with alternative averaging or index methods.

<u>Averaging or index method</u>	<u>A</u>	<u>B</u>	<u>A and B combined</u>
1. Ave. of relatives weighted by year ₁ payroll	10.505%	9.622%	11.383%
2. Ave. of relatives weighted by year ₀ employee years	10.104	6.528	9.745
3. Laspeyres aggregative (yr ₀ employee-yr quantity weighted)	10.556	8.333	9.959

2. Excess compensation calculated under separate and combined reporting for TII purposes, with alternative averaging or index methods.

<u>Averaging or index method</u>	<u>Separate</u>	<u>A and B Combined</u>		<u>Percentage excess C over (A+B)</u>
		<u>Total</u>	<u>(A and B) (C)</u>	
1. Ave. of relatives weighted by year ₁ payroll	\$112.69	\$36.89	\$149.58	21.4%
2. Ave. of relatives weighted by year ₀ employee years	104.49	12.1%	116.67	135.00
3. Laspeyres aggregative (yr ₀ employee-yr quantity weighted)	113.73	26.68	140.33	131.0%

Testing with other illustrative cases has shown that the advantage may also be on the side of combined reporting in contrast

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with the unfavorable result shown above. Other testing also indicates that, as in the example above, while the Laspeyres aggregative index shows less disparity between separate and combined than the average of relatives method, it tends to move in the same direction.

B. Effects on TIF tax liabilities

The implications of separate and combined reporting for TIF purposes for TIF tax liabilities would depend upon the form of TIF tax penalty. If the tax were based on the excess compensation as such or were implemented by the disallowance of the deduction of the excess, the resulting translation of excess into TIF tax is more or less self-evident. However, if the TIF tax took the form of an adjustment of the applicable income tax rate, proportioned (possibly with further scaling factors) to the degree of the excess, wide and not easily predictable differences in the TIF tax liability may arise under combined versus separate reporting for TIF purposes. These differences would of course depend upon the configuration of profits among the affected affiliates in relation to the combined calculation of excess compensation.

C. TIF plan design and taxpayer choice problems

The complexities outlined here suggest problems of TIF tax design to minimize erratic tax variations depending upon the definition of taxpayer unit and business tax decisions

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in response thereto, and to reduce problems of taxpayer choice as to how to organize, consolidate, disaggregate, or conduct business operations.

Some choice problems for the taxpayer (and opportunities for manipulation) could be reduced by mandating consolidated reporting or whatever form of reporting is used for income tax purposes. Either approach would not be entirely effective, however, since subsidiaries may be disposed of, acquired, or decontrolled; business operations may be switched around or repriced with respect to intercorporate transactions within a controlled group. This kind of preventive manipulation or adaptive behavior would of course not meet but rather support possible criticisms that TIP resulted in tax differences between essentially similarly situated economic aggregations.

D. Tentative conclusions

Further study should be given to this general aspect of TIP design. This involves the interplay of the method of computing average percentage pay increases or indexes and the other variables in the situation, including not only the definition of the TIP tax unit but also essential details of the form of the TIP tax. Preliminary results suggest that the TIP disparities between separate and combined reporting may be controlled by using the aggregative index approach.



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INFLATION AND GOVERNMENT POLICY

(A Review of Current Perspectives on the Inflation Issue)

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June 18, 1978

**INFLATION AND GOVERNMENT POLICY
(A Review of Current Perspectives on the Inflation Issue)**

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INFLATION AND GOVERNMENT POLICY
(A Review of Current Perspectives on the Inflation Issue)

THE CURRENT SETTING

Inflation, defined as a persistent upward movement in the general price level, has been a major economic problem to the Nation for well over a decade. Though there have been brief periods of improvement on the price front, the annual rate of inflation in six of the past ten years has been in excess of 5.5 percent.

In periods of high inflation one would expect the economy to operate with relatively low levels of unemployment. However, this has not been the experience of the economy since the early 1970's. With the exception of two years--1970 and 1973--unemployment as a percent of the total civilian labor force has been well in excess of 5.0 percent. As of May, 1978, unemployment was at a level of 6.1 percent. Though this is considerably below the 8.9 percent peak reached in May 1975 during the 1974-75 recession, it is still considered exceptionally high by historical standards. During the latter months of 1977 inflation (as measured by the consumer price index) averaged between 4.5 and 5.0 annually, and most forecasts were projecting a slightly higher rate of 6.0 percent for 1978. However, for the three-month period ending in April of this year, prices rose by an annual rate (compounded) of 10.0 percent.

This report surveys the short-term outlook for inflation. This is followed by a review of the anti-inflation actions taken by the Government to date and the various anti-inflation proposals that are receiving the most active consideration in public policy circles at the present time.

INFLATION OUTLOOK

During the latter months of 1977, the annual rate of inflation (as measured by the Consumer Price Index) averaged between 4.5 and 5.0 percent, seasonally adjusted. Though most economic forecasts at the end of 1977 projected a speedup in the inflation rate to about 6 percent for 1978, very few were forecasting a major spurt in inflation. However, given the experience of the first four months of this year, the outlook for inflation has deteriorated. In January, February and March consumer prices (measured over a three months span) rose at seasonally adjusted annual rates of 6.7, 7.5 percent and 9.6 percent, respectively. In April, the annual rate rose to 9.6. The wholesale price index, which can foreshadow the future pattern of consumer prices, rose by a 12.6 percent annual rate for the three month period ending in April.

As shown in the table below, this marked acceleration in the inflation rate has been due in large part to skyrocketing food prices and sharp increases in the prices of services. Other factors having a bearing on the performance of prices since January have been: the

effects of mandated increases in social security taxes, the minimum wage, and unemployment insurance which add to labor costs; various import controls and regulatory policies which add to the cost of producing goods;^{1/} and sharp increases in worker compensation combined with a marked decline in productivity during the first quarter of the year--resulting in a sharp increase in unit labor costs.

CHANGES IN CONSUMER PRICES

Period	Percent change from preceding period; seasonally adjusted ¹				Percent change from 3 months earlier; seasonally adjusted annual rates				Percent change from 6 months earlier; seasonally adjusted annual rates			
	All items	Food	Com-modities less food	Serv-ices	All items	Food	Com-modities less food	Serv-ices	All items	Food	Com-modities less food	Serv-ices
1969-----	6.1	7.2	4.5	7.4								
1970-----	5.5	2.2	4.8	8.2								
1971-----	3.4	4.3	2.3	4.1								
1972-----	3.4	4.7	2.5	3.6								
1973-----	8.8	20.1	5.0	6.2								
1974-----	12.2	12.2	13.2	11.3								
1975-----	7.0	6.5	6.2	8.1								
1976-----	4.8	.6	5.1	7.3								
1977-----	6.8	8.0	4.9	7.9								
1977: Apr.	.8	1.5	.4	.7	10.2	18.6	6.1	9.0	8.0	10.6	6.5	8.0
May	.6	.6	.3	.8	8.4	11.6	4.8	9.9	8.7	12.6	6.2	8.7
June	.5	.6	.3	.7	7.8	11.5	4.2	9.4	8.9	13.4	5.8	9.6
July	.3	-.2	.2	.7	5.7	4.2	3.2	9.3	7.9	11.2	4.6	9.2
Aug.	.4	.4	.2	.6	5.0	3.6	2.7	8.3	6.6	7.5	3.7	9.1
Sept.	.4	.2	.3	.6	4.5	1.9	2.7	7.6	6.1	6.6	3.5	8.5
Oct.	.3	.2	.4	.4	4.5	3.1	3.4	6.3	5.1	3.7	3.3	7.8
Nov.	.4	.5	.5	.4	4.7	3.5	4.7	5.6	4.8	3.6	3.7	7.0
Dec.	.4	.4	.5	.4	4.9	4.2	5.4	4.9	4.7	3.0	4.0	6.3
1978: Jan.	.8	1.3	.7	.6	6.7	8.9	6.6	5.8	5.6	6.0	5.0	6.0
Feb.	.6	1.2	.2	.7	7.5	11.9	5.6	7.2	6.1	7.7	5.1	6.4
Mar.	.8	1.3	.6	.8	9.3	16.4	6.1	9.1	7.1	10.1	5.7	7.0
Apr.	.9	1.9	.5	.9	10.0	19.1	5.5	10.5	8.3	13.9	6.1	8.1

¹ Annual changes are from December to December (unadjusted).

Source: Department of Labor, Bureau of Labor Statistics.

Note.—Beginning January 1978 data relate to all urban consumers. Earlier data relate to urban wage earners and clerical workers.

- ^{1/} In recent testimony before the Senate Banking Committee on May 23, 1978, Barry Bosworth, Director of the Council on Wage and Price Stability, estimated that the effects of these various Government actions and policies will add about 1.5 percentage points to the overall inflation rate this year.

Despite the recent trend in prices, it is still too early to come up with a consensus forecast for inflation for the balance of the year. Updated forecasts are projecting inflation rates in consumer prices that range between 6.5 and 9 percent annually. (The last time the Nation experienced double-digit inflation was in 1974, when the rate reached a level of 12.2 percent annually--the highest level recorded during the post war period.) Though most forecasters feel that inflation for the remainder of the year will be worse than what they had expected at the outset of the year, the outlook will depend upon several factors: the condition of the dollar in world markets, developments in the energy sector of the economy (including the type of energy package finally approved by Congress), the pace of the economy, the performance of food prices, the control of money supply and credit conditions by the Federal Reserve Board, and the extent to which Administration economic policies can succeed in dampening inflationary expectations in the economy, which are high at the moment.

POLICIES TO COMBAT INFLATION

A number of policy actions to combat inflation have been recommended by students of public policy, in and out of Government.

Of these, however, there are very few actions that the President can take immediately that don't require legislative action. Currently, the President does not have authority to institute mandatory controls on wages and prices. The most recent authority, the Economic Stabilization Act of 1970, expired in April 1974. In August 1974, Congress, however, did create the Council of Wage and Price Stability which was called upon to monitor inflationary developments in the public and private sectors of the economy. The Council (which operates within the Executive Office of the President) has some very limited powers, but it must rely almost exclusively upon the power of persuasion and publicity to encourage wage and price restraint in the private sector. It has no power to require prenotification of wage and price increases in key industries.^{1/} Moreover, it lacks the authority to prohibit, change or even delay price and wage actions it considers unduly inflationary. Though the provisions of the Act by implication sanction the use of "jawboning" as a means of encouraging wage and price restraint, the Act offers no specific guidelines as to how far the Executive Branch may go in seeking industry and labor compliance with its anti-inflation objectives. The Council operates with an authorized staff ceiling

1/ Council on Wage and Price Stability Act, P.L. 93-387, as amended.

of 39 persons. Its authorized annual appropriation for both fiscal years 1978 and 1979 is \$2.2 million.

The Administration's Program of "Deceleration"

Some have recommended that the President set specific guidelines for wage and price increases as one means of reducing the magnitude of the wage-price spiral in the economy. Industry's reaction to such voluntary standards (which would vary from industry to industry, depending upon the level of productivity performance, availability of labor skills, and demand and supply conditions in each industry) has been lukewarm. Organized labor has voiced strong opposition, mainly because it maintains that such standards would constitute unwarranted government intervention in the collective bargaining process, would be difficult to apply with equity to all segments of the economy (including labor and industry), and would serve to dampen wage increases more severely than price increases.

So far President Carter has refrained from taking such action, but in January of 1978 he asked the business community and American workers to "participate in a voluntary program to decelerate ^{1/} the rate of price and wage increase." More specifically,

^{1/} U.S. President, 1977 (Carter). Economic Report of the President; transmitted to congress January 1978 together with the annual-report of the council of Economic Advisers. pp. 19-20.

...this program is based on the initial presumption that prices and wages in each industry should rise significantly less in 1978 than they did on average during the past two years.

I recognize that not all wages and prices can be expected to decelerate at the same pace. For example, where profit margins have been particularly squeezed, or where wages are lagging seriously, deceleration in 1978 would be less than for other firms or groups of workers. In exceptional cases deceleration may not be possible at all. Conversely, firms or groups that have done exceptionally well in the recent past may be expected to do more.

To enhance the prospects for success of this deceleration program, I have asked that major firms and unions respond to requests from members of my Administration to discuss with them on an informal basis steps that can be taken during the coming year to achieve deceleration in their industries. In reviewing the economic situation prior to making my recommendations to the congress on the size of the pay raise for Federal workers, due to take effect next October, I will keep this objective of deceleration in mind.

This program does not establish a uniform set of numerical standards against which each price or wage action is to be measured. [Underlining added] The past inflation has introduced too many distortions into the economy to make that possible or desirable. But it does establish a standard of behavior for each industry for the coming year: every effort should be made to reduce the rate of wage and price increase in 1978 to below the average rate of the past two years.

I have chosen this approach after reviewing extensively all of the available options. There is no guarantee that establishing a voluntary deceleration standard will unwind the current inflation. I believe, however, that with the cooperation of business and labor, this proposal will work.

For some time the economy has been operating with an underlying inflation rate of about 6 percent annually. And in the view of Administration policy makers there is little evidence that it is de-

1/ celerating. In recent years the average annual rate of increase in hourly compensation (including private benefit programs and employer taxes) for American workers has remained stuck between 8 and 9 percent. In the same period productivity growth (the trend rate) has averaged about 2 percent annually, with little evidence for any marked improvement in the foreseeable future. Thus, when the increase in productivity is subtracted from the increases in compensation, one finds that unit labor costs have increased on the average of between 6 and 7 percent annually. Thus, as the Administration perceives it, this is a basic reason why the economy has operated with an underlying inflation rate of about 6 percent during the past two years.

To a large extent, the current wage-price spiral is a reflection of inflationary expectations which are widespread in the economy at the present time. For some time labor and management have based their wage and price decisions on the assumption that inflation will continue at a level of at least 6 percent annually, with no prospects for any major reduction in this basic inflation rate in the foreseeable future. Accordingly, workers seek wage increases which will compensate for any decrease in real earnings that has resulted from past

1/ In this connection, it should be noted that the Administration recently raised its estimate of the inflation rate for 1978 to 6 3/4 to 7 percent from the 6 percent to 6 1/4 range forecast earlier in the year.

inflation. When union contracts come for renegotiation, labor seeks not only to adjust wages for past inflation but to protect wages as much as possible from future inflation. This is why so many labor agreements currently have cost of living adjustment clauses in their contracts. ^{1/} Such efforts in turn set the pattern for wages, or at least have a bearing on earnings expectations of unorganized workers in our economy.

These expectations in turn tend to encourage business to pass on to the consumer, in the form of higher prices, cost increases (past and expected) that cannot be offset by increased productivity. ^{2/} Such increases then become the basis for further rounds of wage increases. The end result is no major let-up in inflationary pressures because both business and labor are caught on a treadmill which neither group can stop alone.

Aside from Government anti-inflation programs intended to achieve, over the long run, increased productivity and basic structural changes in the economy, policy options having an immediate impact in reducing inflation are few.

1/ These adjustments are almost always add-ons to the annual earnings increases negotiated in long-term basic union contracts.

2/ There are some exceptions to this rule, however. Some businesses, because of highly competitive market conditions, may not be able to pass all of the increase on to the consumer, thereby forcing them to absorb such increases in the form of reduced profit margins. On the other hand, some businesses may choose to increase prices to cover both higher costs and to increase profit margins, particularly where they can readily pass on such increases to the consumer without affecting sales volume.-

In recent years, restrictive monetary and fiscal policies alone have not been successful in achieving an appreciable and lasting reduction in the Nation's underlying inflation rate. Conceivably, the Government could reduce inflation by shifting to a policy of greater-monetary and/or fiscal restraint. However, carried out to an extreme, such action could lead to deep recession (or depression), thereby resulting in high unemployment and lost production. At the present time this is not looked upon as a practical option by the Carter Administration, since Government policy is still directed toward the twin goals of achieving relative price stability and full employment. Consequently, as the Administration perceives it, the only two options left to the government at this time (in conjunction with appropriate monetary and fiscal restraint) that can have the most immediate short term impact on the inflation problem are: (1) the application of mandatory wage and price controls and (2) a voluntary stabilization program designed to inspire greater cooperation from labor and business in trying to bring about a marked reduction in the current wage-price spiral (or inflationary expectations).^{1/} As noted earlier, the President has rejected the mandatory controls approach, saying that it would be unworkable and counter-productive. However, as already noted, he has committed himself to a voluntary wage-price stabilization program.

1/ Some would argue, however, that the basic cause of inflation is excessive Government spending and expansion of the Nation's money supply. Consequently, they claim that the only way to reduce inflation is for the Government to exercise much greater fiscal monetary restraint than it plans at the present time.

This program of exhortation and active monitoring of wage and price developments in the economy is based on the assumption that the current pace of price inflation can be decelerated if (1) workers on the average were willing to seek wage gains in 1978 that are significantly less than the 8 to 9 percent average annual increases in compensation recorded in the past two years and (2) the business community were to increase prices on the average by amounts considerably less than those in the past two years. Thus, for example, if workers were willing to accept compensation increases averaging 6 percent and the business community on the average were to increase prices by an amount equal to the difference between the 6.0 percent increase in compensation less the average annual rate of increase in productivity for the economy--about 2.0 percent, then the underlying inflation rate in the economy could be reduced from about 6 to about 4 percent for the year.

An Update: The Administration's Most Recent Anti-Inflation Strategy

In a major address to the American Society of Newspaper Editors on April 11, the President outlined the Administration's latest anti-inflation strategy. He again rejected wage-price controls as a policy option. ^{1/} He also made it clear that he would not support fiscal

1/ In responding to questions by editors following his speech, the President, however, did say that--

The only instance in which I can think wage and price controls might be applied would be a case of national emergency, like an all-out war, or some tragedy of that kind, where normal economic processes would not be at work. (New York Times, April 12, 1978, p. 35.)

policies which would slow inflation by increasing unemployment. The President's anti-inflation program consists of two types of initiatives: those which can be carried out by administrative action and those which would require action by Congress.

The major administrative actions announced by the President include:

- The imposition of tariffs on imported oil to slow imports, if Congress fails to enact his energy proposals;
- The formation of a Cabinet level task force, chaired by the Secretary of Commerce, to report within 60 days on additional measures to increase exports;
- A promise to veto all congressional actions that would increase the budget deficit beyond the level projected in his budget--\$60.6 billion. (The President said that he was "especially concerned" about spending increases for tuition tax credits, highway and urban transit programs, postal service financing, farm legislation, and defense spending.);
- A pledge to veto any farm legislation, beyond what he has already recommended, that would lead to higher food prices or budget expenditures;
- New Government procedures that will require executive regulatory agencies to minimize the adverse economic consequences of their actions, to eliminate unnecessary regulations, and to ensure that future regulations do

not impose unnecessary costs on the American economy (for more detail see Executive Order 12044, Improving Government Regulations, March 23, 1978);

--A directive to Federal agencies to avoid or reduce the purchase of goods and services whose prices are rising rapidly, unless by doing so we would seriously jeopardize our national security or create serious unemployment;

--Instructions to the Departments of Agriculture and Interior, the Council on Environmental Quality, and his economic advisers, to report to him within 30 days concerning the best ways to increase the supply of lumber (which has experienced sharp price gains in recent months) from Federal, State and private timber lands;

--A request that independent regulatory agencies try to reduce inflation when they review rate changes, and to explore regulatory changes that can make the regulated industries more efficient.

Other anti-inflationary actions recommended by the President would require legislative action. These include:

- The freezing of federal executive pay and imposing a 5.5 percent ceiling on pay increases for Federal workers, to set an example for labor and industry to moderate price and wage increases;
- Prompt passage of the airline regulatory reform legislation, which would allow for greater competition in the setting of airline passenger fares;
- A requirement that the Budget Committees of Congress report regularly to Congress on the inflationary effect of pending legislation;
- Early enactment of the Hospital Cost Containment Bill to halt the present spiral in hospital costs.

Though the President believes that these actions can play an important role in combating inflation, he stated that "...it is a myth that the government itself can stop inflation. Success or failure in the overall effort will largely be determined by the action of the private sector of the economy." In reemphasizing the importance of his program for wage-price deceleration established earlier this year, the President stated that "I expect industry and labor to keep price, wage and salary increases significantly below the average rate for the last two years." To accomplish these deceleration goals in the private sector, he said that the Council on Wage and Price Stability has already begun a series of meetings with representatives of business

and labor in a number of major industries, to determine what steps these pace-setting industries can do to reduce inflation. Further the President announced that he has asked his special Trade Representative, Robert Strauss, to take on additional duties as Special Counsel on Inflation, and to "speak for me in the public interest." Strauss is expected to play a key role in encouraging private sector cooperation with the Administration's anti-inflation objectives.

In an interview with reporters on April 12, Federal Reserve Board Chairman, G. William Miller, stated that the Administration's anti-inflation efforts "are good first steps," but "I hope they aren't the last steps." Miller went on to say that fiscal policy should be less stimulative, given the recent surge in inflationary pressures. Accordingly, he recommended that the President consider trimming or deferring his proposed \$24.5 billion net tax cut as a way of reducing the deficit and inflationary forces. He said that next year's budget deficit of about \$60 billion could be cut by \$9 billion if the tax cut program were deferred by October 1 to January 1, 1979. Initially, the Carter Administration opposed any such deferral or modifications in its tax package, taking the position that the requested tax reductions are needed to support adequate economic growth. However, on May 12, 1978, the President, responding to concerns expressed by the Federal Reserve Board and many in Congress, agreed to trim the size of his tax package to \$19.4 billion and postpone its effective date

three months to January 1, 1979. For the forthcoming fiscal year (FY 1979), which will begin on Oct. 1, 1978, this alteration would have the effect of reducing taxes overall by \$15 billion -- \$9.5 billion below the original \$24.5 billion proposal. The balance of the proposed tax cut would be felt in Fiscal 1980. The Administration's budget request to Congress earlier this year assumed a budget deficit of \$60 billion for Fiscal 1979 which it believed would promote continued expansion in the economy without generating additional inflation. However, with the modification of its tax cut proposal, assuming no change in spending levels, the estimated budget deficit would be reduced to about \$50.5 billion.

On May 17, Congress approved the first Concurrent Budget Resolution (Con. Res. 80) which set non-binding spending and revenue goals (including both tax revenues and deficit financing) that would result in a budget deficit of \$50.9 billion for fiscal year 1979--almost \$10 billion below the budget estimate announced by the President at the outset of 1978. Binding revenue and expenditure targets for the Budget will be set by Congress in September of this year.

Finally, on June 8 the President announced that he was ordering an easing of beef import quotas to allow an additional 200 million pounds of beef (most meat to be used in lunch meats or hamburgers) to be imported into this country this year, above the 1.3 billion pounds

allowed under the present import quota program. Though the Administration makes no claim that this action will have a dramatic impact on consumer prices, it believes that this gesture will reduce the price of hamburger by 5 cents a pound by year's end and save consumers \$500 million. In its view this "modest" increase in beef imports "will not change the price of fat cattle at all." However, the Cattlemen's Association deplored this action, saying that "the projected import increase will do little or nothing to lower retail beef prices in the short term. ... Over the long term, the action is expected ^{1/} to lead to smaller beef supplies and even higher prices."

Granting of Additional Powers to the Council on Wage and Price Stability

In the Joint Economic Committee's Annual Report on the Economic Report of the President for 1978, the majority members of the Committee recommended that legislation be enacted giving the Council on Wage and Price Stability authority to "require prenotification of planned price increases from selected industries and to delay for modest periods wage or price increases which could have serious inflationary effects on the economy."^{2/} These Committee members went

1/ Washington Post. June 9, 1978, p. A2. New York Times, June 9, 1978, p. A1.

2/ U.S. Congress. Joint Economic Committee. The 1978 Joint Economic Report; report . . . on the January 1978 Economic Report of the President together with minority and additional views. March 15, 1978. pp. 115-116.

on to say that such action would be

...a reasonable start toward an income policy, short of voluntary or mandatory controls which would allow the council to review and comment on the justification for wage and price increases. In addition, prenotification and delay of wage and price increases would help give the Administration and the Congress time to consider and develop long-run measures to reduce inflation.

Two members of the Majority, however, expressed reservations
1/
about this proposal. Rep. Reuss stated that:

Prenotification is a useful idea under certain circumstances. However, the present nervous business climate is such that prenotification requirements may do more harm than good. Such requirements may impair the willingness of business to undertake new ventures and to expand their capacity, and as a consequence impede the attainment of full recovery and full employment.

Senator Bentsen, vice chairman of the Committee, voiced stronger
2/
opposition to this recommendation saying that--

I disassociate myself completely from this proposal which I regard as a very serious mistake. Despite its reluctance to admit it, this Committee is recommending mandatory price and wage controls. . . The authority to delay wage or price increases is logically the authority to fix and control wages and prices.

1/ Ibid. p. 116.

2/ Ibid. p. 143

Nonetheless, if the current wage-price spiral cannot be broken by conventional monetary and fiscal actions supplemented by the voluntary stabilization program outlined by the President, Congress might come under increasing pressures to give the President some authority to require prenotification and delay of price increases in selected industries, or broader authority to control wages and prices generally. There appears to be little support in Congress for such action at this time. This is due largely to recent memories of the mixed performance of economic controls during the 1971-74 period, especially the widespread difficulties encountered by the Economic Stabilization Program during Phases III and IV.

Other Possible Congressional Initiatives

. In addition to the legislative actions cited in the President's anti-inflation program, Congress could take a number of other actions, if it deemed them appropriate measures to combat inflation:

For example:

- It could cut spending levels below those presently requested by the President.
- It could reduce the size of the President's tax cut proposal, or postpone indefinitely any further reductions in Federal taxes.

- It could take actions designed to roll back or postpone social security tax increases enacted last year, which would reduce the labor costs of employers and increase the take-home pay of workers, thereby moderating the pressures for wage and price increases.
- It could enact legislation to relax environmental, health and safety standards, which could reduce production costs in industry.
- It could enact tax legislation to provide additional incentives to increase productivity and reduce production costs.

Combating Inflation over the Long Run

The Nation's success in reducing the rate of inflation over the long run will depend to a large extent upon how the Government manages its monetary and fiscal policies. However, it is generally agreed that our success will depend also upon how well Government policy and private sector interests address a number of longer term structural problems within the economy which impede the necessary expansion of supply and can generate inflationary pressures in various sectors of the economy. Examples of such problems, which are not necessarily affected by changes in aggregate demand, include:

- the need to make agricultural production more responsive to changing demand and supply conditions, including the maintenance of buffer stocks to offset the effect of surpluses and shortages caused by global weather conditions;
- the need to achieve greater self-sufficiency in meeting our nation's energy requirements;
- the need to overcome inadequacies in the structure of health care and delivery and supply, which have contributed to skyrocketing increases in medical costs;
- the need to eliminate and/or modify outdated Government laws and regulations which adversely affect the efficiency and competitive structure of the market place;
- the need to counter the abuses of excessive market power that may be exercised by certain business and labor interests in the economy;
- the need to improve the functioning of labor markets to assure a much more efficient matching of labor demand and supply; and
- the need to increase productivity in both the private and public sectors of the economy.

Current Role of Monetary Policy

This analysis has reviewed mainly the roles of the Executive and Legislative branches in fighting inflation. Yet, as already noted monetary policy also plays a key role in the Government's anti-inflation efforts. The Federal Reserve Board is empowered by Congress to manage the Nation's money supply in ways that it deems suitable to fulfill certain national economic objectives. Though the Federal Reserve is subject to legislative oversight, it is given broad discretionary monetary policy authority. In addition to making an annual report to Congress, the Federal Reserve, as provided in P.L. 95-188 is expected by Congress to--

...maintain long run growth of the monetary and credit aggregates commensurate with the economy's long run potential to increase production, so as to promote effectively the goals of maximum employment, stable prices, and moderate long term interest rates.

This law also provides that the Federal Reserve shall consult quarterly with the Banking Committees of the Congress about monetary policy and targets for monetary and credit aggregates for the forthcoming year, taking into account past and prospective developments in production, employment and prices.

In making the Federal Reserve's regular quarterly report to Congress on April 25, Fed Chairman G. William Miller, stated that the monetary policy has tightened slightly, but he indicated that any further deceleration in monetary growth rates "has to be undertaken

with caution." He went on to say that the growth in money supply must be reduced gradually over the year ahead, but "the pace of deceleration cannot proceed much more rapidly than the pace at which built-in inflationary pressures are wrung out of the economy if satisfactory economic growth is to be maintained." Thus, the Chairman made it clear that Fed, at the present time, plans to follow a course of "moderate restraint"^{1/} as its contribution in the fight against inflation.

A Word About Tax-Based Incomes Policy (TIP)

Another method of wage-price stabilization currently receiving increased attention in policy circles is the tax-based incomes policy, known as TIP. In contrast to either exhortation or direct controls--the two more traditional methods of incomes policies, TIP would utilize various tax incentives to promote greater wage and price restraint within the private sector. The proponents of TIP assert that this approach to economic stabilization, for the most part, would avoid governmental interference with the normal workings of the market system, a characteristic of most other incomes policies.

There are numerous TIP proposals, but the three receiving the most prominent attention at present are (1) the employer-incentive

^{1/} In testimony before the United States Senate Banking, Housing and Urban Affairs Committee, April 25, 1978.

program proposed by Henry Wallich, a member of the Federal Reserve System, and Professor Sidney Weintraub of the University of Pennsylvania; (2) the employer-employee incentive package recently proposed ^{1/} by Arthur Okun of the Brookings Institution; and (3) a proposal by Professor Laurence Seidman of the University of Pennsylvania which combines elements of the two previously mentioned proposals.

The Wallich-Weintraub plan would place a tax penalty (or surcharge) on employers who grant wage increases that exceed an "acceptable" wage increase standard established by the Federal Government. The designers of this stabilization mechanism believe it would provide an incentive to employers to resist "excessive" wage increases, since they would have to pay a tax penalty based on a formula applied to that portion of the wage increase granted by the employer that exceeds the economy-wide standard for wage increases established by the Government. If the employer were to grant a wage increase in line with the standard, no tax penalty would be assessed. Furthermore, the plan assumes that the penalty could not be automatically passed on by the firm to consumer in higher prices because some of its competitors in the market place may not have incurred as large a tax penalty (or any at all)

1/ Sidney Weintraub and Henry Wallich. A Tax-Based Incomes Policy. Journal of Economic Issues, June 1971: pp. 1-19. Arthur M. Okun. Out of the Stagflation Swamp. Across the Board. January 1978: pp. 68-75.

because of their success in granting lower wage increases. Thus, this element of competition, it is assumed, would make employers generally more resistant to "excessive wage demands."

Instead of the stick approach, the Okun plan would extend the carrot to both employers and employees, to encourage less inflationary wage and price increases. This plan would establish voluntary Government standards (or guideposts) for wage and prices. If employees of a firm were to agree to wage increases that amounted to less than the Government economy-wide standard for wage increases, they would receive a tax rebate in the form of reduced payroll taxes in proportion to the degree of wage restraint exercised. At the same time the employer would receive a tax rebate on its income tax liabilities on domestic operating profits, if the firm held its average rate of price increase (apart from a dollar-and-cents pass through of any increases in costs of materials and supplies) below the Government economy-wide standard for price increases during the course of the year.

The Seidman plan would combine elements of both the Okun and Weintraub-Wallich proposals, providing both a "stick" and "carrot" depending upon how labor and management abide by voluntary Government standards for less inflationary wage and price increases. If labor and management agree to a wage increase by the amount equal to the increase allowed under the Government wage-price standard, neither

party would receive a tax penalty. If the employer were to grant a wage increase that exceeded the Government standard, both labor and management would be assessed a predetermined tax penalty on their incomes (wages and profits) for that year in proportion to the size of the excess. On the other hand, if the employer were successful in negotiating a wage increase that would be less than the Government standard, both labor and management would receive a proportionate ^{1/} tax cut on their incomes.

Despite their differences, these three TIP proposals are based on the assumption that monetary and fiscal policies have not been effective in preventing labor from obtaining wage increases in excess of productivity gains, even in period of economic slack and high unemployment. They consider TIP not a substitute for, but an essential complement to proper monetary and fiscal policy in promoting less inflationary wage and price behavior in the economy. Furthermore, as Henry Wallich noted in recent testimony before the Senate ^{2/} Banking Committee, the various TIP proposals--

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- 1/ Laurence S. Seidman. A Tax-Based Incomes Policy: Statement before the United States Senate Committee on Banking, Housing and Urban Affairs, May 23, 1978. 22 p.
 - 2/ Henry C. Wallich, Member, Board of Governors of the Federal Reserve System. Statement before the United States Senate Committee of Banking, Housing and Urban Affairs Committee, May 22, 1978.

... rest on the well documented fact that prices follow wages [underlining added]. Numerous researchers have arrived at that conclusion. At the same time, of course, prices influence wages, although the relationship is less close. There are other cost factors that often are claimed to be responsible for inflation--high profits, high interest rates, monopolistic practices, high prices of food, of oil, and the depreciation of the dollar. While at times each of these does exert an effect, the main factor governing prices nevertheless is wages. With about 75 percent of national income representing compensation of labor, it could not be otherwise. All other elements, although at times possibly significant, are bound to be small by comparison. Therefore, restraint of wages means restraint of prices. Labor does not lose from wage restraint. Whatever it gives up in the form of higher wage increases, it can expect to get back in the form of lower price increases.

The proponents of TIP view it as the most effective and least disruptive way of attacking the current wage price spiral, and reducing the inflationary expectations of both labor and management. Because TIP relies on market incentives, they believe that direct governmental intervention can be avoided. None of the various plans compel the employer or employee to participate in the stabilization program. Nonetheless, the plans' incentive features are designed to encourage widespread participation by the private sector.

These proposals have generated considerable interest in policy making circles and among students of public policy, representing a wide spectrum of political philosophies. However, recent study of these proposals has raised numerous questions concerning their

workability as anti-inflation measures. Some of the more frequently asked questions include:

- Are they simply another form of wage and price control?
- Would they unduly complicate our tax system?
- Would they open up new tax loopholes?
- Could they lead to economic distortions by tipping the balance between capital-intensive and labor-intensive firms?
- Are labor costs, as the proponents assume, the principal cause of inflation?
- What type of administrative problems might occur?
- How are catch-up wage increases and long-term contract agreements to be handled under such a standardized system?
- What effect will they have on existing industry-wide bargaining arrangements?
- How would they affect the firm bargaining with many different unions?

1/ For two recent critiques of TIP, see: Gardner Ackley, Stagflation Swamp Revisited, Across the Board, April 1978: pp. 84-86. Nancy Ammon Jianakoplos, A Tax-based Incomes Policy (TIP): What's it all about? Federal Reserve Bank of St. Louis Review, February 1978: pp. 8-12.

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- How is the wage rate to be defined?
- How would cost of living escalators in contracts be handled?
- How are firm's costs to be computed to come up with an acceptable figure for profit margins?
- How are multi-product firms to be treated under such plans?

In the face of these concerns, the various TIP proposals will have to be subjected to many tests to determine their feasibility as anti-inflation measures. Because of their novelty and because they offer interesting alternatives to other well known anti-inflation measures, such as jawboning, voluntary guidelines, and direct controls, TIP will likely continue to receive considerable attention in the current debate over incomes policy.

CONCLUDING OBSERVATIONS

Because of the sharp rise in the general level of prices during the first four months of this year, most Government policy makers now consider inflation to be the Nation's most pressing economic problem. Though there is no cost-free solution to the inflation problem, one should not as well overlook the high economic and social costs that stem from high inflation. Among many of its costs, inflation can disrupt

the normal allocative processes of the economy, reduce the purchasing power of the individual, redistribute real purchasing power from creditors to debtors and from those whose incomes rise more slowly to those whose incomes rise more rapidly, and prompt the Government to resort to restrictive economic policies which may or (or may not) reduce inflation, but at the cost of higher unemployment and lost production.

Given recent developments on the inflation front, some believe that the Government should resort to much greater fiscal restraint than is currently planned by the Administration. However, the Administration believes that any greater restraint would cause a premature slowdown in economic activity, resulting in higher unemployment. In administering monetary policy the Federal Reserve Board is following a policy of "moderate restraint" which is aimed at reducing the growth rate of money supply over the year ahead without causing a major slowdown in economic activity. Aside from these conventional policies, the Administration is placing increased pressures on labor and management to exercise greater wage and price restraint. Administration policy is based on the assumption that inflation is largely "cost-push" in nature, because wages in general are increasing at a much faster rate than productivity, despite slack in the economy and continuing high unemployment. However, in its view the blame for

such inflationary pressures cannot be placed solely on labor or any other segment of the economy. Inflation is an economy-wide problem, reinforced to a large extent by widespread expectations of continuing spiraling of prices and wages. To reduce cost-push pressures and thereby lower inflationary expectations, the Administration is banking heavily on a strategy of exhortation designed to encourage voluntary action by labor and management to exercise greater wage and price restraint.

Over the longer run our success in restoring the economy to relative price stability will depend not only upon how the Government manages its monetary and fiscal policies, but also upon how it and private sector interests address a number of structural barriers to price stability which are not readily affected by changes in aggregate demand. These problems are particularly evident in such areas as agriculture, energy, health care, Government regulation, concentrated industries, labor markets and in low productivity industries.

The various Tax-Based Incomes Policies (TIP) proposals which have been given increased attention in policy circles suggest some interesting policy alternatives. However, they will require further study before any conclusions can be reached concerning their suitability as an anti-inflation measure.

Government policy is committed to achieving both full employment and relative price stability. Therefore the Carter Administra-

tion is attempting to steer a middle course in its anti-inflation efforts. All anti-inflation policies involve some costs to society, but the Administration believes that its program of "deceleration" can minimize the costs of inflation without calling for any major economic sacrifices from citizens or any one segment of the economy. However, if this policy should fall short of its objectives, the Government may well come under increasing pressures to resort to higher cost actions. It could tighten the fiscal reins on the economy by reducing Government spending and/or increasing taxes. Likewise the Federal Reserve might choose to shift to a policy of greater monetary restraint causing a reduction in available credit and higher interest rates. In the current economic context, both actions individually or taken together have the potential danger of slowing economic growth and increasing unemployment. Voluntary guidelines could be instituted, meaning greater direct governmental intervention in the decision making process of private markets. Or, if the Congress were to enact a new authority for economic controls, the Government could require prenotification and/or possible delay of price and wage increases in key industry sectors of the economy, or go a step further and institute a broader or more comprehensive system of mandatory controls on wages and prices. Such action would greatly reduce the economic freedom of labor and management in the setting of wages and prices.

In the final analysis, the Nation's success in reducing inflation will depend upon the American people's perception of the seriousness of the inflation problem and the extent to which they are willing to bear the costs of effective government and private sector anti-inflation efforts.

Senator SCHMITT. It has a number of questions similar to those and, in addition to those that Governor Lilly mentioned about TIP. It also I think agrees with Governor Wallich that—and I quote—"they do not believe that TIP could offset the consequences of excessively expansive monetary and fiscal policies."

Governor Wallich, you seem to be a little bit—or maybe I misinterpreted—at odds with Dr. Okun about the effect of Federal monetary and fiscal policies. Is that correct, or where do you stand on this issue?

Mr. WALLICH. Dr. Okun and I use fundamentally similar economic analysis but we come out somewhat differently. I would say, for instance, that in the present situation a large deficit is inflationary—not primarily because it generates excess demand, although we are very close to that situation—but because it generates the expectation of another large deficit next year and the year thereafter, by which time we will have excess demand if the economy is still expanding. Expectations, therefore, are set on an inflationary path. That is one link between Government deficit and inflation.

I do not think one should simply say that without excess demand there cannot be inflation as a result of the deficit. The same applies to increases in the money supply.

I would add to Dr. Okun's analysis that it certainly is true in the short run that the studies show a reduction in demand leading mostly to a reduction in volume and only secondarily to a reduction in prices. But over time the roles are reversed and a reduction, for instance, in the rate of growth of the money supply goes very largely into price adjustments.

Senator SCHMITT. Well, do you think we always have to be wedded to the short-term stimulative effect of the deficit? I think you're right. There have been some very persuasive studies in recent years that showed exactly what you have described. In the first year you generally get some stimulation of demand with a deficit, but after about 2 years you get a very marked increase in the inflation rate. The converse would also be true. Should we make any attempt to balance those two?

Mr. WALLICH. It seems clear to me that where we have the choice between bad effects now and worse effects tomorrow, we have to go for the bad now in order to stave off worse tomorrow. I would always look, therefore, at the long run and "bite the bullet" in the short run.

Senator SCHMITT. Well, let's agree then on just what the effect of the Federal deficit through the money supply and through it inflation may be, and look at some other causes of inflation and some other factors in our economy.

One school of thought, primarily in business, is that Federal tax policy is so designed that capital investment is being retarded and that we may well be reaching the peak of our recovery, another peak is lower than peaks in the past. There are those that would attribute that to tax policy, and say that capital investment is low, that we can't expand to meet all the potential demand, and that we can't modernize plant and therefore we can't cut costs.

Do any of you gentlemen have comments on that particular aspect?

Mr. SUNLEY. Federal tax policy over the last 15 or 16 years has

been aimed continually at reducing the level of taxation on the income from capital, going back to 1962 when President Kennedy proposed and Congress enacted the Investment Tax Credit and shortened depreciation lives. There was further shortening of depreciation lives in 1971. The investment tax credit, though it's been turned on and off several times, has been increased from the original 7 to 10 percent now. The President in his tax program has proposed further significant tax reductions for business so that the overall program that the President proposed would reduce the level of taxation on the income from capital by \$7 billion, whereas the individual tax cuts, as I said earlier, just offset sort of the increases due to inflation and the impact of the social security taxes that were enacted by Congress last year.

So I think that the Federal tax program has really been very responsive to the desire to stimulate and increase the level of investment.

I think if you would look over the last 20 years at just the ratio of the different taxes as a percent of total Federal revenue you will find that social security taxes were 15 percent of the total, individual income taxes about 45 percent, and corporate income taxes about 30 percent.

Individual income taxes are still about 45 percent, but social security taxes have gone from 15 percent up to 30 percent.

That is a tax on labor income. And the corporate income tax, a tax on capital income, has gone from about 30 percent of the total down to about 15 percent, which I think reflects the kinds of shifts that have been made over these years in Federal tax law.

So I think we have done about as much as we can through the Federal tax system to keep twisting the output towards investment.

It may well be that the policy which we ought to pursue, as suggested by Governor Wallich, is one which would involve tighter fiscal policy; that is to say, run a smaller deficit so we can get the interest rate down.

The mix between fiscal policy, on the one hand, and monetary policy on the other is one of the areas which people will be looking very closely at.

Senator SCHMITT. What about the relative bite the Federal Government puts on the gross national product? Do you think that should be restricted and do you think we ought to try to let the Federal budget increase by only 2 percent per year to reduce the amount of total tax we're taking?

Mr. SUNLEY. No, Senator. President Carter is committed to reducing the size of the Federal expenditures relative to GNP.

Senator SCHMITT. What is that?

Mr. SUNLEY. He's committed to bring that down to 21½ percent from the 22½ he inherited.

The 1979 budget, as proposed by the President, included no really new expenditure initiatives. In real terms, that budget has the smallest increase in Government expenditures in the last 5 years.

So the President is committed to holding down the rate of Government expenditures and reducing Federal Government expenditures as a share of GNP and, at the same time, relying on tax reductions to insure that additional jobs are in fact created in the private sector.

Senator SCHMITT. Well, that commitment may be there. It's not entirely obvious that it is being carried out or can be by this administration with all the other desires that they have.

We had a commitment not too long ago to try to balance the budget also within a fairly significant period of time.

Mr. SUNLEY. The President still believes that that is an important goal.

Senator SCHMITT. Well, I understand. Everybody believes it, but we don't seem to see much progress getting there.

What was the percent increase in Federal spending of the President's budget? Wasn't it about 10 or 15 percent over last year?

Mr. SUNLEY. I believe it was about 10 percent in nominal dollars and 2 percent in real dollars.

Senator SCHMITT. Thank you, Mr. Chairman.

The CHAIRMAN. I would like to ask both Dr. Wallich and Governor Lilly to comment on this.

Given the Federal Reserve's very strong interest in inflation, would it be possible for the Federal Reserve to use its regional network to determine business and labor's attitude toward TIP?

I realize that you, Governor Wallich, are personally involved in TIP, but still, it would seem to me that this would be an apparatus that could be very useful in ascertaining what the difficulties and objections might be and whether or not there is much prospect of support.

Mr. WALLICH. I would certainly welcome any comments.

The CHAIRMAN. Can you go out and seek people? Can you aggressively go out and ask for them?

Mr. WALLICH. That could be possible. Of course, by no means are all of the directors of Reserve Banks, businessmen or bankers. There are academics and others.

The CHAIRMAN. I'm not asking the directors necessarily give their views, although they would be welcome.

I'm asking if you use the apparatus of the Federal Reserve to solicit a comprehensive response from businessmen from their region.

Mr. WALLICH. That kind of inquiry might be possible. I hope that by now TIP is sufficiently well known that it would be relatively easy to get responses from people. To the extent that this is not the case, the difficult aspect of such a survey is how to get the facts before the audience, as it were, so that meaningful responses could be generated.

The CHAIRMAN. Governor Lilly?

Mr. LILLY. Well, I think that Governor Wallich is a little reluctant to volunteer the services of his colleagues. But I don't feel under that constraint since I'm no longer on the Board.

I think that it would be an undertaking that could be very well done by the 12 Federal Reserve banks and the Board.

I think you could get a great wealth of information rather quickly.

Senator SCHMITT. Mr. Chairman, if you would yield. I think it's an excellent suggestion. I also, though, would think that it might be useful to balance the record by asking the question: "What other components of inflation does the Federal Reserve System as a whole see?"

The CHAIRMAN. Yes. In other words, any other options.

Senator SCHMITT. I'm asking for options or just their analysis of the present inflation rate. Also what are the contributing pressures?

The CHAIRMAN. Well, we may write a letter to the Chairman of the Federal Reserve Board and ask him to make this kind of a study.

Dr. Wallich, you said that labor does not lose from wage restraint. Whatever it gives up in the form of higher wage increases, it can expect to get back in the form of lower price increases.

Now that would be true if the wage and price restraint were of the same magnitude. But how do you convince labor that you can deliver, if they take the more modest wage increase, that prices won't go up more?

Mr. WALLICH. The evidence shows that prices tend to follow wages. As wage movements have gone up and down, prices have been strongly influenced and ultimately determined by wages. The reason for that, as I said, is that wages are by far the largest cost in production. There is very little else, such as profits, raw material costs, oil, food shortages, and that kind of thing, that might cause significant fluctuations in production costs. But by and large, the evidence that prices are determined by wages is very strong.

Now if labor is concerned that wage restraint would not be followed by price restraint, I have made the additional suggestion that we try to stabilize the share of corporate profits in national income or GNP on some historic basis. Then if profit margins should widen because prices do not decelerate fully as wages decelerate, the profits tax—that is, 48 percent corporate income tax—would be raised sufficiently—

The CHAIRMAN. I understand that.

So you wouldn't have the kind of resentment angle working but you would have the cold, hard fact, prices didn't come down.

Unless you feel the profits tax might result in a price reduction—

Mr. WALLICH. I think the basic fact, Mr. Chairman, is that prices will respond, and my concern is mostly to reassure labor about a concern I know that labor feels, even though I do not think it is a necessary concern.

The CHAIRMAN. Dr. Okun proposed a program for tax incentives for those workers and firms that comply with wage guidelines would lower tax rates, as I understand it, and therefore, increase the size of the Federal budget deficit.

How much do you estimate the cost of your proposal would be and would that amount be added to the deficit or would there be other revenue increases that would compensate for it—

Dr. OKUN. I would hope that the provision for a reward approach on a tax-based incomes policy would be made without enlarging the deficit, either by an explicit decision to defer any tax steps that would otherwise be made during that period, or to put a strong curb on Government spending during that period.

The program that I have outlined, with my guess that you would have two-thirds participation, would involve revenue losses of perhaps \$12 to \$14 billion a year.

I think ideally one would like to exact TIP at a time when we would otherwise be likely to make a tax cut. And we are in such a position now. Because of the inflation upcreep on income tax brackets, on the value of the exemption and so forth, we will have to make recurrent—

The CHAIRMAN. What you are really proposing is a form of a tax cut that would be as deflationary as possible.

Dr. OKUN. That's right.

The CHAIRMAN. Dr. Wallich, your version, as I understand it, would apply a penalty for a wage increase above a certain norm. Dr. Okun's version would give a tax cut for any wage increase less than a certain norm.

Is there a possibility of merging these two? Can they work together in tandem, or do you have to choose one or the other?

Mr. WALLICH. It might be possible. For instance, one could have a penalty for wage increases above a certain norm and a bonus for increases below a certain norm.

It raises the problem, however, that everybody must have access to such a scheme, and I believe it is only on the principle of universal coverage, that one could easily apply something of this kind. Also, there would be familiar administrative problems with evaluating low wage increases of a firm that had created a special situation for itself.

So I have not pushed farther in that direction because of these difficulties, it is not impossible.

The CHAIRMAN. Now, one of the results of TIP, as I understand it, is not only to moderate inflation, but also, to give us a lower rate of unemployment for any given rate of inflation.

Is that correct?

Mr. WALLICH. That is.

The CHAIRMAN. How significant would that be? Do you lower it one-half of 1 percent, for example, or 1 percent?

Mr. WALLICH. I think 1 percent would not be an unreasonable guess. It depends on how forcefully the system is applied.

The CHAIRMAN. How would that work? How do you estimate it would work to reduce unemployment?

Mr. WALLICH. To be somewhat technical, there is a doctrine of the noninflation rate of unemployment; that is, at some rate of unemployment inflation neither rises nor falls. Now if there is such a point, assume we are at that point. If TIP is introduced, we would expect inflation to fall while the level of unemployment remained constant. This tendency for inflation to decelerate could be used to reduce unemployment to the point where inflation remained constant. That would be the point at which there is an equilibrium between the downward thrust of TIP and the upward thrust of a low rate of unemployment.

The CHAIRMAN. Dr. Okun, as the author of Okun's law and one of the outstanding experts in the world in inflation and unemployment, and their relationship to each other, do you feel realistically that TIP could play a part in moderating the rate of employment you would have with a given rate of inflation? And if so, how?

Dr. OKUN. Yes, and along the lines that Dr. Wallich indicated. The balance point in labor markets depends upon how firms and workers respond in setting wage increases with a given degree of tightness or slack.

If you can change the incentives, you can lower the unemployment rate, and presumably, get the output that is associated with that.

Now, I think that gets into the question of whether one visualizes TIP for a fairly limited time period primarily as a way of getting out of the momentum inflation we have gotten into, or whether one envisions this as a long-term continuing program.

My view is, let's strive for 3 years with the main emphasis being to get out of this stagflation swamp. Then, if it turns out to be reasonably manageable, feasible, and not administratively cumbersome, we can take another look and see whether it could do us some good in the long run as a way of having a lower unemployment rate along with a noninflationary economy.

All of this, of course, is a way of making it possible to accomplish a given output and unemployment objective with lower money growth because you won't have to finance as much inflation along with it.

And I would think that with an improvement in investment attitudes and the like, it should be possible to operate the Federal budget much closer to balance.

It seems to me that curing the inflation problem is a precondition for getting the kind of monetary and fiscal policy that would be consistent with noninflationary performance over the long run.

The CHAIRMAN. Senator Schmitt.

Senator SCHMITT. Gentlemen, do you see TIP going to all components of the unemployment rate, or assisting in that? For example, would it have anything to do with so-called structural unemployment? Affecting those people without marketable skills? Dr. Wallich.

Mr. WALLICH. I do not see TIP as a means of dealing directly with structural unemployment if I understand the question correctly. I do think that the unemployment rate can be lowered in the long run given that TIP is continuously applied.

Senator SCHMITT. Governor, my impression is that it would primarily assist in those areas employing relatively skilled individuals, semiskilled or skilled individuals. The unemployment figures, however, contain a great deal of structural unemployment.

They also contain figures for those people that are coming in and out of the job market without a long-term commitment, if you will, to full employment. Will it affect that group, that in-and-out employment group?

Mr. WALLICH. To the extent that the whole unemployment rate is lower over a period of time, I think that that group would tend to benefit more than proportionately, because the unemployment in that group is so high. When unemployment as a whole comes down, that group generally has a higher reduction in unemployment. But TIP is primarily directed against inflation. I believe it is in curing inflation that it would have its main benefit of improving the whole tone of the economy and the investment that you were concerned with, Senator. In that way, I believe TIP would contribute to reducing unemployment at all levels.

Senator SCHMITT. Well, I guess my concern, gentlemen, is that the TIP proposal, taken by itself, tends to imply that the blame for inflation is in the private sector, both labor and business. Maybe I am misunderstanding, but that seems to be where you are directing the cure for something that has many components, one which we can't

completely agree upon, but others, such as energy crisis, regulation, wage increases beyond productivity, and the inflation rate; and then again, tax policy.

Do you think it can be successful without fairly significant action in these other areas, including Federal spending?

Mr. WALLICH. I agree with you, Senator, as my testimony tries to reveal.

Senator SCHMITT. Yes.

Mr. WALLICH. Unless we have fiscal and monetary restraint, although possibly less forceful than would otherwise be necessary, I don't think TIP is going to do the job.

It is not a substitute; it is a complement for the right measures which are in the Government area.

Senator SCHMITT. Dr. Okun.

Dr. OKUN. I think the issue that you have raised, Senator, of the appearance of blame, is an important one. As I see the way our private sector system operates, we have wages that are determined, in large measure, on the basis of certain standards of equity.

There are lots of employers that have long queues of workers looking for jobs, but they don't turn to the present workers and say, "We are going to freeze wages, and if you don't like it, there are lots of fellows out there who would like your jobs."

That was the Marxist model of a labor market, and it turned out to be wrong. We do have a career attachment between employers and employees, and whether you are talking about a union or non-union context, everybody has to do for his workers what others are doing for theirs.

Similarly, on the price side, we have a situation in which, basically, the only way a firm can manage its pricing is to do pricing that has a very strong relationship to costs—cost-oriented pricing; you put a markup onto your cost. In that kind of a world, inflation isn't all that sensitive to the strength or weakness of demand.

The kind of recession that we have had in 1974 and 1975 by the old textbooks should have produced declining prices and wages. And it didn't. In auction-type markets where supply and demand are nearly balanced—copper, lumber, and so forth—we did have major price reductions resulting in an actual turnaround of inflation in 1975.

But that didn't happen in collective-bargaining areas; it didn't happen in the administrative pricing system. I don't think it is bad that our system operates in a long-term context of wagemaking between employers and employees; but in the present situation, it does prevent us from getting out of the box.

It does give an enormous amount of momentum to an inflation that was unquestionably caused by some very serious mistakes that were made by the Government. I regret to say, that they began at a time when I was a public official in the late sixties, they were compounded by some new mistakes made in 1971 and 1972 of seeking to use controls as a way out of the box, and compounded by what I think was, basically, misfortune and bad luck on the energy price explosion.

So we are here. To me it is no more a matter of blaming business and labor than when we take the position that the only way people

toting guns in a frontier town can put them down is when there is some sore of decision to engage in, multilateral disarmament.

We are looking for multilateral disarmament between business and labor here, but not because they are sinful, or because anybody's a villain of the piece, or because the Government is blameless and faultless. Quite the contrary. We are in a momentum situation; we are entrenched in it, and we have to make a collective decision to get out of it.

Senator SCHMITT. Doctor, you and I agree in all but one aspect of your analysis of the history of the sixties and seventies that you mention. I would disagree that the energy was bad luck. We brought that on ourselves, also, by 25 years of bad policy.

Governor Lilly, would you care to comment?

Mr. LILLY. Well, I would comment on Governor Wallich's remark about the question of whether this is to improve, will improve structural unemployment. I don't think it will. I think structural unemployment is something that we have to develop other programs for.

I think the main unemployment problem today is with minority teenagers. I would hate to see that problem finally come to a solution after all these other events of the period. I think Governor Wallich said that he wasn't really addressing that problem with TIP. He was addressing inflation. I think we need all sorts of programs to do something about the minority teenagers.

Senator SCHMITT. I agree with you also. I am not sure Governor Wallich was trying to advocate TIP as a way into that problem.

Mr. LILLY. I don't think he was.

Senator SCHMITT. But we had been coupling or linking TIP with the unemployment picture, and I felt we needed to understand that it really goes to just one component of, if at all, the unemployment. And that is those workers who are career workers. This includes primarily adults, most of whom are adult males, I believe, at the present time. That unemployment rate is somewhere around 3 percent. I believe, right now. That is what we would be working on primarily.

Mr. Sunley.

Mr. SUNLEY. I might add, if I may, one comment on the structural unemployment. President Carter, as part of his urban program has proposed a restructuring of the new jobs credit by Congress enacted in 1977. The 1977 version of the credit is really an award for firms which are rapidly growing. What the President has proposed is to restructure that credit as a reward for firms that are employing disadvantaged youth, defined as those between the ages of 18 and 24 who come from families with incomes of less than 70 percent of the lower family budget published by the Department for different cities in the country.

This is an example of a Government program aimed at structural unemployment and not just relying on aggregate fiscal policy to bring down the unemployment rate.

I think that TIP is another example of a policy which would permit us to moderate wages and prices without at the same time adding substantially to the level of unemployment.

That, of course, has been the basic and difficult problem that we have faced over the last 4 or 5 years—how can you moderate the

level of inflation in the economy without getting unemployment up to 9 and 10 percent.

I think the President's proposal for the new employment credit is moving us in the right direction.

Senator SCHMITT. Mr. Chairman, I think it's been a very interesting panel. I have some very deep concerns. I think we have been unwilling, for example, to see what an expansionary, in the terms of decreasing inflation, tax policy and fiscal policy would do with respect to long-term decrease in unemployment. We have been unwilling to take those longer term steps. We have been trying to work in the short term and have been afraid to do some things that I think would, in fact, work, and not impact the employment picture at all.

I am also concerned that TIP is being advocated in part, certainly not by Governor Wallich, in a vacuum of saying let's go work on the private sector without really taking care of our own house here in the Congress. And the chairman certainly has been trying to do that as have a number of other people. I don't think we can do one without the other.

The CHAIRMAN. Well, I appreciate that. I do think, as I understand both Dr. Okun and Dr. Wallich that they both recognize this is one approach that they think is desirable, but they would like to see a lot of other things done, too. I want to get to that.

Senator SCHMITT. Of course, my other concern is that just administration of a program of this kind is conceivably extremely difficult, particularly if you go the stick approach. We might actually cause more damage to our economy by the administrative structure which operates TIP, than any good that might come from it. That would be something we would have to be very, very careful about.

Thank you, Mr. Chairman.

The CHAIRMAN. Dr. Okun, in your opening remarks you indicated that current economic policies are on a collision course. I take it you think monetary policy is likely to be too restrictive, while fiscal policy may be too expensive. How severe is the collision likely to be?

For example, in your opinion, will monetary policies during the next year be so restrictive as to lead to a credit crunch and a housing recession?

Dr. OKUN. I think that is a very serious risk, Senator. As I see it, our monetary targets today are inconsistent with the projected growth rate of the economy. What we have seen in the last year is roughly a 200-basis point increase in interest rates. We are looking at, if anything, an attempt to lower the growth rate of the money supply over the next year, at a time when there is very little evidence that either private demand or fiscal policy is lowering the growth rate of the economy.

If that is indeed the stance of monetary policy, and I am not sure how wedded monetary policy is to a particular target, I think a realistic estimate is that the rate of increase of interest rates will somewhat exceed the 200-basis points of the past year. And I would find it very difficult to believe that that kind of rise in interest rates could take place without causing catastrophe in home building and mortgage financing. That may well be the only alternative, from the Federal Reserve's point of view, to basically validating 7 percent inflation.

I think that is a horrible choice, between taking a large risk of inflation and taking a risk of saying that 7 percent inflation is acceptable, because it isn't. And 6 percent wasn't acceptable, either. We don't have a fiscal and monetary stance likely to result in a consistent balanced pattern of economic activity.

The CHAIRMAN. We have done that again, and again, and again, haven't we? We have followed a policy of high interest rates in response to an inflation threat with the result we have a housing crunch, with the result that—we have a recession in housing, people laid off there, and maybe some effect, maybe not in lowering prices, but certainly a devastatingly adverse effect on employment and on the economy as a whole.

I realize that the Federal Reserve is put in a touchy position when they feel they—the only show in town—that they are the only show in town fighting inflation and, of course, what you would do here is provide another show to go along with it. You wouldn't take them out of the act, but you would provide something else to try to supplement it.

Governor Lilly, you have said that Government actions and regulations add to inflation, and I agree. The Council on Wage and Price Stability is responsible for examining the impact of agency regulations on Government and inflation, but the Congress, in most situations, doesn't consider the inflation aspect of laws as considering fully enough. As you know, the Congressional Budget Office prepares a budget impact statement so we know what effect legislation will have on the budget. Nobody prepares an inflation impact statement.

What would you think of requiring that all major pieces of legislation carry some indication of what inflation effect they might have? Do you think it would be worthwhile?

Mr. LILLY. I think it would be one of the most significant things that could happen in the Congress, if there were an inflationary impact statement with every major piece of legislation introduced.

The CHAIRMAN. Dr. Okun?

Dr. OKUN. Yes. I have been advancing a proposal that has a slightly different form, but the same intent, that is a quarterly report and scorekeeping system in which all of the pending and recently enacted legislation and executive discretionary decisions would be priced out into their inflationary impact, favorable or unfavorable.

The CHAIRMAN. That would be a supplement, it would seem to me, to have both of them. But it would be great to have it in advance so when we have a vote on the floor, we could make arguments that the given legislation would have inflationary impact.

Dr. OKUN. Exactly. I think these could be complements to each other, having an inflationary impact statement program by program and periodically summing up the totals so we could see exactly what kind of net effect there is. Last year, what I have called the self-inflicted wounds of higher payroll taxes, a major increase in minimum wage, a return to a farm program that puts a heavy emphasis on acreage set-asides, and a number of international trade actions have probably been the decisive factor in making the inflation outlook more like 7 percent than like 6. That really needs to be brought under control.

These cost-raising measures by the Government have become habitual. They have become an easy way out to problems of how to avoid either saying no to interest groups or financing it in ways that enlarge the deficit. Notice these are things that didn't add to the deficit. I think we could have had a much more anti-inflationary program by having a subsidy for low-income wage earners than a major increase in the minimum wage. It would have showed up as a Federal deficit, but would have had less effect on the cost structure.

What we are doing now is passing costs on into the business and household sectors. They don't show up in the federal budget. That strategy, it seems to me, is the most dangerous new proinflationary game in this town.

The CHAIRMAN. When that realization comes, it can be very effective. I can recall what happened to the farm bill, it was defeated in the House. People thought it might be able to muster enough votes to pass it over a veto, but there was finally a realization of how enormously inflationary that proposal was, and it went down.

Unfortunately, that realization doesn't occur on most legislation which can be inflationary.

I would like to have both you, Dr. Wallich, and Dr. Okun comment on the argument by Governor Lilly that TIP is a mild form of wage and price controls. Would you accept that, or would you disagree?

Mr. WALLICH. I have to differ with my colleague. It is intended to be, and I think would be precisely the opposite. The mechanism would be left in place, any employer can pay more than the guideline.

A union can demand and obtain more than the guideline. All that happens is the economic pros and cons of doing that alter. Now, at the present time, obviously, there are economic penalties to the firm for any wage increase that it offers.

Here, the economic penalties under TIP would be further increases. It is simply a change in the balance of bargaining power, but no interference that I can see with the free market.

The CHAIRMAN. Dr. Okun?

Dr. OKUN. I would certainly agree with Dr. Wallich's position on that. I think we have avoided all of what I consider to be the hallmarks and defining characteristics of controls—that they interfere with the market, that they require Government monitoring and advanced approval, and that they prohibit some form of private behavior and make it illegal.

None of those characteristics apply to either a penalty or a reward TIP.

I think TIP puts us in the position of saying there is a public interest in private decisions made on wages and prices. And there is.

We are trying to influence behavior just as we do when we apply an investment tax credit as an incentive to get people to invest more and just as we do when we apply a large alcohol excise tax in an attempt to get people to drink less.

These are ways in which the tax system has traditionally been used, to say that certain forms of behavior have either a favorable or unfavorable influence on society as a whole that goes beyond the decisionmaker, and that we want to give a reward or penalty to reflect that broader social concern.

The CHAIRMAN. Mr. Sunley, I would just like to ask you to follow up on that. The investment tax credit is an approach to try to achieve greater investment by using the tax system. The TIP approach is an attempt to moderate price increases by using the tax system. Would you say that the investment tax credit could be used, in a sense to a limited extent, perhaps, as a kind of model for TIP?

Mr. SUNLEY. One of the points that I wanted to make in my first statement was that there are considerably more administrative problems with the reward TIP than the penalty TIP—

The CHAIRMAN. Let me ask you about the administrative problem. I think you have made that point emphatically, but the only way you can measure that is by looking at the costs. There are other elements too, of course, because the cost is not only cost to the Government but cost of compliance by the parties involved. Can you give us any estimate at all of what the cost of, say, a TIP confined to large corporations and labor unions, that is, this is the area where price leadership and price determination is the clearest.

Mr. SUNLEY. No, I do not have a means of quantifying—

The CHAIRMAN. Would you work on that?

Mr. SUNLEY. I think if the TIP proposal got far enough along that it was fairly well developed, so that the Internal Revenue Service could take a look at it, I think they could at least estimate what the additional costs to the Government are to administer it.

I think it is fairly easy to determine between various ways of doing things which are the more costly ways of doing it, but to actually put a number on it is a major undertaking.

The CHAIRMAN. Without asking for a precise number, just some order of magnitude, how many more people would have to do it, that kind of thing, so we have some notion of what the administrative costs would be.

I don't see why it would be so difficult to say that this is a program that would cost \$5, \$20 million, whatever general order it would be.

I take it would be something like that: is that right?

Mr. SUNLEY. I will take a look and see what is possible there.

The CHAIRMAN. Dr. Okun.

Dr. OKUN. I think this comment that Secretary Sunley made is the most frequent major criticism of the reward approach. It does have to be universal, whereas the penalty approach could be selective.

And that does create a significant administrative advantage in favor of the penalty approach.

I just want to make a couple of comments on whether that issue is overwhelming and decisive.

To begin with, the legislation will look the same and have to be drafted with the same painstaking care whether it applies to as few as 1,000 firms or as many as 1 million firms.

The forms will look the same, even though the amount of mailing is tremendously different under the two schemes. The step for inquiries at the Internal Revenue Service obviously has to be vastly different, as there will be more people calling for information on how to do it, if it is universal rather than selective.

I really question whether these are decisive costs. It does seem to me that in a world in which we have operated with an investment tax credit, employment tax credit, capital gains advantages, deductible

travel and entertainment expenses that are applicable to every employer and, indeed, every self-employed individual in this country, we have a fair amount of experience with fairly complex provisions of the income tax. They apply universally, and are enforced solely by audit; and with low probability of audit, we still get pretty good compliance.

In an attempt to put these costs into perspective, let me highlight a few advantages of the reward route. It seems to me that it provides a built-in incentive for enforcement if you are telling firms that, when they claim the credit, they are getting a tax reduction for their employees, rather than that when they claim a lower wage increase, they are getting a lower penalty on themselves. I don't think they are nearly as likely to take the risk of punishment by IRS to get tax cuts for their workers, as they are to cut their own taxes.

It also seems easier to handle when you start enacting a program and look at the special situations that may in some sense be inequitable at start-up time—like people who got very low wage increases last year being perhaps entitled to a catch-up. The Congress following its traditional approach is likely to say, if we are offering a reward, a credit, a benefit, a loosening of the bite of taxes, that is the way the ball bounces, and some people may not get full equality in the first year.

If you are going to take money away from people, however, Congress is likely to try to be much more precise in making up for all these special cases.

And I think once you try to do that, you create a very difficult program. You really have to accept some imperfections, in order to get an administratively feasible and economically effective program.

The CHAIRMAN. Gentlemen, I want to thank all of you for your testimony. It's been most helpful. This is a kind of a tough technical area, but it is innovation and imagination and can be extremely helpful to us.

The committee will stand in recess until 3:00 o'clock this afternoon, when Ambassador Strauss will be our witness.

[Whereupon, at 12:20 p.m., the hearing was recessed, to be reconvened at 3:00 p.m., this same day.]

AFTERNOON SESSION

The committee met at 3:00 p.m. in room 5302 Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire, McIntyre, Schmitt, Tower, Riegle, Brooke, and Sarbanes.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

THE CHAIRMAN. The committee will come to order.

Mr. Ambassador, we are delighted to see you, if a little tardy. I understand you took the subway to fight inflation in your own way.

This afternoon we are continuing our oversight hearings on inflation and new ways to reduce inflation. We are honored to have with us this afternoon Ambassador Robert Strauss who has been named by President Carter as his number one spokesman and salesman of the administration's anti-inflation program.

We are all well aware that the number one economic concern of most people in our country is inflation. This morning we were told that some new programs to reduce inflation by providing tax incentives would be a desirable complement to the President's program and more traditional fiscal and monetary policies.

Those policies—fiscal restraint and a conservative monetary policy—are not to be abandoned; they would be used along with the so-called tax-based incomes policies.

Also, the President's program to reduce inflation through voluntary programs and by reducing the inflationary impact of the Government itself would certainly be continued.

I am very interested in knowing how well the President's anti-inflation program is doing. It has not gotten 100 percent acceptance from either business or labor. Some press reports indicate that although everyone is concerned with inflation, support for the voluntary programs will be difficult to obtain.

It is obvious that you have undertaken a very difficult job, Mr. Strauss. We would like to hear more about the types of activities and programs that are under way and those that are being considered.

We would also like to find out how successful you have been in getting the business and labor people to agree to at least consider moderating wages and prices.

OPENING STATEMENT OF SENATOR BROOKE

SENATOR BROOKE. Mr. Chairman, I would like to take just a moment to commend you for calling these hearings on anti-inflationary proposals. This committee, with its jurisdiction over all matters relating to the economy is in a unique position to assess the effectiveness of

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anti-inflationary proposals made by the administration and by economic experts in the private sector. The polls I have seen indicate a growing public awareness of the effects of inflation on the lives of everyone of us. Not only does inflation erode the value of savings and push up interest rates, but it in effect imposes an across-the-board sales tax on everything we buy. This "inflation sales tax" falls equally on the rich and the poor; it destroys the value of the welfare check, the social security check, and the stock dividend check as well. This "inflation tax" is a most regressive tax, a tax made all the more insidious by the fact that no one is required to vote for it.

But there is no question that repealing this "inflation tax" will not be easy. It has insinuated itself into all of our economic calculations, from the payment of the grocery bill to the purchase of a house. But we must do all we can to root out this inflationary psychology.

And in this effort, if the President provides strong leadership, I have no doubt he will receive support in the Congress.

I welcome Bob Strauss, to these hearings, and I look forward to his testimony this afternoon.

STATEMENT OF ROBERT STRAUSS, SPECIAL REPRESENTATIVE FOR TRADE NEGOTIATION

Ambassador STRAUSS. Thank you, Senator.

First, may I apologize for being a few minutes late. One of the things I was doing was working on inflation at the time, I might add. I was specifically talking with John deButts, chairman of the board of American Telephone & Telegraph; had a constructive and encouraging conversation with him, one that I think will lead to very positive steps.

May I, with your permission, read about a 12-minute statement, and then take such questions as you might have, or would you prefer I eliminate the statement?

The CHAIRMAN. No. That is fine. Why don't you go ahead with the statement.

Ambassador STRAUSS. Thank you.

As every member of this committee knows, inflation has been a major problem for a number of years, through several administrations.

We are not going to cure our inflationary spiral overnight. But I am increasingly confident that we can begin to chip away at the spiral, cause it to peak and then turn downward a bit.

We will begin to see some results within 12 months, but our program is directed at significant progress over more like a 30-month period.

For nearly a decade we have now been struggling with the twin evils of high inflation and high rates of unemployment. Traditional macroeconomic remedies have not succeeded in relieving the inflationary pressure in our economy—and they have imposed a severe burden on our workers and businesses.

In dealing with inflation, this Administration will not fall back on remedies that seek to solve the inflation puzzle through increased joblessness. There is no magical solution or "quick fix" for a problem that is complex and stubborn, and that we recognize.

To understand our approach, it is important to comprehend the magnitude of the problems we are facing.

The first 3 months of this year wage and price increases accelerated. This acceleration, though not likely to continue through the remainder of the year, provides clear evidence that we need to move aggressively and without delay.

Reading the 1978 figures, in the context of this winter's developments, they tell me that while there is no cause for panic, there is certainly cause for concern and immediate attention by the public and private sectors.

On the wage front, several measures of employment costs displayed sharp increases.

Prices also accelerated in the first quarter of this year. The consumer price index increased at an annual rate of 9.3 percent, compared to the 5.8 percent average annual increases in the 1976-77 period.

The acceleration of wages and labor costs in the first quarter is largely attributable to a series of factors which are not likely to recur or persist in the remainder of the year.

Similarly, a 16.4 percent annualized increase in food prices was the primary force behind the first quarter's price acceleration. If food prices return to more normal levels, the overall rate of price inflation will slacken to some extent.

But we must candidly admit that the food price inflation this winter was worse than expected and, in areas such as meat price increases, we cannot be certain that the worst is behind us. Just look at the futures markets.

There is no cause for all-out alarm, but an all-out alert is warranted.

Inflation may accelerate a bit this year, but it is unlikely that the levels indicated by first quarter statistics would be characteristic of the year as a whole. More likely is a lesser acceleration.

This expectation, however, provides no reason to breathe any sigh of relief. In the absence of specific corrective action, the risks of acceleration are very real and very probable.

If we are unable to slow inflation during a period in which economic slack remains, then we are almost certain to face much higher inflation rates by 1980 or 1981 as the economy approaches higher levels of employment and capacity utilization.

Because of both public attitudes and economic reality, an accelerating inflation would almost surely bring economic expansion to a halt, reverse progress towards lower unemployment rates, and depress investment spending. This is a scenario that we must avoid.

This administration has examined carefully the successes and failures of past efforts to cure inflation. We have studied the advice of the best economic experts.

Our approach will be one of voluntary cooperation between business, labor, and Government. We are setting specific performance standards for each group, and we expect them to be met. We will not be bashful in pointing out who is cooperating with us and who is not.

Too often in the past, Government has called on the private sector to sacrifice without making any contribution itself.

President Carter recognizes that Government must take the lead in this effort, and set the pace through responsible fiscal policy, efficient regulatory efforts, and a wage policy that practices what we preach.

There is little question that price levels in our society are affected directed both by Government spending and by regulatory policy. This is not a criticism of Congressional or executive branch programs, but a statement that the inflationary impact of proposed programs should be recognized and weighed before decisions are made.

Too much fiscal stimulus is clearly inflationary; too little stimulus threatens the continuation of the expansion. We are not going to slash the budget and throw people out of work in the hope that this will moderate wage demands. The appropriate course is gradually to reduce the federal deficit by controlling federal expenditures and sustaining the economic expansion.

The President has already taken, and will continue to take, a great number of specific steps to help reduce the Federal Government's contributions to inflation. Let me mention just a few:

Limited federal employee pay raises to 5.5 percent and frozen Federal Executive pay.

The President will appoint a small, high-level governmental task force to coordinate efforts to improve Government efficiency and productivity. This task force will work to simplify procedures and see that cost-effectiveness is considered in all Federal actions.

It is my expectation to work very carefully, very closely, and take almost a daily interest in the actions of that group, which I tend to think of almost as a governmental strike force against our own Government inefficiency where we find it.

The President last Thursday announced that he will establish a Federal Purchasing Council to direct the purchase of goods and services by the Federal Government in such a way that they do not contribute to price inflation.

The President directed that price escalation clauses of all new or renegotiated Federal contracts reflect the principle of deceleration.

Those of you in Congress have been asked to approve a hospital cost-containment program to restrain the extremely rapid rise in medical care prices.

In the short run, however, we will focus our efforts on measures that promise some short-term relief from the inflation problem.

Senator McINTYRE. Mr. Chairman, may I ask a quick question here?

The CHAIRMAN. Sure.

Mr. Ambassador, Senator McIntyre would like to interrupt and ask a question.

Ambassador STRAUSS. Yes?

Senator McINTYRE. I note that what has always been a high priority of the administration, to balance the budget, does not appear among these thrusts that you are indicating here today. Does that mean that it has been abandoned?

Ambassador STRAUSS. No, it does not, Senator McIntyre. As a matter of fact, I think the—there is going to be a strong and vigorous budgetary process take place within the next few months to try to see what this administration can do with the budget.

I think you will see a strong and vigorous policy as you have ever seen by any administration.

Now, I didn't bring that up in here because it hasn't been cast for me in the light of this inflationary program which I am responsible for, but I am fully participating in that budgetary process and I think it is going to be productive.

Senator McINTYRE. Thank you. I hope so.

Thank you, Mr. Chairman.

Ambassador STRAUSS. But while the Government can take the lead in the fight against inflation, it cannot solve the problem alone. The cooperation of business and labor is essential to a successful effort.

We are asking the business community to publicly and vocally commit themselves to our deceleration standards. We believe that the avoidance of a single number or yardstick and the insistence on steady, gradual deceleration will make it possible for every major American corporation to support our efforts. We expect no less.

We are asking individual firms to calculate the average rate of price increase over the last 2 years, and to make a commitment that any further price increases necessary this calendar year will be significantly less than the average of the last 2 years.

We have an overall industry goal of annual deceleration in the range of one-half to 1 percent, but we intend to view each industry flexibly.

On the wage side, we must bring down the pattern of 9 to 10 percent per year increases in total hourly compensation that characterized the 1976-77 wage round among major unions.

There are already signs of both an acceleration of nonunion wages and attempts by smaller unions to match the inflationary gains won by larger unions in their last round of bargaining. We cannot afford to let this pattern become even more pervasive as labor markets continue to tighten.

We recognize that it is difficult for any one group of workers to make the first step toward deceleration, but the time to begin is now.

We need to see results on both the wage and price side this year, but one can't expect unions to enter into long-term wage agreements until they see comparable restraint in pricing and Government activity.

There are approximately 1 million rail and postal workers currently negotiating new agreements, and nearly another 1 million workers bargaining this year in industries such as paper, cement, retail food, airlines, and construction.

To let these settlements slip by would set a bad precedent for next year's negotiations. Even though the groups that are negotiating now do not receive the amount of national attention devoted to truckers or auto workers, their negotiations are important to the inflation battle. Large settlements in smaller bargaining situations can have very negative effects.

Finally, to make this program meaningful, we need to expand its focus from Washington out to our States and cities. I will shortly be announcing a stepped-up program of regional efforts to educate citizens to the nature of inflation, and what they can do to help us turn the inflationary tide.

I want to assure you that the President has put his full weight behind this program. He has given me and my colleagues in this effort all the authority and support that we could ask for.

I am pleased to report to you that the concerned agencies of the Federal Government are working well together in the way Government officials and agencies should cooperate.

I intend to act forcefully and to speak out frequently, using the full force of available public and private resources to rally support for this fight.

The years that I have spent in association with Members of Congress on both sides of the aisle is one unique strength that I bring to this task.

I will need the cooperation and advice of the members of this committee and your colleagues in the Senate if we are to succeed in this effort. And I know that I can count on that support from Democrats and Republicans alike.

This is a battle we are all in together.

Thank you very much.

The CHAIRMAN. Thank you, Mr. Ambassador.

Mr. Ambassador, some time ago, oh, a couple of weeks ago, you were asked how the inflation battle was going and you said the score right now is inflation 100, Strauss zero.

I wonder if you have had a chance—in view of recent developments and your activity—to give us a picture of what that score is now and how you are doing now.

Ambassador STRAUSS. Well, Senator, that statement I made was intended to get the public to focus in on just how far we were from making any progress in this inflation matter. It is one of those that maybe might have been just as well left unsaid.

We have made some progress, Senator Proxmire, and I really am rather pleased at the progress we have made.

I am disturbed a great deal by people who think that no voluntary effort is going to work. It is amazing to me that the very people who should be most keenly aware—some of our leading business executives—some of those who continually say: "Get Government out of my life; we need less Government," are the ones who say: "Well, the program is voluntary; it won't work."

Well, that is an outrageous posture for anybody in America to be in, and I think this voluntary program will work.

We have seen automobile companies step forward. They haven't made any great national sacrifice, but they have made steps in the right direction. They have said—and they are doing the right things.

I just said to you that I just finished talking to Mr. deButts, chairman of A.T. & T. They are going to adopt a meaningful policy that will be helpful. This afternoon—I think just about this very hour—I think the announcement went off, so I might as well go ahead and reannounce it right now.

Some of you know Bill Battle. His father was the former distinguished Governor of Virginia. He is now in the textile business. He is announcing that his company—this is a much smaller company, about a \$30 million line of textiles, tools, that they sell—they are withdrawing a 7-percent price increase that they had set to go into effect the next couple of months. It was set 2 or 3 months ago.

So we are finding examples of this going on and on.

I leave tonight to meet with a group of business people on the west coast tomorrow, spending time on this. Most of them are cooperating. Republicans, Democrats, conservatives, liberals, big business, little business.

The CHAIRMAN. The cooperation you have seen so far, however, has been quite limited. Of course, you wouldn't expect it to be massive at this point. But this example you gave of Mr. Battle is one example. Are there others?

Ambassador STRAUSS. Well, I just happened to meet today—

The CHAIRMAN. How about labor unions?

Ambassador STRAUSS. Well, the labor approach, I think, Mr. Chairman, was put a bit out of context this past week, 10 days ago when the headline said Meany rejects Carter. I don't think that was true.

I really think George Meany to some extent rejected something President Carter had not really asked for.

Now, what George Meany did was the same thing that I find Government and business do.

You know, Mr. Chairman, you never get an answer to inflation, full answer, when you talk to any group.

I have found I get two-thirds of the answer with every group I meet. One-third of the answer is missing.

If you talk to business, they tell you what labor and Government ought to do. And Government tells you what business and labor ought to do. And labor tells you what business and Government ought to do.

I think that to expect labor unions to ink 3-year contracts or to commit, in 1978, to inking 3-year contracts in 1979, when they haven't seen what is going to happen with Government or what is going to happen with business, is calling on the average working man and woman in this country, union or nonunion, to exercise some restraint a bit ahead of time.

What the President really asked that they do is, subject to so and so and so and so taking place, we would hope the following would follow.

I think labor is prepared to do that. I think George Meany's position is that if we can bring about some deceleration in pricing and some of these other things, that wages will follow suit.

The CHAIRMAN. Let me ask you about another specific part of your program. You were quoted in the Star as indicating that you felt that wide use of the cost-of-living approach written into the contract would be helpful because it would moderate the set increases.

Now, if you do that, don't you run the risk that you are going to have an automatic relationship between inflation, a momentum relationship between inflation and wage increases that is going to be perhaps worse than you would have otherwise?

For example, in the first 4 months of this year we had inflation at a 12-percent annual rate. Then, if you add on that any kind of an addition, it means that you are going to have higher wage increases than you would if you had a set agreement.

Ambassador STRAUSS. Senator, you can argue which—it depends on which way you want to argue. Now, I have used the same argument.

I agree with what you said. But I also think it is appropriate to say to labor:

You can go ahead and step forward without guarantees because if in fact our efforts fail, if in fact we were unable to restrain to the extent that we think we should, a substantial or—it is not all—a substantial part of the detrimental aspect of it will be covered by your cost-of-living increase.

So I will use that argument to say, "Go ahead and sign your name, you are protected to the extent of 60 or 70 or 75 percent."

So I make it a positive argument on one side, you make it a negative on the other. Both are sound.

The CHAIRMAN. You protect them to 65 or 70 percent, you wouldn't have a cost of increase—

Ambassador STRAUSS. The average worker wouldn't be affected fully.

The CHAIRMAN. You find some labor unions are willing to agree to that kind of—

Ambassador STRAUSS. No one has pierced their finger yet and signed in blood. But that is a partial answer when you are in a rather strong argument, that there is some insurance for you.

The CHAIRMAN. Now, you have an assertion that the President will appoint a small, high-level governmental task force to coordinate efforts to improve government efficiency and productivity on page 6 of your statement.

Ambassador STRAUSS. Yes, sir.

The CHAIRMAN. Why a small effort here? It seems to me on the basis of all the testimony we have had for years now, the heart of our inflation problem is productivity. We have had a diminution in productivity lately. It has dropped. And it is very serious because, as you know, as productivity drops, it means almost the full wage increase is reflected in a wage-cost increase.

Why can't we have a more ambitious program of this kind?

Arthur Burns has called for it for years. Others seem to think it is useful.

I have never heard any argument against it.

Ambassador STRAUSS. Senator Proxmire, I didn't say a small effort. I said a small group. My problem is that you start getting every living soul in this Government, you put together a task force that is going to have some power and some muscle, everybody in the Government wants to get in there and you get so damn many people you don't have room in the hall and you never get anything done.

So that is my experience, limited as it is, in Government. I have about had the most frustrating experience I have ever been up against.

This task force is my idea. I don't want it to be a small effort. I want it to be a very, very stern, hard, tough effort. But I want it to be done with a small enough group that it is wieldy and you get something done.

The CHAIRMAN. Perhaps I didn't make myself clear.

You say the task force will work with simplified procedures and see that cost-effectiveness is considered in all Federal actions.

The kind of thing we have been hearing for a really effective productivity operation would be having these task forces in many sectors of the country operating in many industries. You would have a task

force for the automobile industry, a task force for the steel industry, and so forth, working to make people much more conscious than they are of productivity.

Ambassador STRAUSS. Senator—

The CHAIRMAN. As you know, your fellow Texan, Dr. Grayson, has been a great champion of this, he's worked hard on it and, as you know, he had pretty solid experience in the inflation front when he headed the price effort under President Nixon.

Ambassador STRAUSS. Senator Proxmire, I have talked with Jack Grayson. I will meet with Jack Grayson next week. The meeting is set. In fact, I called and confirmed the date on Monday. I think Jack Grayson is one of the two or three authorities on the subject of productivity in this country today. And I will ask him to make a major contribution toward helping us get into this whole area of productivity.

But the two things we are talking about are not necessarily mutually exclusive. When you talk about Government trying to look at Government waste, Government efficiency, trying to see how Government programs should be carried on a bit better, see what each and every agency without cutting back on its program, necessarily, without turning back on its goals, without abdicating its social responsibility, can still do those things with better efficiency and administration, and also see what kind of cost-benefit ratio there is in there, that is what I would expect the task force to do, ask some questions.

What are you, Mr. Chairman, of such and such agency; what are you, Secretary So-and-So, doing to be able to put in this pot to help bring some support behind this inflationary effort? That doesn't have anything to do with the overall productivity approach.

Let me dwell on that for a minute. What I'm talking about is a short term result that I think we can begin to see some results out of in 60 days or sooner. The productivity thing is a long-range plan that needs—you are not going to do that overnight.

I met this morning with the economist, Rudy Oswald, AFL-CIO. Talking to him about productivity. What suggestions they would make to improve this thing.

But you know you have been in a job about 3 or 3½ weeks and enough damn fools around Washington want to walk up and tell you everything they are going to do and they have all the answers tomorrow.

I am very short on answers. I am not short on questions: I am very short on answers, Senator; and I am not going to give you any answers until I know where I am going.

We are working very steadily, we are working hard, I think we are working sensibly to develop the kind of program we can make some progress in, and I know that is what you want.

The CHAIRMAN. My time's up. I will be back.

Senator Brooke?

Senator BROOKE. Thank you, Mr. Chairman.

Mr. Chairman, I ask unanimous consent that my opening statement appear in the record immediately following yours.

Senator PROXMIRE. Without objection, so ordered (see p. 317).

Senator BROOKE. I would like to welcome my dear friend and esteemed Ambassador, Bob Strauss.

Bob, I hoped you would have some answers. I am discouraged to hear you don't have any answers. I hope you do. I hope you are just overstating the case, but I am sure you have some answers.

Ambassador STRAUSS. I think I have given some answers, Senator; but I am not up here claiming to be the world's champion expert on inflation.

Hell, I couldn't spell inflation 2 months ago.

And you're trying to get me to answer all the questions on it, and I am not going to do that. That is the trouble with what is wrong with this Government. People march up here and testify that have all the answers in the world to all the questions asked, and I don't have those answers and nobody else does.

Anybody else comes up here and tells you they do you ought to lock them up, get them out of here. That is what is wrong, the President doesn't expect that out of me and I don't think the Senate does.

Senator BROOKE. The administration's definitely made the decision that you are not going to ask for wage and price controls, is that correct?

Ambassador STRAUSS. Yes, sir.

Senator BROOKE. Under any circumstances, as you can see now.

Ambassador STRAUSS. I can see no circumstances now that would encourage me to recommend it. I know of no whisper anywhere of any discussion of it going on. I can't conceive of a set of circumstances in which I would be in favor of it. All you have to do, Senator Brooke, is look to Canada, look to Great Britain, we have got two examples we are very close to. Their rate of inflation's gone up since they went into these mandatory wage and price controls. They have had a worse success than we had.

Senator BROOKE. So you think jawboning is the bottom line?

Ambassador STRAUSS. No, sir. I don't think jawboning is. Jawboning, Senator Brooke, as I define it, is trying to talk something back out of, talking somebody back out of an action they have already taken.

What we are trying to do is get our hands on these problems before they take place. What we are trying to do is start talking to labor now. They have got major contracts coming up in 1979. What we are trying to do is see things don't get away from us in 1978 that make it impossible to function in 1979.

What we are trying to do is go into business today and say, watch out, stop now, restrain now. Those are the things we are trying to do.

Now, where we miss, we are going to jawbone.

Senator BROOKE. Your candidate said in the election that by fiscal year 1981 he would balance the budget.

Now, he's your President. And my President, our President. Has he changed his estimate of when he will submit a balanced budget?

Ambassador STRAUSS. I would ask him about that, Senator Brooke. I am no spokesman for him on when he's going to balance the budget. I will say this, based on what I have seen right now, I have no rea-

son to believe that the President is not going to be able to balance the budget in 1980.

Let me go further and say, from what I see, have seen and what I know, this President is going to make an allout assault on that budget between now and 1981. That I believe and that I am participating in and that I think he will be successful in.

Senator BROOKE. Do you think he will be able to close the gap between now and fiscal year 1981?

Ambassador STRAUSS. I certainly do.

Senator BROOKE. As President Carter noted in his economic message to the Congress on January 20, over the past 10 years the Nation's rate of productivity growth has slowed markedly. You have touched upon this. It has slowed to about 2 percent or less per year compared with an average increase of 3 percent during the first two decades of the post-war period. That is a one-third drop.

During that same period, the rate of productivity growth of Western Germany, Japan and other industrial nations increased at rates of from 6 to 14 percent a year.

Now, as the President's special counsel on inflation and the chief trade representative, I expect that you would agree that productivity, as you have said, has an impact on our ability to ensure reasonable price stability, as well as to strengthen our competitive trade position and thus to contribute to the availability of jobs in the Nation.

Now, what specifically, are the administration's plans beyond the initiative relating to capital described by the President in that economic message to increase productivity in the public and private sector of the economy?

Ambassador STRAUSS. Senator Brooke, productivity in its overall scope, is not my responsibility. I got about, my plate's reasonably well full right now. The Labor Department, Commerce Department and others, primarily are concerned with that. I have a productivity concern in terms of my inflation, my efforts here.

But let me remind you, sir, that the President didn't say, "I am appointing Bob Strauss to form—to be responsible for programs in the Labor Department." To set financial policy that belongs with the Treasury Department and Council of Economic Advisers.

He said, "He's my special adviser on inflation to speak for me and in my stead." So, I don't really, that isn't a responsibility of mine. I have some notions about it, but I would like to confine myself to what I am responsible for.

Senator BROOKE. Bob, you started out as a trade representative.

Ambassador STRAUSS. Yes, sir.

Senator BROOKE. Then, the President, seeing your usual abilities, has expanded your responsibilities.

Ambassador STRAUSS. Yes, sir.

Senator BROOKE. To inflation, which everyone will agree is the No. 1 problem facing this Nation today. So obviously, you can't say that productivity is not your responsibility because productivity is so intricately woven into the whole question of inflation.

Ambassador STRAUSS. Of course, but, Senator, let me say to you, I will testify what we hope to do vis-a-vis the Federal Government. I further stated, I meet next week with a gentleman that I think

probably is the, has devoted more time and effort and is the leading, one of the leading voices on productivity in our country today.

Senator Proxmire commented on that and I am sure Senator Tower also can tell you about Jack Grayson. We will be developing programs on that. But we have both short run and long run. We have to make two approaches to this thing. As I said to you, I have been on the job less than a month. I am really trying to get a program in place now and to say that I spent a lot of time on that really would be a misstatement.

Senator BROOKE. But it is certainly a matter that has your immediate concern.

Ambassador STRAUSS. No question about that, sir.

Senator BROOKE. You expect between these two Texans that we are going to come up with some answers to the problem?

Ambassador STRAUSS. Maybe a fellow out at George Washington University, Dr.—I forget his name—who also—and a few others. We may not have the answers, but we will chip away at it.

Senator BROOKE. As you are well aware, there are some who feel that the National Center for Productivity and Quality of Working Life should be maintained as a vehicle for joint efforts between management, labor and Government. They believe that if functions are placed in one department or another, they will not enlist that tripartite approach which is needed to ensure improvements in the Nation as a whole.

What are your views on that?

Ambassador STRAUSS. Senator, I am not sure I understood the question.

Senator BROOKE. You are aware of the National Center for Productivity and Quality?

Ambassador STRAUSS. Yes.

Senator BROOKE. Nelson Rockefeller was chairman until the change in administrations.

Ambassador STRAUSS. Aware of it is about all, Senator. You have just about finished the statement there with me.

Senator BROOKE. You are just aware of it?

Ambassador STRAUSS. Yes, sir, that is about all the background I have on it.

Senator BROOKE. Well, the administration requested \$2.9 million for fiscal year 1979 under the National Productivity and Quality of Working Life Act of 1975. And since that submission, and they have not rescinded that submission, the President decided in March or April of this year to propose that the functions of the center be transferred to other agencies. The OMB director communicated that decision to the Congress, and that apparently is what is in progress.

Are you familiar enough with this center to know whether it should have been maintained or whether it should be dispersed in these various departments of Government?

Ambassador STRAUSS. Senator, I am not and I think anybody who comes up here with responsibility on trade and then starts telling you he is an expert on Government reorganization, you ought to get rid of the fellow. Obviously I have nothing, little or nothing, to do with the reorganization program. I am not familiar with that.

I do understand productivity being a most serious matter. I don't think you overestimate it; if anything, you underestimate it. You are on target. It is something we are concerned about, something we are working on. It is not my direct overall responsibility.

Senator BROOKE. Well, Mr. Ambassador, obviously it is not my intent to embarrass you.

Ambassador STRAUSS. It doesn't embarrass me at all.

Senator BROOKE. You have been in the job 1 month and I don't expect you to be an expert on reorganization of the Government. But the Center performs an important function in the area of productivity, that I would have thought that the administration would have discussed this with you as to whether they intended to continue it in its present form, or whether they intended to disperse it and to disperse its responsibilities to the various other departments of the Government.

I think it is an important subject, and I hope you will look into it.

Ambassador STRAUSS. Senator, I will be delighted to look into it.

I must say to you that I have no more information on the subject than I gave you. If I have been derelict, so be it.

Senator BROOKE. Well, if you say it, I believe you. And I know whatever you say—

Ambassador STRAUSS. You mean to say I have been derelict or—

Senator BROOKE. I can count on what you say. I hope you will inquire about this because I would like to see you have some input on it.

As I said, there are many who believe that that Center could perform a very useful service.

My time is up.

Ambassador STRAUSS. Thank you.

The CHAIRMAN. Senator Riegle.

Senator RIEGLE. Thank you, Mr. Chairman.

Let me just say that I missed some of your early comments.

As you may know, we have a labor reform bill on the Senate floor, which some of us are involved in. There are two or three things I want to discuss with you.

First of all, I think there are a number of people who wonder whether we are really going to be serious and competent about coming to grips with the inflation problem. That is not a reflection on you, but I think it is a broader question and feeling about how tough the inflation problem is, the fact that we seem to have some new economic factors that we don't yet fully understand.

It is tough to make the Federal Government even do the things that it wants to do once it figures out what those might be. As a result, it seems to me one of the tough parts of your job is to just convince people that the administration is doing something more than making kind of a token effort in the area of fighting inflation.

Let me just speak to two specific problems that I think give rise to some of the skepticism that obviously you have to be able to overcome and which those of us here who worry about the problem, too, would like to help you overcome.

One is the energy package. A lot of people look at the energy package and whether they are for it or against it or like part of it or don't like part of it, I think there is a general consensus on the

part of many people who look at it—and I include myself in that group—that says that if that package the administration is proposing, is adopted, it is going to raise prices and it is going to have a serious inflationary impact. And yet that gets pushed off to the side because it is argued that we need the energy package for other reasons which we know, and so forth.

I would feel more confident and I think we could do a better job of putting forward the argument that the administration is serious in this fight if we could demonstrate that the energy package either was not inflationary or that we could have some reasonable answer to give to people who raise that question.

The second has to do with the social security tax increase. A lot of people, and I include myself among them, think that the way we have written that tax it is going to be very inflationary as well when it takes effect next year, and that both of those things by themselves may more than offset anything you can do or that we can do in co-operation with you to try to persuade people voluntarily to make restraining decisions and what-have-you.

I am just wondering how we reconcile this. In other words, if the left hand is doing something that offsets what the right hand has got to do, how do we convince anybody that they ought to make some sacrifices for the common good?

Ambassador STRATEGUS. Senator, I think the answer to that is reasonably clear and I don't think it is an avoidance of the question or failure to answer.

First, with respect to energy, I don't think there is any question that to the extent that energy, the energy program that is eventually enacted, if one be out of this Congress, to the extent it raises prices, it has an inflationary impact. As with everything else, there is a tradeoff on everything you do. These aren't black and white questions, yes and no questions, they are tradeoffs.

So, first you trade that off with a sound energy program. One you hope will assist this country in, first, producing more energy and, two, using less energy.

Second, the right kind of energy bill, and I hope we will pass one, and I have no reason to believe it won't be a good one when we pass it, will have a—should have an impact on our trade deficit. If you have an impact on our trade deficit, you automatically have, and our balance of payments, you automatically have a positive reaction in a number of areas, including, I would add, the strengthening of the dollar which in itself is—helps us in our deceleration program.

Nothing would help more than the dollar, it affects trade and you get an impact there. These are tradeoff issues and a balancing act that one has to go into in the choices made and using values as you find them.

I think the benefits we will get out of it will far outweigh the loss in the energy thing.

With respect to social security, again, no one can argue that, as I testified, the increase in social security that went into effect had an effect on our inflationary process. Now should we have—should we bring more effective fiscal stability in that social security program? Should we have done the things we did?

Well, Congress in its wisdom elected to do that, so again it is a tradeoff. Every one of these things asks so much and costs so much.

Senator RIEGLE. Part of this attaches to the question of how much credibility you can hope to have apart from how smart a guy you are or how effective you are because initially the administration said we ought to finance a part of the social security cost from general revenues and I happen to support that position.

The administration lost; the Congress had its way. We made a mistake, I think. We took an approach that, as you admit, will be inflationary. Now the Congress sees the error of its ways and would like to back up.

The administration however, has gotten stubborn and said, no, we like the way it is, and we are going to stick with it and not go back to the original proposal.

All I am saying is that it doesn't take very many of those kinds of contradictions before the inflation program gets dismissed because it doesn't all hang together.

Let me just say with respect to the energy situation, I appreciate the fact that you were honest enough to say that some gains might come out of the package, that it is in effect inflationary, nobody ought to kid themselves about that.

It seems we are going to have to make some technological breakthroughs in the energy area. I think we are going to have to find a way to bring some new energy on line at a cheaper price or we are never going to break this spiral.

Let me move to the labor problem. The Teamsters, as you know will be renegotiating their contract some time in the first half of next year. If I am not mistaken, President Fitzsimmons has made it clear he is not going to settle for less than what the coal miners got percentagewise.

One can argue that the two situations are quite different, but I would like to know how you now in this new position are able or equipped or armed to deal with that kind of an issue. In other words, taking that as a specific, what can we do there?

Ambassador STRAUSS. I would hope, and I fully believe, that we can convince trade union leadership—and I don't even believe that they believe, no one seriously believes that the coal settlement should be taken as some sort of guideline or magic number for any of these other unions to follow. Coal is a unique situation. Industry and labor relationship are a unique situation. I hope the record here will clearly reflect that as the President's counselor on inflation, I will be speaking out very loudly and very clearly and bringing whatever moral force of persuasion and other force of persuasion this Government may have that I personally will have, and that the President personally will have, to see that that kind of process doesn't take place.

Senator RIEGLE. The reason I make the point is not just to give you a tough one to deal with, because everybody else is paying attention to this.

Fitzsimmons' comment, as you know, was widely quoted to the effect that they weren't going to settle—I think his words were to the effect they weren't going to settle for anything less than the coal miners got. You read that, and everybody else read that.

I want to give you an opportunity to put to rest the feelings that people have that say that that particular economic interest is so strong and so powerful that all of the persuasive power of Bob Strauss notwithstanding, they have already announced what their approach is going to be. And if that is left to stand, other people are going to base their behavior and their decisions as to how they negotiate and set prices they are prepared to make off those kinds of benchmarks, the question is: Are we going to get very far?

Ambassador STRAUSS. Let me answer that very specifically. It is my opinion, Senator Riegle, that the standards we begin to set and the pattern that begins to flow from the postal settlement, from the rail settlement—two matters now in negotiation—from the settlement entered into by an independent group of paper unions on the west coast right now—I think they are non-AFL-CIO affiliated—came out of an AFL-CIO union—out on the west coast involving most of the paper people, if not all—we have met with the leadership of the industry there. And I think Barry Bosworth's group has met with or is going to meet with—they are trying the labor side of that.

All of that is important, leading up to the early negotiations next year, Teamsters being one.

We cannot let—we cannot let coal by any sort of an example. I don't mean any example, any sort of an example.

We have got to have an altogether different thrust. We have got—those 10 percent, 9, 10 percent settlements of the past, we have got to be careful about them.

We have to speak up forcefully. And, furthermore, we in Government have to do something first to set an example. And business has to do something first. So by the time we come there we have something to say, "You now must show comparable restraint."

I have to say to you that I think both union and nonunion working men in this country show the same kind of individual citizenship that every other segment of the country shows. If we show an example, they will be there.

I am not worried about it.

Senator RIEGLE. Do you see it as your job at some point to talk to Fitzsimmons about this?

Ambassador STRAUSS. I surely do.

Senator RIEGLE. But you haven't as yet?

Ambassador STRAUSS. I would rather not answer that question, Senator, if I could avoid it.

I wouldn't say we had a long, drawn-out conversation. We haven't negotiated for a long time as yet.

Senator RIEGLE. But you are being clear in responding that you see that as falling within your range of responsibilities?

Ambassador STRAUSS. I certainly do. In fact, I would be derelict in my responsibilities and ought to be fired if I did not, if I don't pursue this in all its aspects.

Senator RIEGLE. That is all, Mr. Chairman.

The CHAIRMAN. Senator Tower?

Senator TOWER. Thank you, Mr. Chairman.

Mr. Ambassador, I want to thank you for your very lucid and very candid statement.

Taking note of the comment in your testimony: "We must candidly admit that the food price inflation this winter was worse than expected. In areas such as meat price increases we cannot be certain the worst is behind us."

One concern of mine is getting at the real cause of the increase in food prices. We have talked about productivity here today and it seems to me that the American farmer may be a victim of the fact that he is very highly productive indeed. Whereas per man productivity has gone down and labor costs have gone up in other areas which contribute to his costs, his ability to supply in abundance, indeed, in surplus, has hurt him.

I point out the fact that 4 years ago the cost of wheat was \$5 a bushel. Today it is \$2 a bushel. Yet the price of bread has gone up 25 to 30 percent.

I can understand the rationale of the President in threatening a veto on the flexible price support program on the grounds it was inflationary, but is some effort going to be made to get at the high production cost that the farmer incurs? At the same time, the enormously high cost that occurs from the time the farm products leave the farm to the time they arrive at the consumer?

I note now that the cost of labor and processing and distributing foodstuffs is higher than our total production.

Ambassador STRAUSS. Senator Tower, I met with a couple bakery executives recently, within the last few days, on that very subject you are talking about. I couldn't agree more with the comment you made and the thrust of your question.

Barry Bosworth's group is going to be meeting, I think, with, oh, cereal manufacturers, bakeries, and a lot of others. Isn't that correct? And they have those meetings scheduled right now.

What we are trying to do is get these people in and talk to them just about that sort of thing.

I just fully agree with the thrust of your question; no question.

Senator TOWER. I am concerned the farmer be not made the scapegoat for high food prices. Indeed, he has a cash flow problem and if a lot of farmers go bankrupt you will have the increased cost of production.

Ambassador STRAUSS. Your question is just as right as it can be, and goes to the very heart of this food problem.

Senator TOWER. In your testimony you note that there is no question price levels are affected directly by both Government spending and by regulatory policy.

It occurs to me that regulatory policy, where—though it doesn't cost the Government too much perhaps to enforce these regulations, costs private, the private sector a great deal, and these costs are passed on to the consumer.

Now, I know that standing alone we need environmental protection, we need some occupational safety and health, we need these things. But we do impose an enormous regulatory burden on the business and labor community. And I don't think that we are really aware of what that regulatory burden is costing us in terms of how it is passed on to the consumer.

Is there any thought given to maybe trying to relax this regulatory burden to some extent or reduce the cost that business itself pays or, indeed, finally the consumer pays for this regulatory burden?

Ambassador STRAUSS. Senator Tower, when I first was appointed to this job I commented on a number of areas that I thought we ought to look at. And in the regulatory area I either wisely or unwisely mentioned, for example, the fellow talking to me said: "Well, what do you mean?" I said: "Well, for example, EPA."

I didn't mean to single out the Environmental Protection Agency in any way, and I am strongly committed to their goals. What I meant was that I think we have an Administrator at the EPA now, Douglas Costle, who understands what cost-benefit ratios are; and I think we can, without turning back on any of their goals, to which everyone is committed, I think we can look and see what administrative procedures we can improve upon and what of their regulatory procedures we can improve upon without lowering science any. And I don't think there is any disagreement between Douglas Costle and myself there.

The Administrator and I have talked a half a dozen times and we are going to be meeting more and more on this.

I share your concern. It is a concern shared by many people around this country. Most people around this country. Not just environmental agency, but all of our regulatory agencies.

People don't want to turn back. They don't want to turn their backs on the buying public here and forget about the consumer. They don't want to turn their back on the environment. They don't want to do that. They don't want to turn their back on regulatory authorities, whether it be the SEC or any other.

But what they do want is a sensible, efficient administration. And most of those things, as you know, are bound by legislation already. But you can function—your regulations under that legislation can be reexamined.

Senator TOWER. I might note that sometimes the regulators go a little further than Congress intended them to go; they do things we didn't anticipate they would do.

I am delighted to note that you said that your tax proposals would expand incentives for capital formation as a means of promoting the growth of industrial capacity and productivity.

I think this is enormously important and I think that one of the crises we may be facing up to over the next few years is the shortfall of capital formation. That itself can have an inflationary impact from the standpoint of both demand-pull and cost-push inflation.

I would like your reassurance that you are really dedicated to this proposition of expanding our potential for capital recovery and capital formation.

Ambassador STRAUSS. Senator Tower, I am, as you know, particularly sensitive to that.

Senator TOWER. Knowing you personally, Bob, I know that you appreciate capital.

Ambassador STRAUSS. I am fully committed to that and I know that and I know that the President is. I think you are—I think you will be satisfied with our efforts in that direction. We are not going

to get everything done that I would like to get done or that you would like to get done or that President Carter would like to get done or members of the business roundtable or others in terms of capital formation but I would hope we would make some progress.

Senator TOWER. I hope we don't come up with the notion that profit is a dirty word because, after all, that is where capital is going to come from.

Ambassador STRAUSS. I have seen no indication in this administration that profit is a dirty word. That I surely haven't seen.

Senator TOWER. You also noted the hospital cost containment program. It occurs to me that there are a lot of things that have contributed to the cost of medical care over which the medical community has no control.

Ambassador STRAUSS. Yes.

Senator TOWER. They are affected by Government regulations.

Ambassador STRAUSS. That's correct.

Senator TOWER. And Government requirements.

I think in terms, for example, of a hospital in a small town that is required to put in a sprinkler system, whereas it might be better and more efficiently served by smoke detector devices and that sort of thing.

Some rigid application of certain Federal standards, I think, have contributed somewhat substantially to the increase in hospital costs.

Are you going to get at that, rather than just try to put a cap on what they are charging for medical service; are you going to look at this business of what is costs them to provide that service?

Ambassador STRAUSS. I think that the President's hospital cost containment bill is a far-reaching and significant piece of legislation, and I think it will go further than anything I know to bring medical care under some sort of control.

Hospital rooms in this country, as I recall the figure, was about, last year, averaged around \$183 per night per room. I think that is the figure. Well, that is just a little outrageous.

I don't blame all that on any one group, but that is an area where —really has a dramatic impact on the public generally and on our senior citizens particularly.

Senator TOWER. Finally, my last question. You talk about labor and labor's contribution to this business and you say one can't expect unions to enter into long-term wage agreements until they see some comparable restraint in pricing. Can we really expect any restraint in pricing unless there is some restraint in union wage demands?

Ambassador STRAUSS. Yes, I think we can, Senator Tower. I think that it can't go on, if we don't get that it's going to fall by the wayside. If wages keep going up.

But I think business generally knows that they are going to have to step forward first and show their willingness to participate in a voluntary deceleration program. They have indicated that. They have indicated their willingness to do so. If we take the right steps the next 6 to 12 months, it will have, in my judgment, a very, very salutary effect on our labor negotiations of next year when the big rounds come up.

Senator TOWER. It seems to me you get into a little bit of a problem if you are going to insist that wage increases come out of profits in terms of your capital formation problem down the road.

Ambassador STRAUSS. Well, you get a chicken-and-the-egg problem, too, in that.

Wait a minute, maybe I didn't understand your question. I really thought you were asking which of these came first.

Senator TOWER. That is not exactly what I said but that is pretty much along the same lines. We are asking business to keep their prices down, perhaps absorb wage increases in terms of diminished profits; then we are trying to address ourselves to long-term capital requirements on the others.

Ambassador STRAUSS. No question, part of our long-term capital requirements come out of profits. They also come out of other things, kind of incentives to enable capital investments to be made.

Let me say this. I do think this, Senator Tower. That when the average working man and woman whether they be a member of a major union or just working in a filling station or a restaurant in some small town in west Texas, I think they have—the average working man and woman really has a right to expect that, if they are going to accept any—as they accept restraints in their wages or in their bargaining for wages, that they have a right to expect that—to see that restraint, to see that restraint whether it's on the carlot or in the department store or the grocery store, see the similar or greater restraints felt there because when that salary check comes in at the end of the week, there is no time left. It has to be there that week. Or things just aren't going to meet.

Senator TOWER. I understand that. And I don't dispute that at all. I wonder if some effort could be made to get at some archaic work rules that result in a diminution in productivity, in some instances the unions fine workers for laying more bricks per hour or producing more per hour than union rules permit them to do.

I am not really so concerned about wage increases as I am sometimes about these archaic work rules that tend to retard productivity or diminish it in some way.

Ambassador STRAUSS. In the rail negotiations right now and also in the construction agreements where we have had considerable success, those things have been taken into account and I think considerable progress has been made on that.

And we have had, we really, while there is no reason for jawing, I think there is reason, in this whole overall thrust, for a little cautious optimism that at the end of this year we will be making some progress, Senator Tower.

Senator TOWER. Thank you very much, Mr. Ambassador. I appreciate your candid answers.

Ambassador STRAUSS. Thank you, sir.

Senator PROXMIRE. Senator Sarbanes.

Senator SARBAKES. Thank you, Mr. Chairman.

Mr. Strauss, the first thing I want to say is that I welcome the statement that the administration will not seek to solve the problem of inflation by falling back on remedies that increase joblessness.

I would like to take it a step further and suggest that joblessness and unused capacity, in fact, contribute to inflation. If you can get high employment, and a reasonably high use of our capacity, not necessarily approaching the high 90's or the 100 percent figure, where you are using antiquated plant, but a good capacity utilization figure, you may, in fact, contribute to productivity and, therefore, help fight inflation. I think that is very important. I hope that you and the administration won't depart from that approach.

I want to ask you this question. You are a very gifted person.

But I have to confess to you, I don't really understand exactly the role or the charge you have been given. I take it you are here now wearing the hat of the Special Counselor on Inflation.

Now, what does that mean?

If I want to reach you as a Special Counselor on Inflation, where do I reach you, in the Office of the Special Representative for Trade Negotiations?

Ambassador STRAUSS. That's correct.

If you ask what it means, I really think that the President felt that we needed an additional drive and thrust in this program, someone to, as he says: "Speak for me and in my stead in all these matters."

I think he's given me a pretty broad mandate. Senator Sarbanes. The President and I have developed a pretty good working relationship during the time he's been in the White House and I have been in his Cabinet. We speak shorthand. And I think he believes I am not going out and do some damn foolish thing, and I don't have such, any specific restraints on me, or I don't have the specific guidelines on me that one would think I might have.

He asked me to take over the coordination of this fight on inflation. That is what I am doing.

Then—let me continue 1 minute, if I could please, sir.

Not, as I said earlier before you came in, not to do the planning for financial planning for this Government, not to do the agricultural planning for this Government.

That belongs in Secretary Bergland's backyard. Not in the housing field, that is Secretary Harris.

But to coordinate all of our efforts to see that we reach into every one of these Departments and we reach around the country.

And that is what I'm trying to do.

Senator SARBANES. Well, now, are you in charge of economic policymaking with respect to the question of inflation?

Ambassador STRAUSS. No, I am not.

Senator SARBANES. What is the nature of your relationship with the Secretary of the Treasury, the Council on Economic Advisors, the Council on Wage and Price Stability, the Office of Management and Budget, and then somewhat apart from that, the Federal Reserve Board? What authorities, if any, do you have in dealing with these economic policymaking organs of the Federal Government?

Ambassador STRAUSS. I have the authority that, being the spokesman, the President of the United States gives me, Senator Sarbanes, and that is considerable. That doesn't mean that the President expects me to write the tax bill for the Treasury Department. It does

mean that the President doesn't expect me to write the agricultural bill that the Congress takes up: or the farm bill.

What it does mean is that working with the Council on Wage and Price Stability, Barry Bosworth, and it does mean working with the Council of Economic Advisers, that we exercise some monitoring over that.

It means we ask some hard questions and it means we call some people in. It means that we have a coordinating role. It means we bring, as I said, the force of the Presidency.

Senator SARBANES. Are you the spokesman from the President to these Government policymakers?

Ambassador STRAUSS. Yes, I would—yes, I think the President would describe me as having that responsibility, yes.

Senator SARBANES. Are you the spokesman from the President to the private sector, management and labor?

Ambassador STRAUSS. Well, with respect to the problem of inflation, there is a role for everyone to play, but I think I am the point man. I am the point man on it, yes.

Senator SARBANES. I am really trying to find out—I think it is important, since this is the first time we have had you here—to get a sense for what your role is and what authority you have been given and where responsibility falls.

Do you have a staff as the Special Council on Inflation?

Ambassador STRAUSS. Well, I have been using, Senator Sarbanes, let me see if I can describe it a bit better in my words, rather than try to answer a narrow question, do I have a staff.

Senator SARBANES. Why don't you answer that, then describe it in your own words.

Ambassador STRAUSS. Do I have a staff?

Senator SARBANES. For this function.

Ambassador STRAUSS. I do not have a specific staff for this function, although Lee Clink, who I think you know, a very distinguished businessman from St. Louis with whom I have worked over the years, has just left his business, taken a leave to come and join me on a full-time basis. So, yes, now we are a two-man staff.

What I would really like to do is have just enough people to kind of be able to coordinate this thing and not build another damn bureaucracy, Senator Sarbanes. I can get all the staff I want, I guess. In Washington there doesn't seem to be any problem getting staff. Getting something done, it seems to me to be the problem, and knowing what—and getting communication between what people term staff.

Now there are a lot of good staff people. But I am—I would like to use some of the people that are there. The young man who is on my left, his name is Jack Myer, he is the No. 2 man, I guess, over there at Barry Bosworth. Well, he's sitting here with me and the Council on Wage and Price Stability is a primary resource. Council on Wage and Price Stability called me, I talk to them three or four times a day. They have a feel for what is going on out there, they are in touch with the various industries, and labor negotiations, and pricing problems that are going on. And they involve me either at point of problem, point of decision, point of meeting. Charlie

Schultze, Chairman of the Council of Economic Advisers, is another one who has the economic data before him who is far better able to analyze that data than am I, and who—he doesn't report to me, and I don't report to him, but I am the President's point man on doing something with that data.

Why? I don't know, you will have to ask the President on that.

But with respect to our initial discussions with a board segment of the labor movement, yes, I spoke with the President. I spoke and he spoke. With respect to contact with business, whether it be the Small Business Administration or whether it be the Business Council, business roundtable, is that my responsibility? Yes.

Senator SARBANES. How do these Government economic policy decisions, how do you coordinate?

Ambassador STRAUSS. First, I would have to ask you what kind of decision.

Let me say this: The Economic Policy Council is chaired by Mike Blumenthal. It deals with all economic decisions of this administration.

Senator SARBANES. Are you now a member of that Council?

Ambassador STRAUSS. I am a member of that since I took this task. That really is a clearinghouse. As those problems relate to a tax bill, it wouldn't be my problem, Senator Sarbanes. As those problems relate to the problems of inflation, it would be my responsibility. If it relates to a sugar bill that comes up there, it will go over to Secretary Bergland.

I might have an input over there and say: Mr. Secretary, this is inflationary as can be, or this is deflationary. But it would be his responsibility to formulate the program.

Senator SARBANES. Let me ask you this question. As Special Trade Representative, you deal with many questions involving import-export policy and they interrelate with questions involving employment and inflation.

Ambassador STRAUSS. Yes, sir.

Senator SARBANES. Now if you have that hat and you have now been given another hat, Special Counselor on Inflation, you still don't have a hat as Special Counselor on Unemployment. I really put the question to you of the nature of the interrelationship between your role as Special Trade Representative and the judgments that have to be made there, and your role as counselor on inflation only.

Ambassador STRAUSS. Well, what is the question, Senator Sarbanes?

Senator SARBANES. Well, I guess the question is whether there should be a concern that your policies in the area of Special Trade Representative will now be overly influenced by your new role in terms of striking the balance—

Ambassador STRAUSS. The answer to that is that no, there should be no concern.

As a matter of fact, while there are some narrow areas of conflict that could arise, 95 percent of it is an area of intertwine and it makes it even more efficient, more effective, and enables one to do each job better than he would without the other.

Senator SARBANES. Are you the President's representative now on inflation questions, to discuss economic policy with Chairman Miller and the Federal Reserve Board?

Ambassador STRAUSS. Well, economic policy, I need not tell you, you know better than I, that the Federal Reserve is an exceedingly independent agency. If you ask, if the question is have I discussed Chairman—with Chairman Miller the problems of inflation, the answer is yes, we have had two very long and constructive conversations, but on the basis of overall planning of economic policy, I suspect Mike Blumenthal would meet with him 10 hours for every 1 hour I would if in fact they do have that relationship.

But I do not determine the economic planning of this administration or this Government. We structured this job just in that way where it would not have that. Nobody can do that and do it well.

Senator SARBANES. I see I have a red light and they are coming to tell me my time's up.

Let me just ask this one final question.

Ambassador STRAUSS. Yes, sir.

Senator SARBANES. How do you see the division of your time as the President's spokesman on inflation between talking to and co-ordinating other policymakers in Government in the economic field, and talking with the private sector, management and labor, with respect to their economic policies? How do you expect that time to break down; how has it broken down so far?

Ambassador STRAUSS. Senator Sarbanes, I think that would be a question if I tried to answer it, it would—I would look kind of silly. I don't know, it depends on the problem.

I know one thing. They are two very serious problems, and I devote a tremendous amount of time and energy to both. I think I am able to do that. I understand the business community. I know them. I understand them. I know what makes them tick. I have been a part of it.

I have been a lawyer representative. They are friends of mine. I have great personal relationships there and I think I can be effective. That takes care of No. 1.

No. 2, with respect to the Government and its agencies. I know a little something about Government. I have been around this town, I have been around the Hill for a while, and I have been around Government for a while and I think I know something about what makes things tick in this town. I think I can be effective there.

If you ask me how I am going to divide my time, hell, I don't know. Let me think today. There is no way in the world of doing that. They are both so very important, Senator Sarbanes. I hope to give them sufficient time, let me say that.

Senator SARBANES. One other question I am going to put to you when I get back to you is, how much time you are going to give to the role of Special Counselor on Inflation and how much to Special Trade—

Ambassador STRAUSS. I have been given—I have been giving about a full day's work to each one. I have been working 7 days a week about 12 to 14 hours a day.

Now, we have got a hard negotiation coming up between now and July 15 in the trade field. I think we are going to be successful there.

Happily I picked two good deputies, Ambassador Wolf and Ambassador Macdonald. They do a major, major part of my work for me there, always have.

I have done other things, as well as my job. And I don't anticipate any breakdown in our negotiating process because of this job, and I don't think you will find that there is any breakdown on it. Obviously, it's hard work. I am tired. I leave, when I get through here today, I started pretty early this morning and I leave to go to the west coast. I have got a breakfast out there at 7 o'clock in the morning. I will be there with a group of businessmen.

While I am on the west coast, the Japanese come in, I will be negotiating with Prime Minister—Mitsubishi on the west coast, negotiating a number of areas having to do with the trade thing. So it fits.

Senator PROXMIRE. Senator Schmitt.

Senator SCHMITT. Thank you, Mr. Chairman, and thank you Mr. Ambassador for your testimony and answers to questions.

I am going to assume you are talking for the President, I think that is what you have been trying to tell us.

But I am also afraid I have to say I am very disappointed, but not in your abilities; you are smooth, quick, intelligent, experienced, as you have said. You know what makes things tick, I think you are very political and I think that is a good reason for the President to have you in the job from his point of view.

But what I have heard you saying you are going to do reminds me a little bit of trying to mobilize the flies to clean up the barnyard. I am very concerned, for example, that the thrust of your testimony, which is apparently what you really wanted to say today, concentrates largely on the private sector, both labor and management, who are the victims—

Ambassador STRAUSS. Let me clear that up very quickly, if I left that impression, I am not as articulate as I should have been.

I do not think that's the case. I started out by saying, I think the No. 1 problem lies with our own Government, we better get our own house in order, if we expect to have any credibility with the private sector, whether it be business or labor, period, paragraph.

Senator SCHMITT. Why don't you have a list in your testimony to indicate the things that the Government is doing that are inflationary? The programs that the Carter administration has sponsored, you have already talked to Senator Riegle about social security tax increases, and energy tax, and regulation increases in the President's energy policy.

The President has been against a permanent income tax cut. He pushed the coal wage package. He pushed the coal-mining regulations, timber withdrawals and new regulatory agencies such as the Consumer Protection Agency, minimum wage increase, labor law changes—all these things have an inflationary impact.

I would hope that you would begin to compile a list, for this committee, for the Congress and, more importantly, for the administra-

tion, of these kinds of things, as well as those concerning what the labor unions and management may do.

Ambassador STRAUSS. Senator Schmitt, let me say this. Compiling lists sometimes, it depends on who's compiling the list, what the list looks like. Your list and my list would probably be, might be a bit different.

I am not here to say that the administration's done nothing that isn't inflationary or that this Government hasn't or that this Senate hasn't, I might add.

But it is not going to do any good for us to start compiling lists of what the Congress has done wrong.

Senator SCHMITT. Well, it might do a lot of good, Mr. Ambassador. It might do a heck of a lot of good. It might at least make those voters out there who think you are coming out to jawbone them to keep their wage increases down and keep the prices from increasing, it might at least encourage them to think that the administration thinks that some things might not be done right here in Washington.

I think Senator Riegle is exactly correct. What we have done this year in this session of Congress to enhance inflation is going to swamp anything you can do out there.

I am not saying, don't go try to do it, but it's going to swamp you. Your abilities are being wasted, if you are not talking to the administration.

Ambassador STRAUSS. Senator Schmitt, let me say to you that, in the first place, I am well aware of the fact, and in every speech, every public utterance that I have made and in my testimony here, I want to repeat, I have made it plain, I said we—that the Government is its own worst enemy in this and we have to do something about it.

But, rather than just talking about the President, let's talk about the Government, let's include the Congress in this.

Senator SCHMITT. I am happy to do that.

Ambassador STRAUSS. And the Congress, Government, all of us in here.

It depends on whose ox is getting gored and it depends on whose program it is.

I started out with the minimum wage. The minimum wage was passed higher than the President requested, as I recall. Let's take that into account.

Number two, social security, the President asked for something different than was passed, let's remember that.

Senator SCHMITT. Mr. Ambassador, let's face it. He was still asking for a major increase in social security taxes at a very opportune time without any indication as to how we are going to get out of a system that basically is not going to work for any length of time. We may be able to shore it up and tie it together a little bit for a few more years, but you know, as well as I do, that it is not an actuarially sound program and that it is taking away from our gross national product, not adding to it.

Ambassador STRAUSS. I would say to you that the social security program is a program I certainly agree presents a great many problems.

But I must point out to you for this record, Senator Schmitt, that President Carter neither built nor created nor funded the social security program, since its inception in the early 1930s.

He inherited a problem, he inherited a problem which the American public was terribly concerned about, and that is improper funding and irresponsible funding, if you want to, and made a suggestion then took some political scars on it, set a program up, suggested that the Congress adopt it.

They elected to adopt a different one and again it's a balancing thing.

Senator SCHMITT. Mr. Ambassador, the difference is whether it is payroll taxes, social security taxes, or whether it is general revenues which are still taxes. At this point in time, that is going to have more impact on the inflation in this country than any one other thing we can do. Except if the Congress is stupid enough to pass that so-called energy policy and if the new taxes which are going to amount to \$300 billion, that are in that bill, at least, by 1985, are included in it.

Ambassador STRAUSS. Senator, one of the things I hoped to get out of here was some suggestions, and is it your suggestion that we shouldn't attempt to appropriately fund in any way the Social Security program?

Senator SCHMITT. No, it is my suggestion, sir, that you and the very, very wise people that should be in the Administration start to look for a program that is actually sound to which we can transition over the next 20 or 30 years. That will mean that money is being invested in the private sector so it is earning something and still guarantees at least as good, if not a better, retirement program for people in the future.

Ambassador STRAUSS. Senator, there are a great many long-term—people in the administration are looking at some terrible problems that we face, of the kind you have enumerated, looking for some long-run solutions.

Senator SCHMITT. They are awfully quiet about it. I would like to, though, further ask you to comment on the energy program, Mr. Ambassador. I know that you are an advocate of it. We have talked about this on other occasions, and found we did not agree.

But the basic problem facing us is that we are not going to produce the things, domestically, that we can produce, whether it is oil and gas, or new technologies that will eventually break the back of the OPEC cartel.

There is nothing in the President's energy policy that is going to eventually break the back of that cartel. There is no real incentive for domestic production. It is only through domestic production that we are going to do that. We need a half-trillion dollars by 1985 in order to do it. But it is there.

Now, is depending on foreign supplies of oil, at a price higher than what we could produce it domestically, anti-inflationary?

Ambassador STRAUSS. Senator, I was really listening to your statement, and I got lost in it before you got to the question.

Senator SCHMITT. I thought you paid attention better than that, Mr. Ambassador.

Ambassador STRAUSS. I'm not trying to be rude; I'm really trying to answer sensibly.

Senator SCHMITT. Let me try again.

Ambassador STRAUSS. Yes, sir.

Senator SCHMITT. If we do not increase domestic production, and provide the incentives to do so, how in the world are we going to get out of the habit of using higher priced, foreign oil?

Ambassador STRAUSS. Senator, let me, in a positive way, I think it is essential that we increase domestic production. And we also search for new and other sources, or, obviously, be dependent upon foreign imports.

Senator SCHMITT. Do you think the energy policy, energy bill that President has advocated, is going to do that?

Ambassador STRAUSS. Yes, Senator. I think so. I have talked to, at least, oh, any number of people in the oil industry, energy business, in the last few weeks, major representatives of major oil companies on down, who think so.

Senator SCHMITT. Well, I have talked to them, too, Mr. Ambassador, and they are telling us different stories, or we are talking to different people.

Ambassador STRAUSS. They don't think it's A-plus; I don't want to say that, but they think it is a bill that would be good for the country, and ought to be passed, and I certainly urge that we get it passed.

Senator SCHMITT. Well, I know you do, and I am sympathetic, particularly with all the reasons, I think, that require you or encourage you to say that. But, Mr. Ambassador, there is nothing in that bill that is going to tap these vast resources, that I think everybody knows are there, in this country, whether it is oil, or natural gas, or uranium, or geothermal, thorium. It just isn't going to happen.

There is not a coherent short, medium, and long-term policy available to this country, right now, and the people realize it. Frankly, Mr. Ambassador, the people learned how to spell inflation years ago. And it is just now starting, everybody in this country is starting to realize what the inflationary problem is.

And they won't tell you that it's wages and prices. They will tell you it's the Government. Now, you may not believe that that's true, and those of us who have been in this room saying it is true maybe ought to be locked up, but there is no question in my mind, and I think, in the mind of anybody that looks at the history of our economy over the last—since World War II, and look at the way the Federal deficit, the money supplies, the recessions, the recoveries from recessions, how they have gone, and how they interrelate, who can't say that Government isn't largely responsible.

Ambassador STRAUSS. Senator Schmitt, I think I started off my testimony, and all through it I have tried to resay and restate, and I want to say again, for the record, and so you will know, I agree with you that the first steps must be taken by this Government.

Unless the Government shows that it is going to do some things to clean up its own house and improve it, there can be no credibility to the program. I repeat again, I don't know what else to do, but I believe that. I have said it. I say it publicly, and I say it privately.

Senator SCHMITT. Well, I am glad you are saying it. I will look forward to hearing you continue to say it. I just hope that the next time you testify with us you will have the list of things you are recommending to the Administration that it do to fight the inflation problem, and along with the things that you say you are going to do with industry and labor.

Ambassador STRAUSS. Senator, I have in my testimony a list of those, and we read them off. I think you will find them in there, things we have already done, and recommended, and have announced. You came in late. Possibly, you missed it.

Senator SCHMITT. I was here the full time, Mr. Ambassador.

Ambassador STRAUSS. I'm sorry. I must not have made it clear.

Senator SCHMITT. I am afraid the impression I get is that there is no coherent recommendation, for example, for a specific annual cut in the Federal deficit, or specific annual cut in personal income taxes, or a specific annual cut in the rate at which our money supply grows, or in the rate of increase in the absolute amount of the Federal deficit.

A specific set of recommendations on how to decrease regulatory impact rather than not having any further increase; it is too late. It has already been done. The damage is there.

Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Ambassador, you have just—you have piqued our curiosity by indicating that you have just returned from a conference with the head of the biggest corporation in the country, and a man whose corporation, of course, has a lot to do with prices people pay, certainly, in the communications area.

Can you tell us what, if any, progress you were able to make in that conference?

Ambassador STRAUSS. Senator Proxmire, I would not like to be specific because we didn't sign off on anything specific. I am sure he will want to make his own announcement, but I would say substantial progress was made, Senator Proxmire. And he could not have been more positive, and more supportive, and more encouraging; Mr. deButts could not have been.

I possibly did him a disservice by mentioning that. But I had a most positive, constructive conference about the total thing, the total contribution that A. T. & T. might make to this effort.

The CHAIRMAN. It is very encouraging to hear. Incidentally, that is one industry which, over the years, has remarkably stable prices.

Ambassador STRAUSS. Amazing productivity, and I was very pleased with that. John deButts also expressed his personal confidence this program will work, which meant a great deal to me.

The CHAIRMAN. Without any criticism of you, and with, not meaning to criticize the President, who also has been in office, relatively, a short time in relationship to the enormous momentum behind the inflation situation, I just wonder if this program is really up to the size of the problem.

This is a—this is such a big problem right now. Let me just point out, we have a \$50 billion deficit, at best. We have a \$500 billion budget which is, of course, far bigger than it was in years past. We have a one-third drop in productivity in recent months. We have a

galloping inflation in the last 4 months, as we pointed out. We have big increases in steel, in food, in social security, in energy, energy prospective. First-class stamps are likely to go up; medical costs.

If you look at the wholesale price index, the discouraging element there, the crude costs which are on a lag, as the year goes on the crude costs are up sharply, so I just wonder if it is not necessary to have a really dramatically tough program to knock out the inflationary expectations. I'm talking about a "No more Mr. Nice Guy" from the President; a program of really vetoing legislation that comes down the pike that reaches the budget.

The President said, "*" * by every means at my disposal. I will resist those pressures, and protect the integrity of the budget."

Now, this committee, with bipartisan support, both sides of the aisle, including some people who speak, mostly likely, against expenditures, voted to bust that budget on mass transit, voted to bust that budget on housing. I hope the President will use that veto, and wield it very strongly if it goes through the House and Senate that way. Can we have that kind of assurance?

Ambassador STRAUSS. Let me say this, Senator. I share your hope the President will use that veto, and use it freely on any budget-busting that comes up there, and I think he will do that.

The CHAIRMAN. Well, that is reassuring.

Ambassador STRAUSS. I wouldn't say it just without some reason to believe he would do that. President Carter is determined to maintain the integrity of this budget process.

The CHAIRMAN. I would like to look at it in a little broader sense. There is a tendency on our part, particularly in the Authorizing Committee, to improve programs that have their real impact in their effect on uncontrollable spending so-called, 2, and 3, and 4, and 5 years out.

The outlay may not be so big but the obligational authority may be very big indeed. I wonder if the President would feel obligated, under those circumstances, to veto, even though the effect on the—immediate effect on the budget in the coming year might not be so great.

Ambassador STRAUSS. I do.

The CHAIRMAN. How about a program in which you show the real concern of the Government by going as far as to ask for an even stiffer cut in Federal salaries, cut in the increase in Federal salaries, I should say.

Say, for example, that the general guideline of the industry might be 6 percent, reducing the Federal salary increase to 3 percent. Calling on—having the President reduce his own salary, and members of Congress to reduce their salaries. Calling on top business executives to freeze their salaries this year, not just to increase it slowly, but to freeze it. How about that kind of program.

Ambassador STRAUSS. I am not prepared to answer that question with any authority or responsibility, so I prefer not to. If you care for me to attempt to do so, I will attempt to provide one.

The CHAIRMAN. What I am trying to understand is whether or not a more dramatic, more far-reaching program wouldn't be more likely to have a real effect on inflationary expectations, persuaded both

business and labor unions to realize that the Government does mean business, that it is making sacrifices, and, therefore, when the Government asks them to hold, for instance, wage increases down below the expected increase in prices, that there is a basis for people asking for it without being hypocritical.

Ambassador STRAUSS. I think anything we can do to put toughness and hardness in this, Senator Proxmire, we should do. I do believe that with the tools we have, and with the authority we have, and the direction we have, I think we can develop a tough program that will make some progress.

We are also, I might add, we continue to look at, will be looking at in more detail, all of these other things that are floating around, various policies, whether—one columnist suggests as well as another, and we are trying to see what we can do to put together a really hard-hitting program.

I feel we can do that. I also feel, and share Senator Schmitt's concern, and others expressed here, Senator Riegle's and Sarbanes', we have to start with the Federal Government. You know that better than most of us around here. We have got to start with our own house; I hope we will do that.

May I just say one thing? I have a plane to catch in about 45 minute at Dulles. I wonder if I could—will we be completed in time?

The CHAIRMAN. I have other questions I will ask for the record, and I will desist right now.

Senator SCHMITT. Mr. Chairman, I have no other questions. I want to thank the Ambassador.

Ambassador STRAUSS. Thank you, Senator Schmitt.

Senator SCHMITT. Like he does, I get excited about this problem, and I apologize if I got too excited.

Ambassador STRAUSS. You don't need to apologize to me at all, Senator Schmitt.

The CHAIRMAN. If you have to be in Dulles in 45 minutes, maybe one more question, and we will send you on your way.

Senator SARBANES. No. I don't have a question; I want the Ambassador to catch his plane. I want to leave with him two thoughts. One, people come at you pretty hard from a lot of directions. I think that your statement, in terms of what you are going to do, you say, first of all, there is no magical solution or quick fix.

Second, where you talk about a steady, gradual deceleration that is a sensible approach to this problem.

Ambassador STRAUSS. Thank you.

Senator SARBANES. A few years ago, both unemployment and inflation were significantly worse than they are today, and that fact ought not to be lost sight of. I think a policy that lurches from one side to the other may well be the worst kind of policy.

I don't want unemployment back at 9 percent because you are going to panic and do a lot of unwise things because the inflation problem is serious. Inflation and unemployment are both serious problems, and we ought to address them both in a balanced way, and I think your statement reflects that, and I don't think you ought to let people press in on you and get you off course.

Ambassador STRAUSS. Not one bit, Senator.

Senator SARBANES. Stay on a steady course.

Ambassador STRAUSS. Senator Sarbanes, I served 4 years as chairman of the Democratic Party. I have got a course charted, and I am going to stay there come hell or high water.

Let me tell you one more thing I am not going to do, Senator Sarbanes. It is awfully easy to be pressed before a distinguished committee like this, and other places, and get where you overpromise and underperform. I don't intend to do that. I got to this table under-promising and overperforming. I expect to do the same damn thing in this job. Thank you very much.

The CHAIRMAN. Thank you very much, and thanks for your over-performance today.

The committee will stand adjourned.

[Whereupon at 4:45 p.m., the hearing was adjourned.]

ANTI-INFLATION PROPOSALS

TUESDAY, MAY 23, 1978

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING,
AND URBAN AFFAIRS,
Washington, D.C.

The committee met at 10:00 a.m. in room 5302, Dirksen Senate Office Building, Senator William Proxmire (chairman of the committee), presiding.

Present: Senators Proxmire, Stevenson and Schmitt.

The CHAIRMAN. The committee will come to order.

This is the second day of hearings on the anti-inflation program of the administration. We had an excellent record made, in my judgment, yesterday on using the tax system to try to retard inflation and also a vigorous statement by Ambassador Strauss on the administration's program.

One of the most outstanding figures in the country in fighting inflation over the past few years has been the former chairman of the Federal Reserve Board, Arthur Burns. We asked Dr. Burns to testify and Dr. Burns thought he couldn't testify at this time but he did send us a statement on his position on what course we should follow in combatting inflation under present circumstances. That statement is available to the press. I'm going to read briefly from that statement this morning before we call on our witnesses for their statements because I think we all recognize Dr. Burns' great integrity, tremendous ability, great years of experience, and while many of us disagree with some of his recommendations and some of the actions that he took as chairman of the Federal Reserve Board, we all recognize his great ability and I think we should share his judgment at this time on what is the most troublesome and difficult economic question that confronts us.

So I'm going to take just a couple minutes to read only a part of the Burns statement and the entire statement will be printed in the record.

Former Chairman Burns writes:

On April 11, President Carter addressed the issue of inflation in a forthright fashion. A little later the Administration announced that it will seek a smaller tax reduction than it had previously recommended to the Congress. Clearly, President Carter's concern about inflation deserves our commendation and support. I believe, however, that the policies thus far announced by the Administration fall short of being a strong and credible anti-inflation program that our country needs.

Let me comment therefore on some of the ingredients of an anti-inflation policy that in my judgment"—

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this is Chairman Burns speaking—

would make practical sense at the present time.

First of all, the Federal Reserve needs to continue its monetary policy without any interference from the executive or the Congress. Second, the federal budget for fiscal '79 needs to be substantially revised so that the deficit would definitely shrink instead of remaining at its current level or continuing to expand. Third, both this year and next increases in salaries of federal employees should be scaled down to one-half of the figure indicated by wage comparability studies. Thus, if those studies suggest an increase of, let us say, 6 percent, salaries should go up only 3 percent. By adopting such a measure our government would set an example for the country at large and thus take the lead in the process of unwinding the inflation. Fourth, and again to emphasize federal leadership in unwinding the inflation, I would suggest that the President cut his own salary by say 10 percent and call on all presidential appointees and members of Congress to do likewise. Fifth, the President should call on top corporate executives to refrain entirely from any increase in their compensation over the next two years. Sixth, the federal government should establish rather promptly a national productivity center to assist business and labor leaders in each of our sizable cities to form productivity councils within individual factories, offices, and so forth, with the objective of raising output per man hour. This country has to go back to work. Seventh, it would be well if our government finally made a start on reducing the cost-raising practices that it has encouraged or tolerated over the years. I have in mind dropping or relaxing restrictions on agricultural production, relaxing legal requirements on minimum wages, suspending if not abolishing the Davis-Bacon Act which simply escalates costs. Finally, eighth, our government needs to deal more firmly with the dollar problem in foreign exchange markets. If the dollar should continue to depreciate further there would be a risk of recession in the entire international economy.

I think those are rather far-reaching recommendations and I wouldn't hold my breath until all of them are put into effect, particularly Congress reducing their salary by 10 percent, but I think we should have the counsel of Dr. Burns who has the respect of all of us.

[Complete statement of Dr. Burns follows:]

Arthur F. Burns
American Enterprise Institute
Washington, D. C.
May 22, 1978

MEMORANDUM ON INFLATION

The quickening of the rate of inflation in our country during the past year is a disturbing development. It has many causes.

For one thing, our economy has been expanding rather rapidly. As generally happens in such a case, some upward pressure on prices in individual markets has developed--for example, the market for lumber and the market for insulating materials. There is still considerable underutilization of capacity in our country, but this has not prevented supply problems from emerging here and there. That is one factor in the quickening of the inflation rate.

Another is that our government has delayed attending to the depreciation of the dollar against foreign currencies. This has naturally served to raise our domestic inflation rate.

Third, governmental policy has contributed more directly to the faster rate of inflation. As the expansion of our economy stretched out, the deficit of the Federal Government--instead of narrowing rapidly as is normally the case at such a time--has tended to become larger and now appears to be in process of becoming larger still. When the Federal Government runs a deficit, it pumps more money into the pocketbooks of people than it takes out. That has always been a major cause of inflation, and this process has lately been speeded up.

Moreover, our Government has sanctioned increases in the minimum wage; that serves to raise costs and also prices. Our Government has sanctioned increase in Social Security taxes, and that also affects prices. Our Government has sanctioned subsidies to farmers for producing less; that, obviously, will tend to raise prices. Our Government has sanctioned restrictions on imports of steel, shoes, television sets, and all that tends to raise prices. Our Government has sanctioned a spate of consumer protection and environmental bills that run up costs for industry and thereby serve to raise prices. And more recently, our Government has done little to prevent a highly inflationary increase of wages for coal miners--an increase that will tend to raise costs and prices broadly.

These policies are already reflected in a faster rate of inflation. As a consequence, fears have mounted that in the absence of modified governmental policies the rate of inflation in our country may keep moving higher and higher.

On April 11, President Carter addressed the issue of inflation in forthright fashion. A little later, the Administration announced that it will seek a smaller tax reduction than it had previously recommended to the Congress. Clearly, President Carter's concern about⁴ inflation deserves our commendation and support.

I believe, however, that the policies thus far announced by the Administration fall short of being the strong and credible anti-inflation program that our country needs. Let me comment, therefore,

on some of the ingredients of an anti-inflation policy that, in my judgment, would make practical sense at the present time.

First of all, the Federal Reserve System needs to continue its monetary policy without any interference from the Executive or the Congress.

Second, the Federal budget for fiscal 1979 needs to be substantially revised, so that the deficit would definitely shrink instead of remaining at its current level or continuing to expand.

Third, both this year and next, increases in salaries of Federal employees should be scaled down to one-half of the figure indicated by wage comparability studies. Thus, if those studies suggest an increase of, let us say, six per cent, salaries should go up only three per cent. By adopting such a measure, our Government would set an example for the country at large, and thus take the lead in the process of unwinding the inflation.

Fourth, and again to emphasize Federal leadership in unwinding the inflation, I would suggest that the President cut his own salary by, say, ten per cent, and call on all presidential appointees and members of Congress to do likewise.

Fifth, the President should call on top corporate executives to refrain entirely from any increase in their compensation over the next two years.

Sixth, the Federal Government should establish rather promptly a National Productivity Center to assist business and labor leaders

in each of our sizeable cities to form productivity councils within individual factories, offices, etc., with the objective of raising output per manhour. This country has to go back to work!

Seventh, it would be well if our Government finally made a start on reducing the cost-raising practices that it has encouraged or tolerated over the years. I have in mind dropping or relaxing restrictions on agricultural production; relaxing legal requirements on minimum wages; suspending, if not abolishing, the Davis-Bacon Act, which simply escalates construction costs. I also have in mind relaxing the detailed regulations that run up costs all around for industry-- in particular, postponing the target dates set for compliance with environmental regulations.

Finally, eighth, our Government needs to deal more firmly with the dollar problem in foreign exchange markets. If the dollar should continue to depreciate further, there would be risk of recession in the entire international economy.

A fundamental cure to the international dimension of the dollar problem is to be sought simultaneously along four routes.

First, we need an anti-inflation policy that is both firm and credible. Obviously, it may or may not contain all the specific features that I've enumerated.

A second path to curing the dollar problem in international markets is to work out an energy policy that will help this country to conserve oil and, far more important than that, that will serve to develop new substantial sources of energy supplies.

The third cure to the dollar problem in international markets is a tax policy that will encourage business capital investment, including foreign investment, in our business enterprises, in our market securities, and in real estate.

And, of course, there is a fourth route, but it is not under our control; that route is faster economic expansion in the outside world.

There are also some financial bridging actions--such as the sale of gold or the sale of Treasury securities denominated in foreign currencies--that may become necessary, since the permanent cures cannot become effective very quickly.

Let me close by saying that a strong and credible anti-inflation program is long overdue in our country. If we embark on such a course we could have a true renaissance of our free enterprise system. On the other hand, if we continue to rely heavily on rhetoric in dealing with the inflation problem, our economy may be headed for serious trouble.

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The CHAIRMAN. We have as witnesses this morning Dr. Barry Bosworth, Director of the Council on Wage and Price Stability; Prof. Albert Rees, Princeton University, economics department; Prof. Sidney Weintraub, University of Pennsylvania, economics department; and Prof. Laurence Seidman, University of Pennsylvania, economics department.

Dr. Bosworth, go right ahead, sir. I might say that these statements are all brief and we appreciate that very much. We would appreciate it if you could limit your remarks to about ten minutes. If you go a little over that it's certainly OK, but for your guidance we are going to run the clock here. The green light will be on 9 minutes, the yellow light will be on 1 minute, and then the red light goes on after 10 minutes.

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

Mr. BOSWORTH. I do have a statement, Mr. Chairman, which has been submitted for the record.

One place I might try to start this morning is simply to try very briefly to summarize where I think we stand and to outline the administration's goals that it has tried to put in place thus far and the progress that's been made in those areas. I'll also speak of the difficulties that we envision coming up.

First, it's very clear that we are not at the present time making any significant progress in reducing the rate of inflation. Over the last 3 months there's been a rather dramatic acceleration of the rate of price inflation, now running at nearly 9 percent. We can anticipate both in April and in May that inflation will continue to remain at levels near 9 percent.

Because so much of the inflation of the recent months has been due to food price increases, I think we can also look forward in the latter half of the year to a substantial moderation of the rate of inflation, very like what occurred last year. Unfortunately, all of that moderation, just like the acceleration, is due almost exclusively to food prices and a few erratic elements of the Consumer Price Index.

After adjusting for some of these erratic movements, it's perfectly clear that the underlying rate of inflation in the industrial sector is one of longer-term significance. While it's not worsening the way it was indicated in the first quarter, it's definitely not getting better. There seem to be signs now that the basic rate of inflation in this country is starting gradually to accelerate.

In hourly earnings, for example, we find that wage increases have now run up and are averaging year-over-year increases of close to 8 percent compared to something around 7 percent last year. Less than half of this can be attributed to the minimum wage and a very real problem seems to be developing in an acceleration of the average rate of wage increase.

Because of the sluggishness in wage movements, it's clear that this sort of inflation has longer term significance and cannot be turned around in a few months.

With that outlook of not making progress, what are the alternatives that we have available to us?

One way to start is to state two extremes which we hope to prevent. One is that this country could repeat another episode of aggregate demand. We could have an increase in unemployment, and try to throw so many people out of work that they would quit asking for wage and price increases. The answer to that is that it is excessively costly and has been totally ineffectual in the past.

The Council's own estimate, just looking back over the last couple of business cycles, is that it would require about 1 million unemployed people for about 2 years simply to take 1 percentage point off the rate of inflation. I don't think that the nature of the current inflation problem we have is due to excess aggregate demand and a policy of trying to increase unemployment is not a reasonable response to that inflation problem.

At the same time, I think the other extreme of wage and price controls is an unworkable policy. It does not address the more fundamental, long-run structural changes that have occurred in the economy. At best controls would be a panacea for a short period of time but would ultimately cause even further distortions and other problems that would increase the inflationary pressures.

Thus, this leads us of necessity to focus on some form of a voluntary program that tries to induce people to exercise some restraint. That's the policy the administration has finally adopted and has been trying to promote vigorously in recent months. That policy has four parts to it.

The first has to be a clear recognition that Government itself has become a major source of inflation, but not because Government is trying to create jobs and not because Government is running substantial budget deficits in order to stimulate the economy. Rather, it is because in so many of its other actions and its attempts to aid special interest groups and provide them with price protection, protection against imports, and in the regulatory area, Government in a very direct fashion is adding significantly to the rate of price inflation at this time.

In the regulatory area alone we could provide estimates indicating that regulations are contributing about three-quarters of 1 percentage point in terms of the rate of inflation. If we just take three specific tax actions—the minimum wage, the increase in social security taxes, and unemployment taxes in 1978, then the sum of those three items would add another three-quarters of 1 percentage point. Therefore, the Government is contributing at least 1½ percent to the rate of inflation.

Therefore, one of the first actions we have to take is to adopt more vigorous policies by the Government to resist the efforts of special interest groups and others to get a little bit of price protection. I don't know how many times over recent months we have heard that each one of these proposals for administration action or regulatory action would add two-, three-, or maybe four-tenths of 1 percent to the price levels. It's always true that they are all very small. But what people forget is that we take hundreds of these actions in a

given year and the cumulative impact of this sort of regulatory actions and administrative and legislative decisions has now reached the point where its impact on inflation is considerable.

The administration has adopted a much more vigorous policy in resisting these sort of pressures than they did last year. I think it began with the President's speech indicating that he would veto the farm bill that was then being proposed by the Congress. It also shows up in many regulatory reforms that the administration has taken to try to improve the cost effectiveness of our environmental, health and safety, and other regulations without backing off from the ultimate goals of those regulations.

I disagree, for example, with Mr. Burns that we have to postpone those goals. I think that there is so much progress to be made in learning to do the regulations better, at lower cost, and more efficiently that it is not necessary to back off from the nation's environmental goals or health problems. However, we do have to recognize that these regulations are not free. They do cost the country in terms of resources and they do contribute to inflation, but we can do them in a far less inflationary fashion than we have been.

The second aspect of the problem is on the price side. While there must be a recognition that Government is contributing to inflation, there must be an equal recognition in the private sector that they also are contributing to the inflation problem and it can't be solved by Government actions alone.

I think that there is a standard of pricing behavior for business that makes sense. They can calculate the average rate of price increases that they have had over the last few years, price increases which will reflect a lot of the underlying trends in productivity, material costs, energy costs, and labor cost that they have incurred. We could then work to take the edge off that rate of price increase and cost increase.

So we are asking business basically to make an effort to limit price increases during calendar year 1978 to less than the average for their industry in the prior 2 years. In the recent months we have been fairly successful in getting a fairly good understanding on the part of business of what this objective means and how it can be implemented. And we have received a considerable level of support for it, at least verbally. Whether or not that will be translated into actual pricing action will be determined a little later in the year.

The third part of the program is on the wage side. You cannot get down the rate of price inflation in this country without having a comparable amount of restraint in wage negotiations. Labor costs, after all, are about 70 percent of total GNP. You will never solve the inflation problem by exempting 70 percent of income from the effort.

But on the labor side we do have a special problem because, unlike prices, we can't ask everybody to undertake an equal constant amount of deceleration from average wage increases of the past 2 or 3 years. The reason for that is that there's been such a wide dispersion of wage increases. Some people, particularly in the large industrial sectors of the country, have received wage increases averaging about 30 percent over a 3-year contract period. At the same time, if we look at workers in the apparel industry and others, where competition and

fears of unemployment have had a greater restraining influence on wage behavior, they have received very small wage increases. It is not equitable to ask people who have had very little to show an equal amount of restraint with people who have had a 30-percent wage increase.

So we have to ask labor that there be greater restraint shown by those who have had the very large increases in the past. It has been difficult thus far to get active support from those in the labor unions for such an effort toward wage restraint.

The fourth part of the program is dealing with some aspects of the economy, such as health care, housing and food prices, where the source of the inflation is not easily addressed by talking about labor costs or looking at prices alone, but reflects many fundamental structural problems.

In those areas we have developed individual task forces within the administration to focus on those specific problems, including compiling a list of policy actions that could be developed by the administration to slow the rate of health costs and specific actions that could be taken to slow the rate of inflation in housing prices.

Those four parts describe fairly completely what the administration's current efforts are in the inflation area.

The topics specifically that you wanted to talk about this morning, like TIP programs, are various incentive programs which come to mind for me specifically because of our difficulties in dealing with getting wage restraint. I understand the problem on the wage side, particularly in a 3-year contract, to undertake wage restraint on the basis of some promise that there might be a comparable amount of price restraint. It is a lot more risky for wage earners than it is for a business firm who 6 months later, if things don't work out, can jack its prices back up again.

One looks to tax incentives, from my point of view, as a way of reducing those risks, to provide some form of a guarantee to labor that if they cooperate in a program of wage restraint they will be protected to some degree against unanticipated price increases.

Thank you.

The CHAIRMAN. Thank you very much, Dr. Bosworth.

[Complete statement follows:]

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

TO THE CHAIRMAN AND MEMBERS OF THE SENATE BANKING COMMITTEE:

Mr. Chairman, my name is Barry Bosworth. I am director of the Council on Wage and Price Stability in the Executive Office of the President. It is a pleasure to appear before your committee today.

I wish I could appear before you bearing good news. I would like nothing more than to be able to tell you that we have made progress against inflation.

Unfortunately, this is not the case. As you are well aware, the rate of inflation has worsened some in the past few months. There has been some wage and price acceleration.

The most recent figures have been, needless to say, disappointing. But they do not suggest that the country is headed for unbridled inflation with double-digit rates on the horizon. There is no doubt that the direction is up when we would like it to be the other way. This is disturbing, but it is certainly not cause for hysteria.

It is true that if we look at the latest CPI, inflation is running at an annual rate of more than nine percent. If we thought for a moment it would remain there we certainly would be frightened. But we are convinced it will not. We expect the year-to-year inflation rate to approach seven percent. Most of the increased inflation is coming from food.

And as the summer wears on and we get the bad effects of last winter behind us we expect significant improvement.

If we look at the underlying industrial rate of inflation, which excludes volatile items like food, mortgage interest rates, energy and used car prices, the rate of inflation is inching up only a little.

Essentially we are bogged down in an inflation rut. We are not really sinking much deeper. But neither are we making any progress in extricating ourselves. And to me this is one of the most worrisome aspects of the current dilemma. If we cannot improve our position with six percent unemployment, how will we be able to as the economy moves closer to full employment?

For the moment I do not see very convincing evidence that demand pressures threaten to exert a new inflationary influence. There is still too much unused capacity in our industrial economy. We could be heading in that direction, however. This is why it is so very important that we do something about the kind of inflation we have before it is compounded by aggregate demand intrusion.

For the past few months the Administration has been working to slow the rate of inflation through its voluntary deceleration program. So far this effort has not produced any dramatic results. We did not expect any in this short time.

It took a long time for us to arrive at this inflation plateau. We won't get off quickly.

The first part of the deceleration program is a recognition that the Federal government itself is a major contributor to the inflation process. This applies to both the executive branch and Congress. Increases in Social Security, the minimum wage and unemployment insurance added three quarters of a percent to the inflation rate. Regulatory actions added an equal amount.

I am not for a moment arguing that there are not some things that must be done despite inflationary implications, especially where the public good is involved. But I am saying that if we are going to get a handle on inflation the Federal government must be more aware of the interaction between what it does and inflation. We are going to have to learn to say "no" to special interest groups, even when we recognize there is both merit and equity in their requests. The President led the way in April when he announced his intention to limit pay increases for Federal employees to 5.5 percent. This was not a popular move. It was not easy. It will not be easy for Congress to demonstrate restraint in the face of rising pressures. It is painful to deny new programs where there is demand; or extend old ones where there is a need. We could, of course, not try. But I think this could lead us down the

path of recession and to a point where the Federal government would be forced to do even less.

The second part of the deceleration program is to convince business to hold price increases below the 1976-77 average. For the last two months the Council on Wage and Price Stability has been meeting with representatives from key industries. We have stepped up the pace of those meetings and in coming weeks there will be more. When the program was first announced last January business leaders viewed it with considerable skepticism. This was not surprising, given past performance. Recently, however, we have detected a very noticeable change. A good many business and industrial people now feel the approach is a reasonable one. And they are persuaded that it is in their best interest. Our success has been limited, but I think important. The automobile companies have pledged to meet the deceleration target by the end of the year. We have every reason to believe the aluminum industry will be able to do the same. We are confident there will be additional commitments as the result of future meetings.

The deceleration program has been criticized because of its voluntary nature. This is understandable. But the problem is that between the extremes of wage and price controls and aggregate demand restraint, there just is not very much left. We don't want controls because they don't work and cause distortions. We don't want demand restraint because this just a

polite way of calling for more unemployment.

Given the lack of options between the two extremes, we decided to try the voluntary route. We think it does have a chance. Great Britain, which went right to the brink and didn't like what it saw over the edge, found voluntarism will work if the national will is strong enough. I hope that we don't have to go as far as Great Britain to gain the will to voluntarily restrain ourselves.

We have been searching for other ways to strengthen incentives if a desire to avoid another recession is not enough.

We have looked especially at a number of ideas that are loosely lumped together as tax incentive programs (TIPS). There are some interesting aspects to them. For one thing, they seem to address the problem caused by the fact that demand restraint is not an effective tool in dealing with the kind of inflation we have today. The cost of jobs and lost output simply would be unacceptably high. There is a possibility that the incentive notion could serve as an inducement to price and wage restraint stronger than jawboning without ignoring market forces.

The incentive approach is indeed a novel one as a possible tool to combat inflation. It is too early to talk seriously about attempting to implement such an idea. But I think it is time to explore the possibility carefully and develop a public

dialogue to determine whether there is enough merit to seriously look in this direction.

Two variants of the so-called tax-based incomes policies recently have received considerable public attention. One, proposed by economists Wallich and Weintraub, uses a "stick" approach. It would levy a surcharge on corporate income taxes for firms that grant wage increases in excess of a predetermined figure. The surcharge would be proportional to the excess wage increase.

Arthur Okun has proposed a variant of his own using only the "carrot" approach. It proposes that firms and workers become eligible for tax relief if they voluntarily enlist in an anti-inflation program. Firms would pledge to keep their average rate of wage and price increase below certain target figures. In return, workers would receive a tax rebate equal to some fraction of their wages or salaries up to a ceiling (\$225 per person). Firms would receive a rebate (5 percent) on their income tax liability on domestic operating profits. The idea is to provide incentives to both workers and companies to hold down wage and price increases.

The Council on Wage and Price Stability has studied both ideas. And in our view, for different reasons, both encounter some serious difficulties.

The stick approach has the advantage that it could be

limited in its application by excluding very small or competitive firms. This would go a long way toward lowering the administrative costs. In addition, it almost certainly would generate some revenue since it is hard to imagine that some firms would not increase wages beyond the target. But it seems to us that the problems far outweigh the benefits. There is a very real possibility that firms with market power would grant big increases and simply pass the cost of the higher tax, as well as the wage increase, on to consumers in the form of higher prices. This could be true especially in those industries where all firms negotiate with the same union.

The straight carrot approach probably would be more politically acceptable since it rewards good behavior rather than penalizing offenders. It would also be more difficult for workers to oppose since it provides a reward for them. But since it does provide rewards, it would be difficult to exclude segments of the economy such as small firms or non-profit institutions. This would add to administrative costs. It would also require Federal budget expenditures, thus putting it in conflict with efforts to reduce the budget deficit. Probably the largest objection of all is that it would require enormous administrative machinery -- particularly if it is extended to prices. There are hundreds of thousands of prices in our economy. To keep tabs on each and every one would

require a bureaucratic effort at least equal to the one we had during controls. I don't think anybody wants this.

The notion of incentive payments to reduce inflation may be useful in a slightly different context. In our efforts to develop support for a voluntary restraint program we have frequently been told that it imposes an unfair burden on workers. Unlike prices, wages are often locked into two and three labor contracts. Thus wage earners are reluctant to commit themselves to a deceleration effort lest it fail and they are left holding the bag while prices are free to rise.

It may be possible to respond to this perceived problem by offering workers an insurance plan that guarantees that those who cooperate in a deceleration effort would not suffer a loss of real income. This might be preferable to the uncertain promises of government. Workers would have to pledge that they would limit increases in their wage and fringe benefits to less than some fixed figure approximating the inflation rate. In return they would receive a one-time Federal payment equal to the increase in the cost of living above the target figure.

For example, if a worker belonged to an employee group that agreed to limit its average wage increase to seven percent, the government would commit itself to a payment equal

to the excess of the rise in the CPI above seven percent. The employer would certify the wage increase by placing an asterisk on the employee's W-2 form.

The focus on average wages for an employee group and the need to check compliance only for those wage increases near seven percent would sharply reduce the administrative costs. In addition, the insurance feature would be triggered only in about one year out of 10. This would result in major administrative cost savings.

The CHAIRMAN. Professor Rees.

**STATEMENT OF ALBERT REES, PRINCETON UNIVERSITY,
ECONOMICS DEPARTMENT**

Mr. Chairman and members of the committee, I am very pleased to have this opportunity to present my views on the tax-based incomes policy, or TIP's. Professor Weintraub was one of the first to propose them. They have recently been receiving renewed attention because of our lack of progress in reducing the rate of inflation. TIP's may have some advantages over alternative ways to fight inflation, but in my opinion they also have substantial disadvantages that have not received sufficient attention. These should be carefully considered by the Congress.

[Complete statement follows:]

Statement of Albert Rees before
the Committee on Banking, Housing, and
Urban Affairs, United States Senate

May 28, 1978

Mr. Chairman and members of the Committee, I am pleased to have this opportunity to present my views on tax-based incomes policies, or TIPs. Such policies were first proposed a number of years ago, but they have recently been receiving renewed attention because of our lack of progress in reducing the rate of inflation. TIPs may have some advantages over alternative ways to fight inflation, but in my opinion they also have substantial disadvantages that have not received sufficient attention. These should be carefully considered by the Congress.

Several variants of TIP have been proposed. Some apply only to wages and others both to wages and to prices. Some would levy tax penalties on firms that exceed wage and price guideposts; others offer tax rewards to firms or workers whose wage or price behavior is more moderate than the guideposts.

In my opinion, only one of these four basic varieties of TIP is administratively feasible, and that one is the original Wallich-Weintraub proposal for a tax penalty based on wages only. The other three possibilities are administrative nightmares. The basic source of the administrative problems of reward TIPs is that everyone will want to be included in the program so as to receive the possible reward, down to the very smallest firms and employers. Reward TIPs will be almost

impossible to end if they prove to be unsuccessful in reaching their objectives, and they could be extremely costly in terms of reduced tax collections. The difficulty with penalty TIPs levied on prices is the impossibility of setting reasonable price guidelines for all products, given the incredible diversity of products in our complex economy and the great disparity across industries and firms in changes in materials costs and in labor productivity. A uniform price guidepost would be manifestly unfair to firms with large increases in materials costs or small or negative changes in productivity. Separate price standards for each product would make a price TIP as hard to administer as price controls.

Since I have argued that only a wage-based TIP is administratively feasible, I shall devote the rest of my remarks to that proposal. The theory underlying a wage-based TIP is that inflation in the American economy has been essentially wage-push inflation. This theory is at best a great oversimplification. It does not allow for the role in recent inflation played by higher food prices at the farm, by the sharply increased price of energy, and by the costs of environmental and safety regulation. More fundamentally, it does not allow for the contribution to inflation of continuing Federal budgetary deficits and of increases in the money supply, and for the effects of these forces on expectations of future inflation.

Proponents of TIP argue that their proposal is superior to wage and price controls because it will not cause distortion in relative prices and consequent misallocation of resources. Distortion is avoided

because firms facing shortages or excess demand are free to raise wages and prices and to pay the appropriate tax penalties. This is a true advantage of a price TIP over price controls, since it is well established that the price controls of 1971-74 did cause substantial distortions of relative prices in some product markets and severe shortages of some commodities. However, there is no corresponding advantage of a wage TIP over wage controls. I do not know of a single instance in which wage controls created or contributed to labor shortages during the period 1971-74. This is because wage controls were applied largely to wages that were already above the levels that would clear the market -- to relatively high wages in jobs for which there was an ample supply of applicants. Wage controls can create inequities in wage structures, and in this respect TIP would probably be superior.

A wage TIP would work, according to its proponents, by "stiffening the backbone" of management. When faced by possible tax penalties for excessive wage increases, management will take a tougher negotiating position and make fewer concessions at the bargaining table. A predictable consequence of a policy that stiffens management resistance to union demands is that we will have more and longer strikes. These strikes could themselves contribute to inflation by creating shortages. The Federal government would no doubt have to intervene in an effort to settle some of these strikes, as it did in the recent coal strike. When it does, it will be working at cross purposes with its own tax-based incomes policy, or may have to set it aside. Wage controls, in contrast to TIP, actually reduce the number of strikes, since unions will not strike for gains management cannot legally concede.

One of the principal difficulties of a wage TIP is that of setting a wage guidepost that is fair and equitable. In 1977 the adjusted hourly earnings index for private nonagricultural workers rose 7.3 percent. To have an appreciable effect in restraining inflation, the TIP guidepost would have to be set lower than this -- let us say at 6 percent, which is a number that some advocates of TIP have suggested. But 6 percent is less than the increase in the Consumer Price Index during 1977. In other words, to have a substantial effect a TIP guidepost would have to try to induce a decline in real hourly earnings. This would be totally unacceptable to the trade union movement for obvious reasons. In some areas, such as the construction industry, there is also a danger that a wage guidepost would become a minimum demand for unions that might otherwise have settled for less.

Where employers have both union and nonunion employees, as almost all employers do, strong unions might insist on wage increases above the TIP guideposts, and might argue that management could nevertheless avoid tax penalties by giving nonunion employees increases smaller than the guideposts. Management would then be left with the unpalatable choice between allowing union-nonunion wage differentials to widen or paying tax penalties -- and in most cases they would probably choose the latter. But, of course, unions would not have to give any particular reason for demanding more than the guidepost. Where unions have enough muscle, stiffening management's backbone is not likely to do much good.

I have mentioned that I believe that the Wallich-Weintraub TIP proposal is administratively feasible, a judgment that rests on its being confined to large private corporations. This feasibility is achieved at a price. By omitting state and local government and nonprofit institutions, the proposal omits sectors in which union wage pressures have been strong in recent years. By omitting small firms, it fails to cover many employers in construction and trucking, industries with high wages and strong unions.

The Wallich-Weintraub proposal also does not offer any deterrent to wage increases for unprofitable corporations with no corporate tax liability. It therefore creates a danger that in collective bargaining some unions would concentrate on unprofitable corporations to set wage patterns, which profitable corporations would have difficulty in breaking.

To say that a proposal is administratively feasible does not mean that it is without administrative costs. These costs would be substantial, both to the government and to the private sector. Detailed regulations would be needed explaining how to compute wage changes, fringe benefits, bonus payments, and other elements of compensation. Special rules would be needed to deal with incentive pay plans, with cost-of-living escalator clauses, and with collective bargaining agreements that were already in effect when TIP began. Although TIP might not require a completely new administrative agency, it would require the Internal Revenue Service to add to its staff many experts in the area of wages, collective bargaining, and compensation.

One reason why the administration of wage controls in the early 1970's was relatively inexpensive to the government is that few employer returns to the Wage Board or the Cost of Living Council were ever audited. A tax-based incomes policy would be subject to tax audits and controversies arising from the policy would form the basis for tax litigation. All of this will take much of the valuable time of corporate executives and union leaders -- time that could better be devoted to improving collective bargaining and raising productivity. The only sure beneficiaries of this process will be accountants and tax attorneys.

Before the Congress imposes tax penalties on the private sector for contributing to inflation, I think it should first examine its own contribution. As the economy approaches full employment, the Federal budget deficit should be substantially reduced. New regulatory legislation should be designed and existing regulatory legislation redesigned so as to minimize its adverse impact on costs and prices. Cuts in excise and payroll taxes should be given high priority when the budgetary situation permits tax reductions. If the Federal government leads the way, I believe that slow deceleration of inflation is possible without resort to the elaborate new machinery of TIPs. But there is no quick and easy solution to an inflation as well established as the present one. We shall have to be content with modest progress over a long period.

Mr. Chairman, this completes my prepared statement. I should be happy to reply to questions.

The CHAIRMAN. Thank you very much, Professor Rees.
Mr. Weintraub.

**STATEMENT OF SIDNEY WEINTRAUB, UNIVERSITY OF
PENNSYLVANIA, ECONOMICS DEPARTMENT**

Mr. WEINTRAUB. Thank you, Mr. Chairman.

My seat here occupied by Governor Wallich yesterday is merely coincidental.

I'm going to just comment on why an incomes policy is necessary to free our economy of the stagflation blight. You have had copious discussion through the years of monetary and fiscal policy. They haven't worked. The question is why; and what do we do now?

I share the views of others that inflation is the No. 1 problem. It is "the one in many." It affects the foreign exchange value of the dollar, leading to the decline of the dollar in the world markets. It affects oil prices; it gives OPEC a reason for its higher prices. Our continued inflation leads to higher interest rates, tightens the mortgage market, and thus the housing market. It gives rise to stock market jitters.

If we can solve the inflation problem we can then devote our energies to the other problems that face us. I'd say that inflation has been our No. 1 intellectual distraction. I have been in this profession for 40 years, and through my entire lifetime we have been discussing inflation and unemployment, and unemployment and inflation. It used to be one or the other. Now it is both simultaneously. We have succeeded only in creating the impossible. The kinds of things that we used to think only happened in "banana republics" or comic operas has been happening to us—the mature, the affluent, the advanced, the politically stable democracy with all the modern stabilization tools. And I say it does raise some questions in this age when economics has become mathematized and aspires to a scientific status. With econometrics, the computer, and piles of data, we have just succeeded in doing what no previous generation of economists has been able to accomplish; have simultaneous inflation and unemployment.

I think the problem is at a different level, at the level of basic ideas. In essence, this is the stagflation ordeal. What to do about it?

Now monetary policy has been ineffective and I predict it will continue to be ineffective. We have had champion inflation fighters—Mr. Martin, Dr. Burns. There was no lack of dedication on their part. They had the keenest desire to accomplish the job. They just couldn't do it with the tools available. Mr. Martin fought inflation consistently. After 19 years in office, after this valiant fighting, the price level was about 65 percent higher than when he came in. Dr. Burns, an equally valiant inflation fighter, left office after 8 years with the price level 50 percent higher.

I think the question is not a matter of will. It's not a matter of zeal. It's a question of the lack of instruments. In the military, if you had a general who promised light at the end of the tunnel, I think that after 64 years when this promise was repeated, asking for eternal vigilance and dedication, you would question whether it could be done. You would question the weaponry. You would question the strategy. The time has come to question the traditional cures.

Now then, you have all been confronted with the Phillips curve doctrine, the fact that we need unemployment to fight inflation, to fight unemployment we'll have to have some inflation. This reminds me of the doctor whom you go to and you tell him you have a coronary and he'll say: "Yes, I can take care of it, but you will have kidney disease for the rest of your life"; or you go to another one and say you have trouble with your kidney and he says: "I can take care of it but you will have coronary problems." We've got to get rid of both. We've got to get full employment. We've got to get a stable price level, and we must not be misguided or beguiled by views that we've got to live with both ailments.

Now, Mr. Chairman and members of the committee, we are embarking again on what I call a destroy-to-revive fantasy. Whenever we get close to the promised land of full employment we are always told we'd better draw back; we'd better start fighting inflation. In other words, whenever we get close to a robust and healthy economy we are told we'd better make this economy a little sick, a little sicker, because if it gets healthy it will really be sick. Frankly, I don't understand that at all.

Again, I say I have been watching this for 40 years and the last 10 years have been rather disastrous, creating so much havoc in our world.

I have long argued that what we have been trying to do is assault the laws of arithmetic. Production goes up by 2 or 3 percent per annum. We have been trying to raise our incomes by 8 and 10 and 12 percent per annum. In the U.K. they try by 25 percent; in Australia by 25 percent; in Canada by 10 and 12 percent; and then they are astonished that the price level rises by 25 percent or 10 percent, or we are astonished; yet we should not be.

If there was a way to raise money incomes without inflation by 10 and 15 percent per annum, while productivity goes up by 2 percent, then there's no reason why we should not say to labor when it asks for 10 or 12 percent per annum, "Why are you so modest? Why don't you ask for 120 percent or 1,200 percent? Let the Fed fight inflation. Let the Federal Government fight inflation." It cannot be done. We cannot create instant-money billionaires without inflation.

Now I have spoken of the futility of monetary policy under outsized pay increases. This is an implication of my remarks. I must not be misinterpreted to suggest that monetary policy is impotent. It's not. It's very potent, but its potency is not on the price level but on jobs. To say it's impersonal is erroneous. It's very personal. It always clouts the housing industry. We know who gets socked by tight money, and with multiplier ramifications spread through the economy.

Now then, let me talk of what I call some errant theories of inflation and I suspect there will be discussion of my remarks here.

First: I want to say inflation occurs in the private sector of the economy. It's for food prices. It is clothing prices, appliance prices—these are goods produced by the private sector. We are talking about the price level in the private sector.

There are those who argue that it's due to Government expenditures. Our fiscal 1979 budget projected outlays up to \$500 billion. At 1963 prices that would be about \$240 billion. It is inevitable that

Government expenditures will go up when money wages and salaries rise. If money wages and salaries go up next year by 10 percent, I will predict the price level and Government expenditures will go up by that amount. If you find that costs go up in the defense industry, why is it surprising that Government outlays on defense go up? The deficit is not remotely the cause of inflation. The deficit currently is about 2.5 percent of the GNP, much smaller than in the 1930's when prices were falling. I will say more on this later.

Likewise, with respect to the Government debt, Federal Government debt has not been rising remotely as fast as private debt.

Now I oppose wage and price controls. The Wallich-Weintraub TIP is reasonably well known but I had always hoped people would read the original rather than just skim it off the top. Many of the questions raised I think were answered there. To get around the weighting problem that Dr. Wallich suggested, I suggested TIP-CAP—CAP for corrected average product—to get away from the weighting trouble, and it seems to me there's been absolutely no discussion of this point.

On the Okun variant, Dr. Okun has spoken. I won't comment further on it.

Now I have developed another idea on policy that can be implemented rather quickly, and which would not require the 2 years to go, perhaps through congressional committees; it is called CAIP—a contract authorization incomes policy—under the Davis-Bacon Act. Currently, there are labor lobbies for new construction awards. Business firms want them—3 months, 4 months, 2 months, whatever the day is—and then there is a strike for higher wages. For the life of the contract I would suggest clauses in the Davis-Bacon Act to the effect that average pay increases do not rise by more, perhaps, than an average of 5 percent per annum. Raids on the Treasury could then be averted.

Lincoln, during the Civil War, spoke of the "slows" of his generals. He had lavished equipment on them. He gave them large numbers of men, and all they wanted to do was stay in the drill camp. They never wanted to go into battle. And this, I think, characterizes our national life over the last 10 years in dealing with inflation. We have a case of the slows. I do not regard the present approach as likely to be successful. I wish it would be successful. The only consequence then would be for people to say: "Well, he was wrong." Fine. No great loss. But it's not going to work. You're going to have to face this issue—this committee or a future committee. We are losing valuable time.

One or two final remarks. Thomas Jefferson, if he were writing the Declaration of Independence today and if I knew him, I'd try to prevail upon him to put a clause in on labor's "unalienable right to a job." Employment opportunities must be abundant. People should have the opportunity to work, to have income, and to walk in dignity; but labor—and whenever I say labor I'm talking about wages and salaries—labor does not have an inalienable right to inflate, and to inflict damage on others. We must have the vision to proceed, noting the prospective costs relative to the overwhelming gains. We must have the courage to venture, to restore, to revive, to improve, and to salvage the market system from both its foes and its complacent

friends. Both are too willing to preside over its substandard performance, thereby to provoke the biggest threat of all to its survival.

One final remark. I call your attention to the artwork at the close. It is good artwork because I didn't do it myself. You can see the steep rise in the average money wage. You see the much slower rise in profit markups. From the standpoint of business markups you would find that the price level would be lower today, on the score of profit margins, than perhaps in 1950. That's not the problem.

The problem is in that big line, "w", that high line, of average wages and salaries, money incomes, rising so much faster than productivity.

I thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Mr. Weintraub.

[Complete statement follows:]

Statement of Sidney Weintraub, Professor of Economics, University of Pennsylvania
 Committee on Banking, Housing, and Urban Affairs, United States Senate, May 23
 1978, Senator William Proxmire, Chairman

Comments on why Incomes Policy is necessary to free our economy of the stagflation blight will be brief; over the years the Committee has heard copious discussion of the monetary and fiscal policy alternatives which have not worked, and which cannot be effective even under the best rules of implementation. Remarks on Incomes Policy design will concentrate on key features of TIP, the tax-based incomes policy that has been associated with the names of Governor Henry Wallace of the Federal Reserve and myself. Some supplementary features to strengthen and simplify the implementation of TIP, and a slightly different approach to Income Gearing (through CAIP), will also be sketched.

Inflation: The Number One Problem. Inflation remains our number one economic problem. It is "the one in many" that mars our economic achievements, holding our actual accomplishments far short of our potential performance. It impedes full employment, it creates social unrest and some political turbulence, it contributes powerfully to the international decline of the dollar, it occasions stock market jitters and record high interest rates; it upsets government and private budgets; it has repercussions on housing and construction, with 'multiplier' ramifications through our economy.

The Great Intellectual Distraction. Not least, inflation, and the alarms over its acceleration, constitutes the great intellectual distraction. We constantly discuss it, and fear it, so that new issues are pushed out of mind and new initiatives are denied the attention they deserve. In the competition for the limited attention span devoted to public issues, Gresham's law is at work: concern with the familiar diverts attention from the more novel problems of our age. An undue amount of professional skills, likewise, becomes preoccupied with the old and now chronic economic ill. To be sure, despite this concentration of skilled resources, the number of good and original ideas to arrest the inflation mess are conspicuously few.

The Stagflation Ordeal: The Impossible Has Happened. The last decade has witnessed the simultaneous distress of too much inflation and too much unemployment, marking the stagflation ordeal. The debacle in the United Kingdom has been even more severe as output fell amid a more ruinous price level surge, giving currency to the slumpflation term.

In the older boom-bust cycles, prices and output rose, and unemployment rates fell, during the upswing; the paths were reversed during the downswing. Thus there was either inflation or higher unemployment rates. Now, rather than the tandem movements we encounter simultaneous bad tidings. Instead of a single disorder at one time, we have come to suffer a twin trauma. What used to happen only in 'banana-republics,' or in bizarre comic opera where everything went wrong, has happened to us, and to other affluent, politically mature, and sophisticated economies presumably endowed with all the advanced stabilization techniques.

The 'impossible' - or 'inconceivable' - has thus happened. Manifestly, it attests to some failure of ideas. It is disconcerting to contemplate that in an age where economics has become mathematized, with econometrics, the computer, and piles of data, we have only succeeded in generating what previous generations avoided, namely, the simultaneous inflation and unemployment ills. Buried under the technical intellectual avalanche, progress in ideas on the operations of the economy, and the consequences of familiar stabilization mechanics, has been impaired.

The Ineffectiveness of Monetary Policy: The Keynesian-Monetarist Dialogue.

Passing reference might be made of the dominant Keynesian and Monetarist dialogue. Monetarists generally allege that monetary policy has been too lax, culminating in inflation. They usually advocate annual money increases in the 3 to 5 percent range, and direct much misplaced profanity to "the" proper definition of money supply. Keynesians have generally targeted on unemployment, advising rates of money expansion in the 7 to 10 percent zone. Each has thus focussed on half-a-loaf of economic policy though, to be sure, each group has insisted that its policies will restore full stability.

Much of this discussion is misspent. Monetary policy will not, of itself, stabilize the economy. Monetary policy is potent, but its direct hammer blows descend on jobs and production, particularly destructive to the housing industry when it is severely restrictive. To be sure, by creating enough unemployment - as under ~~bad~~ Phillips curve doctrine - it can indirectly slow up the money income advance (particularly in wages and salaries); by inflicting the unemployment disaster it can abort the inflation disorder: it inflicts the unwanted for the undesirable. Past Keynesians, bereft of an inflation policy, have concentrated on rescuing us from the unemployment seas by casting us out with the inflation tides. Each has a recipe for returning us to the world of one disaster, without ameliorating the double anguish.

Monetary policy has failed, as documented in the statistical annals, to protect us from the inflation agonies. It is also my conviction that it is destined to fail. The dismal record of inflation is a result not of the loss of will on the part of the Federal Reserve but of a lack of tools to do the proper job, without dumping us in the unemployment ditch.

The Fed has been fighting inflation over most of its 64 year history. The last two chairmen of the Fed were dedicated inflation fighters; both left office with prices over 50 percent higher than at their incumbency. Even as they reminded us of their zeal and vigilance, they lugubriously announced the toll of mounting price statistics. In the military analogy there was always 'light at the end of the tunnel.' After 64 years of retreat and culminating distress we would long ago have changed our military strategy, and probed whether the weaponry was adequate to the task. My conclusion has been, for a long time now, that unaided monetary policy cannot usher in a sidewise price trend.

Mischiefous Phillips Curve Doctrine. Monetarists nonetheless insist that their tight money medicine will stop inflation. The more candid among them admit that the policy will engineer substantial unemployment. This is good Phillips curve doctrine - but bad theory or policy, even dangerous to the viability of our market economy.

There is no need to dwell on the intricacies of Phillips curves, or their wayward patterns of recent years, or the transformation of what was originally a predictive law into a post-mortem on why events went awry.

What is most dejecting is the advocacy of a policy that aims to replace one dismemberment with another disfiguration, or to supplant the inflation woes with the unemployment wickedness. To me it is sheerly immoral, let alone uneconomic, to recommend unemployment for other people, to menace the least adaptable members of our economy with the loss of jobs and income. I have said on occasion that advocates of these policies should resign, join the ranks of the unemployed, and become the great inflation fighters. If unemployment is good policy they should enlist in the battle.

The policy is spurious, too. It is as if a doctor advises a patient that he can cure him of a coronary ailment by inducing a kidney failure. Most of us would seek a new physician. Medicine itself generally tries to eradicate all ailments, and not to substitute a new pernicious disease for an old one. In economics, however, we seem less concerned with restoring total health. We prefer some impenetrable, often mystic, talk of "trade-offs."

The Destroy-to-Revive Fantasy. Monetary policy, as practiced, also entails a curious "destroy-to-revive" fantasy that would stir disbelief in wanderers not steeped in the conventional mythology.

Every time the economy advances, in lowering the unemployment rate and entering the Promised Land of jobs for all, we are warned of inflation ahead, of the economy 'overheating.' The sequel is a tightening of the money screws, the deliberate retardation of the GNP growth rate and of job access.

This is bewildering. Every time we show signs of good economic health, we are consciously reined by inflation fears. Thence the economy is dropped into some recession tailspin. When this depressive process runs on for a time, we quickly denounce the government for unemployment; money policy is thereafter eased, to restore the patient to better health, not too robust to be sure, but to mitigate the worst symptoms.

Thus we are capped below our best performance, deliberately. We are compelled to adopt a posture of deep underachievement at worst, and significant frustration at best. Self-immolation, or masochism, assumes the fancy name of "fighting inflation."

Of course we have not succeeded in preventing the skyward price ascent, but we have succeeded too well in making the market economy sputter rather than to ride smoothly at top efficiency. Monetary policy, despite good intentions, has mired us in an abject performance compared to our attainable goal.

The Assault on the Laws of Arithmetic. We have, over the last decade especially, been engaged in a mad assault on the laws of arithmetic. Average productivity has been inching ahead by 2 and 3 percent per annum, and money incomes - with money wages and salaries comprising the bulk 75 percent of the total - leaping ahead by 8, 10, 12 . . . percent or more per annum. In the United Kingdom and Australia, to name but two countries, the pay increases have sometimes approached 25 percent per annum.

The imperative has been a price level surge, inevitable whenever there is a sharp money income and productivity disproportion. The only source of amazement has been our inability to apprehend that this would happen. The results must follow from the truism of $P = Y/Q$, where P = price level, Y = money income (or Gross Business Product) and Q = physical output.

Regardless of what the Federal Reserve does, so long as the rate of money income ascent surpasses the rate of production flow, price level stability is doomed.

Futility of Monetary Policy Under Outed Pay Increases. Another formula makes money wages and salaries stand out more indelibly in the inflation surge. Writing $Y = kW$, and therefore $P = kW/A$, where W = the average wage and salary, and A = average productivity of labor, with k = the average mark-up of prices over unit labor costs (which equal w/A), the inevitability of the inflation outcome when average money wages jump faster than labor productivity, is disclosed. It happens that year-to-year, and over the long haul, k is fairly constant with a slight downward drift.

There are those who characterize this as a "wage-push" theory of inflation. This is a cultivated error: money wages are simultaneously the chief cost-ingredient on the supply side of the price equation, and the mainspring of consumer demand. "Cost-push" and "demand-pull" are thus inherently simultaneous strings emanating from the same phenomenon, rather than being diverse strands of a price level theory. As an illustration, salaries paid to university faculty are costs to the university and, at the same time, the source of purchasing power and demand to faculty recipients.

The attached chart shows on ratio scale since 1929 the course of average money wages (and salaries) of average productivity, and average mark-ups over the period. From the side of markups (k), the price level should be lower today than in 1950. Likewise, growing productivity has acted as a price level brake. Money wages and salaries, however, have climbed at a heady pace. Inflation has been an irresistible outcome in the circumstances: if P were plotted on the chart field it would run about half-way between w and A .

Instant Billionaires? The general theory must be correct. Otherwise we could raise money wages and salaries not by 8 or 10 or 12 percent per annum, but by 1,000 or 1 million percent or more. We could ask labor at the beginning of each year how much of a pay increase it wants, and then deplore the modest size of the wage demands, multiplying them a thousand or million-fold. Why not make everyone an instant billionaire? After all, the monetarists assure us, the Fed can protect us from inflation! Why leave people unhappy with their money income lot?

Once we say there is a "right" or optimal rate of money wage increase we are recognizing the ubiquity of Incomes Policy.

Some Errant Theories of Inflation. A word on other, and errant, theories of inflation. Many would fault big business for excessive price markups. Our chart invalidates this view as a general factor. Others allege that government deficit finance is at the bottom of the price virulence. Yet, over the last 50 years we have only had nine years of surplus, often of piddling amounts; until the last decade the price level, by recent standards, behaved well; in 1933 the deficit was about 55 percent of expenditures - far above the projected 12 percent for 1979 - yet the 1933 price level fell. Deficits are hardly the

inflation-maker that passionate controversy indicts. Analytically, the deficit theory is usually a step-sister of monetarist versions of increases in the money supply as the price culprit.

Stress also goes to the government debt. The facts are that since 1945 private debt has increased far faster; likewise, the big lurches in the relative debt size occurred between 1930 and 1945 when the price level was "orderly" by recent standards. Too, in that period we were concerned with "reflation," or lifting the price level.

Others blame government expenditure. The projected \$500 billion of outlays for 1979 would, at 1963 prices, amount to about \$240 billion. It would be more accurate to argue that government expenditures jump more as a consequence of higher prices than as cause. When money wages go up civil service pay can hardly lag too far behind. When military hardware costs more it is inevitable that the defense bill mounts. The federal government has hardly increased its portion of GNP purchases; in fact, while eyes have been riveted on Washington the State and Local outlays have spurted, and are now about 50 percent higher than Federal GNP purchases.

Income Gearing: Some Proposals

All economic systems that pay out money incomes, whether a capitalist or collectivist model, must have some method of gearing money incomes to output flows. Those of us who want to preserve the market system must seek out policies that are compatible with the market system and its institutions of private decision-making and largely unfettered choices.

Those of us who have suggested some institutional changes are concerned to protect, to improve, to salvage the market system, to see it operate up to its best potential. Foes of the market system are content to witness its failures. Paradoxically, avowed friends of the market system who refuse to even consider new policies lock hands with its foes; persevering in old policies, and thereby tolerating inflation and unemployment, they are in some tacit and unintended alliance with those who would dethrone the system without any concern with the chaos that would ensue and the threats to freedom itself.

Opposition to Price and Wage Controls. Before discussing some inherently non-interventionist policies, and to avoid any confusion on the matter, wage and price controls are not advocated. They are noxious for they are bureaucratic, dilatory, harassing, costly to administer, apt to be politicized, requiring a legion of snoopers and enforcers, and too anxious to make criminal offenses out of consensual agreements involving transactions as simple as purchases of a quart of milk or loaf of bread. Controls would clog court calendars, providing mainly a forum for histrionic performances by lawyers, and full employment for them, and a retinue of court attendants and jailers.

The image of Captain Queeg tyrannizing over the theft of a plate of strawberries must not be rendered the prototype of our economic system. So, nothing in my remarks are to be construed as advocacy of price controls. I oppose them except for the shortest possible period while other policies are being prepared. The Nixon Phase One, some will say, succeeded in stopping the 1971 price upheaval. In my view they only proved that our economy can stand almost anything for 90 days.

The Wallich-Weintraub TIP. The Wallich-Weintraub tax-based incomes policy (TIP) is reasonably well-known. Briefly, it is intended to subject firms that violate an average money wage and salary norm of, say, 5 percent per annum to an extra corporate income tax. The object, however, is not to collect taxes but to deter inflationary conduct. Corporate tax levies can, on balance, be reduced, especially as the economy works toward full employment. Insofar as TIP yields some revenue, the ordinary corporate tax can be lowered so that no erosion of corporate financing-capital occurs. TIP cannot be tarred with aiming to increase the corporate tax burden; this would misconstrue or misrepresent it.

An analogy with a speed limit can convey the essential idea. Speed limits are imposed to prevent suicidal road conduct, menacing mainly life and limb of others. Revenue is not - or should not be - the objective; if revenue were sought we should put the limit down to about 3 miles per hour, to collect revenue all day long!

Speed limits, however, do permit individuals to violate them in cases of emergency with cognizance of a penalty. TIP, likewise, permits the pay guides to be punctured, with penalty. Thus TIP, like all good legislation, contains a safety-valve for firms who see the need to surpass the pay norms.

I would confine TIP to the largest 1,000 or 2,000 firms, or firms employing above a given number of people. If TIP were confined to firms of 500 employees or more we would encompass firms with sales of perhaps \$15 millions or more for inclusion. Administrative convenience should largely govern the lower cut-off point. There is no need to subject small business to TIP; on pay policy they typically follow the practices of the larger business cohorts.

To strengthen TIP and compel settlements of unions with firms that offer an average increase of, say, 5 percent (or perhaps slightly more), a variety of supplements can be conceived. Some firms may face bankruptcy, in the event of a long strike, because of onerous fixed charges. Some circumscribed guaranteed loan features may thus be attached. Some NLRB penalties may, as a strike continues, be placed on unions, for a period of years. No particular recommendations are made here but labor market specialists may have ideas that could hasten wage settlements in the 5 percent range.

TIP-CAP. In my own earliest statement of TIP, a simple average pay level was calculated for the first year, say 1977, and then another similar average was computed for 1978. If the average rate of pay increase exceeded the norm, say 5 percent, a penalty corporate income tax would be imposed. In the collaboration with Governor Wallich, a weighted pay average was injected to mitigate some possible fudging by firms that granted top executives extravagant increases and then hired superfluous low skilled employees to drive the average pay award below the taxable increment.

Weighting the average introduces extra complexity, and invites interminable controversy on a correct set of weights. To avoid this, and to immunize some pay grants in excess of the average guidepost, firms can be permitted to compute a simple average of labor productivity, and correct this for price level changes (following their selection of a price index), and to enable labor to share in superior productivity improvements. This is the CIP aspect, where CAP signifies "corrected average productivity." Labor would thus be the direct partial beneficiary of extraordinary productivity improvements stemming from technological improvements in equipment. Only elementary arithmetic calculations are entailed, well within minimal accounting skills.

The Okun TIP Variant. The Okun TIP variant is discussed very briefly for Dr. Okun, who has contributed so much to recent discussion and awareness of TIP, may have some modification of his ideas. For one thing I remain skeptical of the original voluntary participation in his plan; this would be tantamount to asking speeders to behave voluntarily. Too, the main principle seems to be to "bribe" drivers to travel below the speed limit rather than to penalize them for surpassing the posted norms. It is questionable whether the payment can be large enough to sponsor proper wage conduct.

Too, the use of the personal income tax to pay rebates for non-inflationary conduct would appear to be complicated, with the disadvantage of being discriminatory against non-union employees. Finally, the original Okun variant fares better as a method of reducing the rate of inflation, whereas the Wallich-Weintraub plan could be a mode of stopping it. Inflation would be stopped if the average pay increase was set within a 3 percent threshold, and a steep graduated penalty was imposed for violations.

CAIP. TIP, because of its tax aspects, would have to clear the tax committees of Congress where it could be misperceived as a tax measure, and subject to long debate. Faster progress in incomes Policy, or Income Gearing, might follow another approach.

Under Walsh-Healey and Davis-Bacon the government already operates an incomes policy. Davis-Bacon, for example, mandates that on government or government assisted construction contracts, prevailing wage rates, apparently interpreted as the highest in the general vicinity, be paid employees. Effectively, this nails a high floor under pay scales.

Often, labor lobbies for government construction contracts and then, when the sums are voted, there are strikes for higher wages. It should be possible to limit pay grants, over the life of the contract, to an annual increase of no more than 5 percent (or whatever pay norm is adopted). The limit would also cover executive pay scales, thus taking some of the fat of salary aggrandizement out of the government outlays. Penalties could take the form of disallowing magnanimous pay increases from entering as costs for computing corporate income tax, or denying cost overruns occasioned by the pay upkick in contract negotiation.

Raids on the Treasury could be thwarted under this proposal to make Davis-Bacon conform to a limited annual lift in the pay ceiling. The idea could be extended to military procurement. Inasmuch as construction and government procurement outlays extend to a veritable Who's Who of American enterprise, this approach could blanket about 10 to 25 percent of the business sector and could suppress a money income explosion. Government employees could be allotted limited annual average pay increases, subject to correction every three years, conformable to pay experience in the private sector.

CAIP (= Contract Award Incomes Policy) could thus establish a fairly quick transition to a more universal TIP-CAP policy. CAIP could remain to cover the past runaway wage costs in the construction sector.

Lincoln and the Slows

During the Civil War Abraham Lincoln moaned over his Generals, until he found Grant, as having a case of the 'slows.' He felt he gave them superior equipment and advantageous manpower, and yet they rarely wanted to move out of their training camps, preferring drill field maneuvers to battle. The 'slows' have also afflicted inflation policy over the last decade. We talk of inflation but we have - until very recently - shut our eyes to any innovative policies to staunch the debilitating phenomena. The Nixon-Ford years yielded the rhetoric of "game plans," and the spectacle of "gradualism;" apparently the intention was sneak up on the stagflation phenomenon and dispel it.

A decade has elapsed. Policy-wise little has changed. The 16 Carter months have been devoid of a policy to cope with the double-trouble of inflation and unemployment. Recently the President has uttered more encouraging sounds and has concentrated anti-inflation policy in the hands of Ambassador Strauss.

A Fly-Swatter Approach? Recently we have witnessed the end of the coal strike, a cut-back in what appeared to be an extraordinary steel price rise, some efforts at boosting farm prices, and a promised restraint on government pay increases. The progress seems to be by nature an ad hoc patching of what is inherently an income-productivity problem. Only an integrated income gearing policy, resembling TIP, is likely to stop inflation and permit full employment. Otherwise we are likely to resemble the man in an unscreened house near the lake, running about with a fly-swatte to stomp out one by one the countless pests entering through windows on all sides.

An Addendum to the Declaration of Independence?

Resisting entreaties on his behalf for the onerous and vital chore of drafting the Declaration of Independence, John Adams advised that the assignment go to Thomas Jefferson for, as Adams said, Jefferson possessed the gift of "a peculiar felicity of expression."

Capturing the mood of the times and ideas in the air, Jefferson wrote of man's "unalienable" rights. If the document were written today, perhaps we might petition Jefferson to include a passage on labor's "unalienable right to a job." But with rights go obligations: there is no unalienable right to inflate, and thereby injure others in the economy, or to invite anti-inflation responses that jeopardize jobs.

TIP Is Not Anti-Labor but Anti-Inflation and Pro-Full Employment

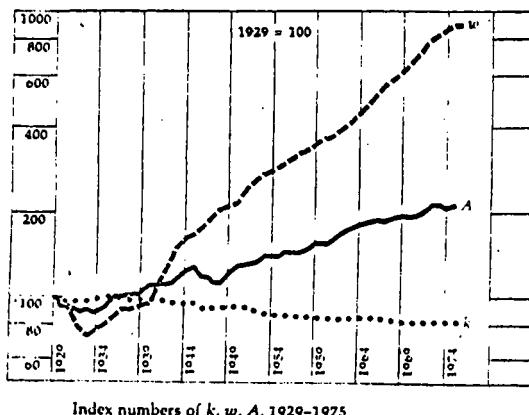
TIP is not anti-labor. It is not anti-business. It is anti-inflation and pro-full employment. By tethering money incomes to productivity advances the price level can be stabilized, rational behavioral decisions on saving, business investment, and government budgeting, can be made; jobs can be assured for all willing to work at prevailing wage scales; monetary and fiscal policy can be devoted to full employment ends so long as the inflation fears are eliminated.

Events between early 1961 and late 1968 demonstrated that we can achieve continuous expansion and abundant job opportunities. It is a Marxist tenet, too often pronounced by conservative friends of the market system, to assert that the expansion of the 1960s was attributable to the Vietnam war. It is not war that makes a market economy tick, but expenditures by the private and public sector. There is much work to be done as we enter the 1980s. Our traumatic fear of inflation, and our futile and inept methods of combatting it, have created the stagflation folly, with an output and income loss ranging from \$75 to \$100 billions per annum.

This is wasteful in the extreme. A big \$100 billion annual prize dangles before us, waiting to be grasped. TIP is a promising lever, free of the oppressive features of wage and price controls. Administratively it is feasible; cost-wise it is modest, requiring \$1 to \$5 millions for implementation.

We must have the vision to proceed, noting the prospective cost relative to the overwhelming gains. We must have the courage to venture, to restore, revive, improve, and salvage the market system from its foibles and its complacent friends. Both are too willing to preside over its sub-standard performance, thereby to provoke the biggest threat of all to its survival.

The WCM Theory: The Double-Edged Demand and Cost Blades



The CHAIRMAN. Professor Seidman.

**STATEMENT OF LAURENCE S. SEIDMAN, UNIVERSITY OF
PENNSYLVANIA, ECONOMICS DEPARTMENT**

Mr. SEIDMAN. Mr. Chairman, Senator Schmitt, because of the time constraint I will be skipping sections of my prepared statement and I will indicate the page I'm skipping to so you and others can follow my testimony.

The CHAIRMAN. Let me say the entire statement will be printed in full in the record as will the other statements.

[Complete statement follows:]

A TAX-BASED INCOMES POLICY:

Laurence S. Seidman

May 23, 1978

My name is Larry Seidman. I am an Assistant Professor of Economics at the University of Pennsylvania. During the last four years, I have been engaged in research concerning the theory and design of a tax-based incomes policy (TIP). I recently presented a paper on tax-based incomes policies at the Brookings Conference devoted to that subject.

This morning, I want to explain why I believe a tax-based incomes policy should be adopted, and offer specific suggestions for its design. A permanent tax-based incomes policy-or TIP- complemented by proper monetary and fiscal policy, offers the prospect of permanently reducing both inflation and unemployment. Moreover, I believe it is the only policy that will enable us to reduce inflation and unemployment simultaneously. Labor, business, and the general public would therefore benefit greatly from a tax-based incomes policy.

TIP is fully compatible with our market economy, its institutions, and traditions. In contrast to either persuasion or controls-the two traditional methods of incomes policy- TIP would harness the instrument that has proved its effectiveness in our market economy: financial incentives. Business and labor would remain free to bargain collectively, and weigh the particular features of their own situation against the TIP incentive, arriving at the wage and price decisions they regard as best, without government interference.

It must be emphasized that TIP does not seek to blame labor or business for inflation. Employees, or their unions, who seek higher wages and salaries to catch-up with inflation, to stay ahead of it, or to improve their standard of living, are simply

reacting to protect their own self-interest, exactly as management do when they seek profits. Since labor is responding to the same incentives that drive all economic agents in our economy, fault-finding is unjustified. Similarly, when business firms grant wage increases in excess of productivity increases, and pass the higher unit costs on to consumers through higher prices, they are protecting their own interest in response to the constraints they face. The aim of TIP is not to place blame on labor, or business, but to permanently restructure financial incentives so that the outcome is best for the public, labor, and business.

The logic of TIP can be simply explained. When the average firm grants, and its employees receive, a wage increase in excess of its productivity increase, the result is an increase in its unit cost, which the firm must cover by raising its price. This behavior imposes a cost on society in either of two forms. If monetary and fiscal policy accommodate such wage-price behavior, the social cost takes the form of inflation. If monetary and fiscal policy tries to combat such behavior, the social cost takes the form of unemployment and recession.

Yet today neither the employer nor employees have an incentive to take this external social cost into account when their own wage increase is set. Many economists would diagnose this as a standard "externality" problem, and therefore recommend the standard remedy: "internalize the externality." The employer and employees at each firm should bear a private cost whenever they impose a social cost, in the form of higher inflation or unemployment, on the rest of society. They should either incur a financial penalty, or forego a financial reward, when they engage in such behavior. The aim of TIP is to provide such a financial incentive.

Even advocates of TIP have not yet agreed on the best design. Today, I want to set out tentatively a TIP package that promises to restrain wages, prices, and profits. It combines elements from the original employer TIP, first proposed by Drs. Henry Wallich and Sidney Weintraub in 1971; and the recent employer-employee package suggested by Dr. Arthur Okun. Moreover, it contains specific guarantees and protections for labor concerning prices and profits, similar to those that have been offered by Dr. Okun, and Drs. Lawrence Klein and Vijaya Duggal, among others. I offer this package tentatively, to serve as a concrete starting point, and as a basis for my analysis this morning. The TIP package consists of three parts: wages, prices, and profits. I will consider each in turn.

WAGES

When I say "wages" I really mean compensation, including salaries, fringe benefits, and executive pay. Incidentally, I mean the salaries of university professors, as well as the wages of factory workers. Economic theory, econometric evidence, and common sense all strongly support the conclusion that a smaller wage increase, and therefore, a smaller unit cost increase, will result in a smaller price increase. Today, the average annual wage increase is 8%; but because the trend growth rate of productivity-output per manhour- is only 2% (and varies little from this figure), the average unit cost increase is 6%. Our basic inflation rate, therefore, is 6%. The best way to predict the inflation rate is to observe the average wage settlement and subtract 2%- the productivity growth rate. Table 1 shows that over the last thirty years in this country, in most years the inflation rate has been approximately equal to the difference

TABLE 1

**Price-Unit Labor Cost Relationship
(Percent Change from the Previous Period)**

Year	Output per hour	Compensation per hour	Unit labor costs	Implicit price deflator
1948	3.1	8.9	5.6	6.6
1949	3.6	3.1	-0.5	1.0
1950	6.1	5.5	-0.6	1.7
1951	2.4	8.8	6.3	6.8
1952	2.2	5.5	3.2	1.7
1953	2.1	5.7	3.6	2.2
1954	1.8	3.2	1.3	1.6
1955	3.4	3.5	0.1	2.1
1956	-0.3	5.9	6.2	3.2
1957	2.3	5.7	3.4	3.5
1958	3.1	3.7	0.6	1.0
1959	3.2	4.6	1.3	2.2
1960	0.7	3.9	3.2	1.6
1961	3.4	3.3	-0.1	0.8
1962	4.1	4.2	0.0	1.5
1963	3.1	3.6	0.5	1.3
1964	3.6	4.8	1.2	1.3
1965	2.6	3.6	1.0	1.7
1966	3.1	6.2	3.0	2.8
1967	1.7	5.7	3.9	3.1
1968	2.6	7.4	4.7	4.1
1969	-0.4	6.7	7.1	4.7
1970	0.6	6.8	6.1	4.9
1971	3.4	6.8	3.3	4.7
1972	3.4	6.2	2.7	3.1
1973	2.0	7.8	5.7	4.2
1974	-2.4	9.5	12.2	10.1
1975 ^p	0.9 ^p	8.9 ^p	8.0 ^p	9.9 ^p

^pprojected by Bureau of Labor Statistics.

Note: All data are for the private, nonfarm economy.

Source: Bureau of Labor Statistics, Department of Labor,
Presented in Table B-31 (p. 207), *The Economic Report of the
President*, January 1976.

between the average wage increase and the average productivity increase. For example, in the early 1960's, the average wage increase was 4%, the average productivity increase was 3%, and the inflation rate was 1%. This rule of thumb is one of the most stable empirical relationships in economics. There is no mystery about this. Every business must cover an increase in its unit cost by raising its price. Moreover, the degree of competition in each industry- whether high or low- establishes a specific relationship between unit cost, and the price firms charge, so that price and unit costs move together. Both theory and empirical evidence strongly reject the view that sustained price increases can occur without accompanying increases in unit labor costs. Today, unit labor costs are rising 6% per year, and therefore, so are prices. The only way to bring the inflation rate down to 0% is to stop the advance of unit labor costs, by gradually reducing the growth rate of wages from its current 8% down to 2%, the growth rate of productivity.

Suppose TIP sets as its initial target a wage inflation rate of 6% (instead of the current 8%), and a price inflation rate of 4% (instead of the current 6%). Then TIP might consist of the following two incentives:

(A) Employer Incentive

A firm that grants a wage increase in excess of 6% would receive a surcharge on its income tax for that year in proportion to the size of the excess. If it grants less than 6%, it would enjoy a proportionate tax cut; if it grants 6%, its tax rate would remain at the base (currently 48% for many corporations). For example, if a firm grants 7%, and the TIP multiplier is 6, its tax rate would rise to 54%; if it grants 8%, its tax rate

would rise to 60%.

(B) Employee Incentive

Employees at a firm that grants an average wage increase in excess of 6% would receive a tax increase for that year in proportion to the size of the excess. If the firm grants less than 6%, they would enjoy a proportionate tax cut; if it grants 6%, their tax rate would remain at the base. The penalty or reward would depend only on the average wage increase at the firm, so that individual promotion is not discouraged.

One method of implementing the employee incentive would be to use the income tax withholding system. If the firm grants a wage increase in excess of 6%, it would be required to raise the actual withholding rate; yet employees would only be credited the standard rate on their W-2 forms. Symmetrically, if the firm grants less than 6%, it would be required to reduce the actual withholding rate; yet employees would be credited the standard rate on their W-2 forms. In this way, the incentive would be fully implemented by the employer, so that there is no additional compliance burden on individual employees. But on each paycheck, and on the W-2 form, employees would be informed of the TIP surcharge or credit, so they would know the penalty or reward that has resulted from the wage increase at the firm.

It is crucial to understand how these TIP incentives differ fundamentally from controls. For both incentives, the tax penalty for exceeding 6% must be stiff, but not prohibitive, for either the employer or employees. Where market forces, and the special conditions of the firm or industry, call for a relative wage increase, it is essential that the firm still be able to exceed

6%, though by less than it would have without TIP.

For example, suppose firm A faces a sharp rise in product demand, and thus a labor shortage; while firm B faces a decline in demand, and thus a labor surplus. Without TIP, A might grant 9%, and B, 7%, for an average of 8%. With TIP, A might grant 7%, and B, 5%, for an average of 6%. TIP would not replace the market forces working on each firm, and would not prevent the relative wage increase required by A to attract additional labor. Both A and B would be free to set their wage increase without having to seek regulatory approval.

Now contrast the situation of A and B under controls. Under controls, all firms would be prohibited from exceeding the wage target of 6%, unless a firm could prove to a regulatory board that it deserved special treatment. Under TIP, the employer and employees at firm A, through collective bargaining, would be free to set a 7% wage increase, and accept the tax penalty. Under controls, the employer and employees at A would not be free to arrive at their own decision. They would have to submit their case to a regulatory board. Their collective bargaining agreement would in effect require government approval. The outcome would not depend on their own assessment of the particular situation in their industry, but on the assessment of a board reviewing a large volume of cases- a board which would therefore be far less informed about the merits of their case. The appeal process under controls would be time-consuming, costly, frustrating, and inefficient. TIP would entirely avoid this regulatory interference in collective bargaining decisions. It would preserve the freedom of business and labor at each firm to make their own decisions.

Dr. Henry Wallich, a respected conservative, has written:

"The essence of TIP is that it differs fundamentally from the usual kind of wage and price controls. Business and labor are free to bargain for any wage increase they choose. Only the weight of market forces is changed, with the tax doing the weighting."

TIP differs from controls exactly as the investment tax credit and accelerated depreciation differ from government controls over each firm's investment. Like these tax incentives, TIP would change the profitability of particular firm decisions. But each firm would be free to respond as it wishes, without seeking approval from regulators or regulations. The IRS would investigate a sample of firms according to its usual procedure.

TIP would complicate the tax code. But so do the investment tax credit and accelerated depreciation. For example, IRS must develop service lives for many classes of assets, often requiring arbitrary judgments. Businessmen clearly do not regard such tax incentives as controls. Despite their complexity, these incentives leave each firm free to make its own decisions. It cannot be over-emphasized that TIP is a tax incentive, to which firms can respond as they wish.

The practical difficulties of implementing TIP have nothing to do with controls, or the interference by government in the decisions of business and labor. Instead, they are exactly analogous to those encountered with accelerated depreciation. IRS must carefully draw up rules that firms must follow in computing their tax liability. Under TIP, IRS will have to define how the wage increase, including contributions to fringe benefits, is to be computed for tax purposes.

The most serious technical problems that have been raised

against some versions of TIP can be completely avoided if TIP is properly designed. For example, the question has been raised: Whose estimate of the cost of a labor contract will be accepted? This problem, however, disappears if TIP is based on the labor expenses actually paid by the firm in a given year, rather than attempting to estimate what the negotiated contract implies. Tax liabilities are based on actual income earned, not on a forecast of prospective income. What must be grasped is that TIP is a tax incentive, and should be implemented according to standard principles of taxation, not according to the methods of controls.

Moreover, if a firm actually pays 9% more per manhour this year than last, it should not matter how much of this is the base wage, a cost-of-living adjustment, or a contribution to health or life insurance, or pensions. The important fact is that actual total labor expense per manhour has increased 9%; this is what counts for the firm's costs, pricing, and inflation, and is therefore the basis on which TIP should be computed.

The most valid objections have been raised against a TIP that would provide penalties or rewards based on prices or profit margins. These objections will be reviewed later. A TIP that provides incentives for wages-only avoids these problems. Later, I will show how prices and profits can be restrained effectively without direct tax incentives.

In summary, TIP differs fundamentally from controls. Indeed, in my view TIP is our best hope for avoiding controls.

The above TIP package contains both an employer and employee incentive, and combines both penalty and reward. I want to emphasize that in my view, the most crucial ingredient in the package is the income tax penalty on the employer- the original

Weintraub-Wallich incentive. In a technical paper that will be appearing in the next issue of the Brookings Papers on Economic Activity, I present the economic theory and econometric evidence that I believe leads to this conclusion. I will briefly summarize the central argument.

An employer can ignore the opportunity to earn a tax cut; and employees can ignore either the penalty or reward, provided the penalty is not prohibitive. An employer, however, cannot afford to ignore the imposition of a stiff tax surcharge on its income tax. In the above TIP package, the employer incurs a tax penalty if he grants a wage increase above the 6% target. Suppose instead, under a reward-only TIP, he were offered a tax cut for reducing his wage increase below today's average of 8%- but his tax rate would remain 48% if he grants 8% or higher. It is possible that the opportunity for a tax cut will induce him to reduce his wage increase below 8%. But if he does not, he will be no worse off than he is today. It is therefore uncertain whether he will respond. Suppose under the penalty proposed in the above package, his tax rate would rise to 60% if he grants 8% (6 percentage points for each 1% excess). If he insists on granting 8%, he will be significantly worse off.

In my view, there is significant econometric evidence that when the profit rate declines below normal, business firms grant below-normal wage increases, reflecting their reduced ability-to-pay. The income tax penalty would threaten a squeeze in after-tax profit if the firm grants the same wage increase. The evidence suggests that this threat would cause managements to stiffen their resistance and reduce the wage increase towards the target to

avoid the potential after-tax profit squeeze.

It must be emphasized that if firms respond to the potential penalty by reducing the wage increase to the TIP target, their tax rate will remain unchanged, and no after-tax profit decline will actually occur. A central feature of the employer penalty TIP, in contrast to an increase in the ordinary corporate tax rate, is that it can threaten a profit squeeze if firms fail to respond; but will not cause an actual one if firms respond as expected.

In response to this argument, the following question can be raised: Is it possible that firms will ignore penalty-TIP, grant 8%, accept the tax increase, but pass on the higher tax cost to consumers through higher prices, thereby avoiding a decline in their after-tax profit? Let me explain why this possibility will not undermine penalty-TIP.

Since the tax penalty is on the income tax of the firm, in effect "IRS goes last." First, the firm raises its price, hoping to increase its before-tax profit enough to offset the TIP tax increase. Then, IRS taxes a fraction of this gross profit. If the TIP penalty multiplier is made stiff enough, the firm will be unable to avoid an after-tax profit decline if it grants 8%, no matter how great its market power. For example, if the TIP multiplier is 6, so that the firm's tax rate increases from 48% to 60%, the firm would have to be able to raise its before-tax profit by 30% to avoid a decline in after-tax profit (without TIP, the firm would keep 52%, which is 30% greater than the 40% it would keep under TIP if it grants 8%). If the multiplier were 13, so that the firm's tax rate increases from 48% to 74%, the

firm would have to possess the ability to double its before-tax profit to avoid a decline in its after-tax profit (since it keeps 52% without TIP, but 26% with TIP if it grants 8%). Finally, if the TIP multiplier were 26, so that the firm's tax rate increases from 48% to 100%, it would be literally impossible for the firm, no matter how great its monopoly power, to avoid an after-tax profit squeeze if it grants 8%. Of course, so extreme a TIP multiplier is neither desirable nor necessary. The extreme example is given to illustrate that, regardless of the degree of oligopoly power of the firm, there is a TIP penalty stiff enough to force the firm to respond by reducing its wage increase.

Even if it is understood that raising prices cannot fully protect the firm, it may be asked: Won't firms try to cover part of the tax cost by raising price, and won't this worsen inflation? The answer is as follows. As long as the average firm reduces its wage increase to the target, the average tax rate will remain at the base (today, 48% for most corporations), and there will be no tax increase to pass on. Suppose, pessimistically, that the average firm exceeds the target, and incurs a tax increase. The result will at worst be a one-time increase in the average firm's mark-up, and price. Once the price is adjusted to the higher tax rate, price will again follow unit labor cost. The pass-on can only occur once, because the tax rate will at worst only increase once. Thus, even under the worst scenario, penalty-TIP will soon permanently bring down the inflation rate.

Moreover, it is far from certain that firms can raise prices and before-tax profits significantly in response to TIP. Even under industry-wide collective bargaining, where the firms are

large oligopolists, import competition may limit the ability to raise gross profit by raising price. It is therefore important that if TIP is introduced, firms clearly understand that the government will refuse to protect them from import competition if they ignore TIP, grant a wage increase above the target, and try to pass on the tax cost through higher prices.

The shifting problem just described will not undermine TIP if the penalty is on the income tax, because in effect, "IRS goes last," after the firm tries to raise its gross profit by raising price. If the penalty were on the payroll tax of the firm, in effect IRS would "go first," and the shifting problem would be more serious. After paying the tax, according to the size of its wage bill, the firm could then try to maintain its after-tax profit by raising price. There would be no guarantee that the firm would suffer an after-tax profit squeeze if it granted 8%. The version of TIP that would disallow excess wages as a deduction when the firm computes its tax liability can be shown to be equivalent to a payroll tax surcharge. Because it is less vulnerable to the shifting problem, the income tax surcharge is preferable to the deduction disallowance.

In summary, the threat of an income tax penalty will force firms to respond by "digging in" at a lower wage increase in order to avoid an after-tax profit squeeze. Today, the average firm "digs in" at 8%. If the TIP target is 6%, the average firm will "dig in" with the same intensity at 6%.

The employer penalty is most readily applied to the private, profit sector. I would suggest, however, that the penalty should also be applied to large firms in the non-profit sector, such as universities, to the regulated sector, and to state and local

governments. For the latter, general revenue sharing could be reduced the larger the wage increase. Both equity and efficiency require as broad a coverage for TIP as is consistent with administrative feasibility. In light of the cost of compliance and administration, small firms might be given the option of inclusion or exclusion from TIP.

Some of my colleagues who have suggested tax rewards, instead of penalties, agree with my conclusion that the employer income tax penalty is likely to be the strongest, and most reliable ingredient in a TIP package. They have settled for a tax reward because they fear that the patient will refuse to accept stronger medicine, and that you will not have the political courage to enact a tax penalty.

Our anti-inflation policy has suffered from an unwillingness to recommend anything that may be temporarily unpleasant to the patient. The result of this timidity has been that the disease has grown worse, and the patient feels worse than before. The time has come to recognize that the best medicine does not always taste best. It is understandable that the patient seeks to avoid unpleasant medicine. It is the responsibility of the physician, however, to prescribe what will work.

Your willingness to enact an employer tax penalty will not only provide the key ingredient for reducing inflation. It will do more to reduce the expectation of higher inflation than any other single action you can take. The public is justifiably alarmed when it observes political leaders and policy-makers "running for cover" when someone complains that he will refuse to consider any medicine with an unpleasant taste. What is required is a TIP package, containing penalties as well as

rewards, together with monetary and fiscal restraint, to restore public confidence, reduce the expected inflation rate, and begin to wind down the actual inflation rate without subjecting the economy to a severe recession.

If the TIP package, together with proper monetary and fiscal policy, succeeds in reducing wage inflation to 6%, and price inflation to 4%, then the dividing line between penalty and reward under TIP should be lowered to 4%, and ultimately (after several years) to 2%, the average growth rate of labor productivity, and therefore, the rate required to keep inflation near zero.

As disinflation steadily occurs, the unemployment rate can gradually be brought down perhaps to near 4%. Econometric evidence suggests that without TIP, a 4% unemployment rate would cause wage and price inflation to gradually accelerate, so that 4% could not be maintained. With a permanent TIP, exerting permanent downward pressure on wage increases, it should be possible to keep wage increases equal to productivity growth at a 4% unemployment rate.

My own analysis suggests that a permanent TIP would cause a significant structural change in the economy. TIP would permanently reduce the non-accelerating-inflation rate of unemployment (NAIRU) of the economy- from perhaps 6% to 4%. It would then become possible to run the economy at 4%, instead of 6%, without generating a rise in the inflation rate. This reduction in the NAIRU would yield large social benefits each year. According to Okun's Law (a 1% reduction in unemployment yields a 3% increase in real GNP), if the economy can be run at a 4% unemployment rate, real (inflation-adjusted) GNP, labor income, private investment, and profits, will all be 6% higher each year than if

the unemployment rate were 6%.

The monetary growth rate prescribed by monetarist economists would then be essential, on average, to maintain 4% unemployment (the new NAIRU under TIP), and near 0% inflation. It will be easier for the Federal Reserve to gradually reduce the monetary growth rate to its target if the full employment budget is brought approximately into balance, so that pressure on interest rates from fiscal policy is reduced. Thus, TIP is a complement to, not a substitute for, responsible monetary and fiscal policy. Of course, periodic disturbances will move the economy away from its targets, and flexible, countercyclical monetary and fiscal policy will remain necessary. Nevertheless, a permanent TIP should significantly reduce the frequency, and degree, of stagflation in our economy.

Why can't we use monetary and fiscal discipline alone? Why must we also adopt TIP? Monetary and fiscal discipline, if applied long enough, and severely enough, can eventually cause enough unemployment and low profits to reduce wage increases, unit cost increases, and therefore price increases. Those who advocate a balanced budget and slow monetary growth as a substitute for TIP seldom indicate, specifically, the process by which wage increases are eventually to be brought into line with productivity increases. They leave the impression that there is a mysterious link between such discipline, and prices firms set. But firms will raise prices as long as unit costs increase; and unit costs will increase as long as wage increases exceed productivity increases. So the issue becomes: How can we bring down the growth in wages?

Monetary and fiscal restraint, alone, can only do it in one

way: By causing a severe enough recession. This is precisely the policy that was tried in 1974 and early 1975. Tight monetary and fiscal policy helped cause a sharp decline in aggregate demand, and the most severe recession since the 1930's. The impact on wage inflation, and therefore, price inflation, was meager. Wage inflation was reduced from just above 10% to 8%; therefore, price inflation declined no further than 6%. Despite the loss to our society of billions of dollars worth of output, the inflation rate declined only a few percentage points to 6%. Sole reliance on monetary and fiscal discipline is not a new approach waiting to be put to the test. It was just tried, with dismal results. Let advocates of discipline-only tell us what went wrong in 1974 when their experiment was attempted. How long, and severe, a recession do they recommend to bring down the inflation rate?

This traditional method of reducing wage inflation is indirect, ineffective, and enormously harmful. TIP provides a direct incentive to reduce wage increases, and therefore, cost increases and price increases, instead of relying on a severe recession to do it. Monetary and fiscal discipline are then required to reinforce TIP, so that its disinflation effect is permanent. It is true that TIP cannot succeed in the absence of monetary and fiscal restraint. But who asserts that it can? The real choice is between TIP plus monetary and fiscal restraint; vs. monetary and fiscal restraint alone. The choice is therefore between reducing inflation and unemployment together; vs. reducing inflation through high, prolonged unemployment.

Moreover, even if restraint, after years of recession, eventually brings down the inflation rate, it will not change the

NAIRU- the unemployment rate required to keep the inflation rate from accelerating. We would have to accept an unemployment rate of 6% or higher to prevent a rise in the inflation rate. Thus, the traditional approach asks us to endure years of high unemployment to reduce inflation, and a permanent unemployment rate of perhaps 6% in order to maintain low inflation. In contrast, TIP offers the prospect of reducing the NAIRU perhaps to 4%. Thus, in the longer run, the choice is between running the economy at a 4% unemployment rate without inflation, vs. running the economy at a 6% unemployment rate without inflation. TIP therefore deserves to be regarded as an anti-unemployment, as well as anti-inflation policy.

PRICES AND PROFITS

At first glance, it might seem natural to suggest tax incentives for price increases, just as TIP provides tax incentives for wage increases. Tax incentives for price increases, however, are almost certainly administratively unfeasible. Most firms make a variety of products, with a variety of quality levels. It is extremely difficult to distinguish a price change from a quality change.

The key practical distinction between wages and prices is that the manhour- the unit of labor input- is well defined, while the unit of output is not. To compute the wage, total compensation can be divided by total manhours, where the latter can in principle be measured unambiguously. Price is revenue per unit of fixed output; but the latter is not well defined. For example, suppose McDonald's keeps the nominal price of a Big Mac constant, but

somewhat reduces the quantity of beef, while changing the sauce. Has the true price of a Big Mac increased? Similarly, suppose it keeps the quantity of beef the same, but improves its quality, and also improves the quality of the sauce. If it raises the nominal price of a Big Mac a dime, is this a price increase, or simply a quality improvement? If it were regarded as a price increase under a tax incentive, quality improvements would be discouraged.

Furthermore, a guidepost for prices is less justified than for wages. Although wage increases are not identical for all firms, most increases are not too far from the average, because labor mobility and perceptions of equity force most wage increases to stay close to the general pattern. Wide disparities in productivity change, however, across firms- caused by diverse rates of technological innovation and capital formation- cause wide disparities in unit cost changes, and therefore, price changes. Although the average price increased 6% in 1977, some prices were cut sharply, while others increased sharply. These disparities serve a vital function. They signal consumers where costs are falling, and where costs are rising, so that consumers are encouraged to shift towards products with falling costs, and away from products with rising costs.

Fortunately, tax incentives on prices are unnecessary. As explained earlier, theory and evidence strongly suggest that prices are tied to unit costs, and a decline in the growth rate of unit costs will automatically bring down the growth rate of prices. Nevertheless, labor deserves insurance. I would therefore suggest that "real wage insurance," first proposed by Dr. Okun in 1974, be included in the TIP package. Suppose wage inflation declines from

8% to 6% in the initial year under TIP, but price inflation declines from 6% to only 5% (although theory and evidence expect a decline to 4%). Then Congress would authorize in advance compensatory tax cuts for employees to make up the difference. These tax cuts could be integrated with employee-TIP, and implemented through withholding at each firm. Moreover, the withholding tax cut could be varied with the wage increase at each firm, so that those who exercised greatest wage restraint would receive the largest tax cut. The expected cost to the Treasury of real wage insurance is zero, because the decline in price inflation should automatically match the decline in wage inflation. Nevertheless, it is important to guarantee protection. Real wage insurance should be enacted as part of the TIP package, so that the compensatory tax cuts would be assured in advance.

As in the case of prices, tax incentives for profit restraint at each firm would have harmful effects. The firm's incentive to improve its efficiency, from which consumers ultimately benefit, could be weakened by reducing the profit reward. The practical experience with the excess profits tax has not been encouraging.

Fortunately, as in the case of prices, tax incentives on profits are unnecessary. As long as price inflation stays approximately equal to unit labor cost inflation, the ratio of capital income to labor income must remain fairly constant; if price inflation declines 2% when unit labor cost inflation declines 2%, then unit profit inflation must decline 2%. Nevertheless, labor deserves insurance. I would therefore suggest that the following proposal, offered by Drs. Lawrence Klein and Vijaya Duggal of Wharton Econometric Forecasting Associates at the

University of Pennsylvania, deserves careful consideration. According to their proposal, if the ratio of after-tax profit to labor income for the whole corporate sector rises above some threshold when wage inflation declines, then the base corporate tax rate can be raised equally for all firms to keep the ratio at the threshold for that year. To reassure labor, this adjustment can be enacted in advance and made automatic. It should be emphasized that their proposal would not attempt to define and tax "excess" profit at each individual firm. Only the ratio for the whole corporate sector (or economy) would be of concern. Their proposal would therefore avoid the difficulties of past excess profit taxes.

CONCLUSIONS AND RECOMMENDATIONS

- 1) A tax-based incomes policy (TIP) should be adopted. TIP together with monetary and fiscal restraint can reduce inflation and unemployment simultaneously and permanently. Labor, business, and the general public would therefore all benefit greatly from TIP.
- 2) TIP differs fundamentally from controls. It would harness the instrument that has proved its effectiveness in our market economy: financial incentives. It would leave business and labor free to make their own decisions without government interference.
- 3) The employer and employees at a firm that grants a wage increase above the TIP target should both incur a tax penalty; the employer and employees at a firm that grants a wage increase below the target should both receive a tax reward. The tax

penalties must be stiff, but not prohibitive. Where market forces, and the special conditions of the firm or industry, call for a relative wage increase, it is essential that the firm still be able to exceed the TIP target, though by less than it would have without TIP.

- 4) The most crucial ingredient in the TIP package is the income tax penalty on the employer who grants a wage increase above the target. It is most likely to be effective. The best medicine does not always taste best.
- 5) Although TIP focuses on wage increases, this does not mean that employees (or their unions) who seek wage increases in excess of productivity increases, or employers who grant such increases, should be blamed for inflation. Both labor and business are trying to protect their own position in response to the incentives they now confront. The aim of TIP is not to place blame, but to restructure incentives, so that the outcome is best for labor, business, and the public.
- 6) Economic theory and econometric evidence strongly suggest that the price inflation rate approximately equals the wage inflation rate minus the productivity growth rate (2%). Thus, if TIP reduces the wage inflation rate gradually to 2%, it will automatically reduce the inflation rate to zero. Tax incentives for prices or profits are therefore unnecessary. Moreover, they would have harmful effects.
- 7) Labor should be protected by "real wage insurance," which would guarantee automatic tax cuts for employees if the decline in price inflation fails to match the decline in wage inflation

for the whole economy; and possibly by an automatic upward adjustment of the corporate income tax rate for all firms should profit inflation fail to decline with wage inflation.

- 8) A permanent TIP may be able to reduce the non-accelerating-inflation rate of unemployment (NAIRU) of the economy. If so, it would be possible to run the economy at perhaps a 4% unemployment rate without causing a rise in the inflation rate. TIP should therefore be regarded as an anti-unemployment, as well as an anti-inflation policy.

The CHAIRMAN. Thank you, Professor Seidman. Thank you for a very lucid clear explanation of TIP and Professor Weintraub also did an excellent dramatic and very amusing job of explaining our problems; and we are delighted to have Dr. Rees, who gave us the other side of it so well, and, Dr. Bosworth, I must say your appearances are very impressive. I think you hit exactly the right tone in pointing out we are not making progress on inflation and we should recognize and you recognize it right off the bat, and we do need vigorous action by the Government to achieve it.

You say that the first part of the deceleration program is a recognition that the Federal Government itself is a major contributor to the inflation process and you say this applies both to the executive branch and the Congress. Then you go on to say we are going to have to learn to say "no" to special interests.

One of the elements that's necessary if we're going to say "no," is an awareness of Members of Congress when they vote on this legislation that it has an inflationary effect. When they vote on it, not after, as a matter of history. We don't have that now. We have been hoping the Congressional Budget Office would provide us on major legislation at least some notion of the inflationary impact.

Do you feel this is practical and do you know whether or not this should be forthcoming in the near future?

Mr. BOSWORTH. I think it's practical and I think it's an absolute necessity because I'm convinced that even though many of the actions in the regulatory area are well-conceived, it's pretty clear that the Congress does not look at the cost of those programs as intensely as it looks, say, at defense expenditures.

The CHAIRMAN. We look at the budgetary cost.

Mr. BOSWORTH. Yes, budgetary.

The CHAIRMAN. But we don't look at the cost in relationship to prices.

Mr. BOSWORTH. But that's the biggest change that's occurred. If somebody asked 20 years ago, "What's the impact of Government on the economy?" you'd answer, "The Federal budget," and it would be a pretty good summary of what Government was doing to the economy. Today, I'd almost argue that the budget is irrelevant to what the Government is doing to the economy because we got tired of getting used to the Government increases. More and more now we have national goals like cleaning up the environment. We don't want to spend budget funds on this. We've got a gimmick. We order people to do it—"You clean up the environment." Who at that point makes the calculation of what it costs society? We don't pay for it in taxes.

The CHAIRMAN. You say you're in favor of cleaning up the environment, you think it's a good end and you don't think, as Dr. Burns suggests, we should suspend that; but you think we should be aware of the costs of doing so and of the various options. In other words, we clean it up to a certain point the cost may be moderate, if we clean it up beyond that point the cost may be excessive. Is that right?

Mr. BOSWORTH. One good way of putting it is I don't give a damn what you do if I am convinced you understand the cost of what it

is you're doing. In many cases, I don't think the Congress does understand. We can now in most areas provide you with as good an estimate of the costs of these actions as you can get on budget actions. What we seek to do is get an estimate of the cost that's in order of magnitude correct, a basis for judgment. I think that the estimates today of the cost impact of specific regulations or special interest legislation is of an order of magnitude to be very useful to you in making decisions. We have had some discussions with the Congressional Budget Office on our procedures used to measure those costs. We have measured the cost impact of a lot of such actions ourselves.

Frankly, we are always too late. We never find out what's going on in Government until after the fact.

The CHAIRMAN. That's it. If we could at the committee level—this is where it would be most useful to us. Certainly we'd like to have it before we act on the floor.

Mr. BOSWORTH. Since these agencies know what the Council is going to have to say about it they try to keep it a secret; we never hear about anything until it's announced by the Congress or announced by the administration. We have no idea what's going on inside major Government agencies because they know if they tell us we're likely to have a negative-type comment about it because it's bound to be costly. So it is better for them to keep it quiet. So many times anything we have to say is too late. We're after the fact. We're irrelevant.

The CHAIRMAN. Now the second part of the deceleration program you say is to convince business to hold price increases below the 1976-77 average. You argue that they were making some good progress in that respect and you refer to the automobile industry and aluminum industry and that is encouraging. I just wonder, though, on the basis of past experience, number one, if we are likely to get delivery like that from the automobile industry and, number two, whether or not this can be sufficiently comprehensive to really assure us that we are likely to have a slowdown and, three, whether when you leave food out, which is the area where we are most sensitive to inflation where I don't see what you can do this way, I just wonder what kind of substantial progress we can make.

Mr. BOSWORTH. I think it's going to be very limited. I would say with respect to automobiles, it seems to me we'll get deceleration in automobile prices one way or another. If there is enough leverage that the American public and Government can bring to bear on the automobile industry we can deliver on that one.

Unfortunately, you're absolutely right about food prices. We can't jawbone food prices down and our policy is just so inappropriate to this major portion of the U.S. economy, where there's nobody to talk to about these price increases, so that sort of thing is always going to be quite limited.

The CHAIRMAN. Now you get into the TIP situation and you indicated a kind of a modified TIP proposal yourself, did you not? That is, that you would favor for those industries that hold wage increases down, as I understand it—correct me if I'm wrong—a tax credit to the employees who have less than an average increase in their wages.

Mr. BOSWORTH. No. One of the problems I see with the tax credit approach is that you can't go around every year cutting tax rates. You run out of money after a while. But I do understand labor's problem with the current program. They say, "We can't give you a commitment for 3 years to hold down our wages when you give us some promise that prices will come down. We've heard those promises before." Well, it does seem to me one way to handle this is to give them an insurance contract—to give them a conditional tax cut. In other words, we could pledge that if prices do not come down, then we'll cut your taxes if you held your wages down.

The CHAIRMAN. If prices do not come down, then they would get a tax credit that would compensate them for the increase in the cost of living?

Mr. BOSWORTH. Right. If, for example, a worker belonged to an employee group that held its average rate of wage increase to say 6 percent, I think it would be reasonable to guarantee him that if prices rose more than 6 percent he would get a tax cut equal to that.

Now as Professor Seidman pointed out, 99 times out of 100 that would never happen, but the worker is not sure of that. He remembers 1973 and 1974 and it happened then and he says, "Well, I want a guarantee on that." So you give him some insurance. Wouldn't he be better off with a guarantee than with a vague promise from Government that somehow we will do it when we have broken all our promises before?

The CHAIRMAN. But here you begin to move into what is a misallocation of resources. You spoke yourself about some industries that are so depressed for one reason or another—the apparel industry, for example, where they had no wage increase at all. Under those circumstances they have to do it because of the competitive situation and the demand situation. Now aren't you going to have tens of millions of people in the country who are going to have a tax increase and aren't you going to have then a tax cut and then aren't you then going to have a kind of a removal from the market economy that could be pretty severe?

Mr. BOSWORTH. One is that there would be a lot of free riders, as you put it. Everybody who got a wage increase—

The CHAIRMAN. Tens of millions of them.

Mr. BOSWORTH. Yes, but normally if there were a lot of people with wage increases below 6 percent, prices would not rise more than 6 percent. You don't pay them anything. Only if the rate of inflation went above 6 percent would you pay anything. And is it such a bad idea for workers in depressed industries who have been getting 3 percent wage increases—does it bother you to get 1 year out of 10 when they may get a small tax cut? There is a free rider problem associated with any of these proposals, which is that some people are going to get it when they have really not changed their behavior.

The CHAIRMAN. Dr. Seidman, why is the limited Bosworth proposal inadequate? Why wouldn't that be at least an approach in the direction of your proposal?

Mr. SEIDMAN. His real wage insurance policy here is essential and exactly the kind of thing I was suggesting that Arthur Okun had proposed back in 1974. Let me just review this last point that be

made about why these tax credits will in all likelihood not be necessary.

Today, or last year at any rate, we had roughly wage increases of 8 percent. We have productivity increases of only 2 percent. So unit labor costs went up by the difference, 6 percent, and that was our basic inflation rate last year, 6 percent.

If we bring the average wage increase down from 8 percent to 6 and productivity stays at 2 percent, then the difference between them, 4 percent, will be the unit labor cost increase, and we expect, based on all empirical evidence, that price increases which are tied to unit costs will go up only 4 percent rather than 6 percent.

Now if we get that result, which past empirical behavior supports, then this guarantee—this tax credit, will not have to be paid. The way it ought to work is to say to labor, if your wage increase comes down on average from 8 to 6 in the economy but price increases don't come down from six to four, then we will give you a tax credit. If it comes down from six to four, you're just as well off getting a 6 percent wage increase and a 4 percent price increase, a gain of two, as you would have been with an 8 percent wage increase.

This is an insurance proposal which we don't expect will in fact have to be paid, but I think Dr. Bosworth's point was exactly right. You can't expect the average wage earner to have as much reliance on econometric relationships as maybe economists will. They deserve and will need insurance. But given that insurance, it's very likely that we will not in fact have to pay that compensatory tax credit.

The CHAIRMAN. My time is up. This would seem to me to exaggerate the cycle somewhat and it would do so because as you don't meet your inflation target and prices rise then you have to feed the inflation by providing for a reduction in tax revenues and taxes. Therefore, your deficit gets bigger, not smaller.

Mr. SEIDMAN. That's right.

The CHAIRMAN. On the other hand, when you're going the other way and you've moving into a recession period, you don't provide the tax benefits that might stimulate the economy which might be desirable under those circumstances and you therefore aggravate the cycle, don't you?

Mr. SEIDMAN. It's possible, but, for example, if you look at 1974, the reason that prices advanced as much as wages—what drove a wedge into the traditional relationship was the OPEC price increase and that was a period of time where had we had some more stimulus we may have greatly reduced the severity of the recession.

So you're right. It's possible that at certain times you wouldn't want that stimulus. In that case monetary policy might have to be called upon to provide the restraint at a time when equity requires you to pay the insurance in the form of a tax credit, but there are other cases where a tax credit would be what you wanted. So again, I think looked at on the whole, if the only equitable way to get labor to agree to a TIP focused on wages is to provide this insurance, I think that the benefit of doing that greatly outweighs this possible minor problem with it.

The CHAIRMAN. My time is up. Senator Schmitt.

Senator SCHMITT. Mr. Chairman, I don't know whether I have discussed this with you or not before, but I think I have discovered a new natural law in the Washington environment. I had first made it relative to agencies. That is, once created they tend to take on the characteristics of their acronym and if you think about some of the acronyms that we deal with in this committee such as DUD and DOT and a few others and just use your imagination I think you know what I'm talking about.

I have discovered today that programs tend to take on the characteristics of their acronym and we have heard about CAP and CAIP which suggest really a coverup of the basic inflationary problems in my opinion. TIP is sort of a negative acronym in the sense it's probably almost certainly not a gratuity of any kind, or it's been suggested it might be the tip of an iceberg.

I'm afraid, Mr. Chairman, as I said yesterday, the hearings have tended to focus on the symptoms of inflation rather than on the real causes, particularly workers and business. It would be interesting if the economists of the world had to go out and get elected to their positions and talk to the voters because voters believe that it's Government that's causing inflation, whether the economists agree with that or not. When they mention to me—and I'm sure they have mentioned to you—the size of the Federal deficit, they don't understand how it can continue and still permit a viable economy. The cost of regulation which has been discussed today I'm glad to see, payroll taxes, institutionalized wage increases, decreased productivity due to tax depleted supply of risk capital, and a dependency on high cost foreign energy. And I think most of the people in this country fully understand where the source of inflation is and when we come to them and say, well, we want wage and price restraint, it's hard for them to grasp why in the world they should be the ones that are showing restraint when the Government is not.

Now Dr. Burns in his statement to the committee said, "When the Federal Government runs a deficit, it pumps more money into the pocketbooks of people than it takes out. That has always been a major cause of inflation and this process has lately been speeded up." Now I detected maybe a little bit of difference in opinion here. Professor Weintraub said deficits don't cause inflation. At least I presume he's saying that a deficit of about \$50 or \$60 billion a year does not cause inflation.

Professor, is there a deficit that would cause inflation in your mind? Would a deficit of \$100 billion, \$150 billion cause inflation?

Mr. WEINTRAUB. Let me put it this way, Senator. If our economic system was different, different things could happen. I'm talking about the here and now. We have had since 1929 50 budget years, through fiscal 1979. Of those 50 years, we have had surpluses in only 9 years. Many of them were piddling amounts of \$20 million, that sort of thing. Over most of the 50 years, until the last 10 years really, the price level behaved rather well. In other words, with deficits, the price level behaved rather well.

Now in the worst deficit, the biggest—and I think you will agree we don't know how big an elephant is unless we compare it to some-

thing—compared to a fly it's very big; compared to a mountain it's not so big. Now then, let's make a comparison with GNP.

In 1933 the expenditure total was \$4 billion, revenue intake was \$2 billion, a deficit of 55 percent, and prices actually fell by about 12 percent. Through the 1950's we had deficits, and by the standards of the last 10 years the price level behaved rather well. In other words, the deficit of \$50 billion is a lot of money, as Senator Dirksen might have said to you and me, and to the country, but \$50 billion as against \$2.2 trillion GNP—that's less than 2.5 percent.

Senator SCHMITT. But, Professor, we changed the base conditions. For example, the tax bite in terms of the percent of the GNP is vastly larger than any of those other examples that you gave.

Mr. WEINTRAUB. Right, Senator. So you can reduce the deficit by cutting expenditures or raise taxes. Would anybody argue for a rise in taxes currently?

Senator SCHMITT. No.

Mr. WEINTRAUB. They would not.

Senator SCHMITT. But what I'm saying is the effect of a large tax bite on the vitality of the economy is a very real fact that was not present in those particular examples which you mentioned.

Mr. WEINTRAUB. Well, there are the same sort of complaints as we go back, but I agree that taxes are too high and through TIP I want to cut taxes.

Senator SCHMITT. Well, Professor, what I'm interested in is "where do we get a deficit that would be inflationary?" The scenario is, of course, that a deficit does require, in order to keep interest rates down, an increase in the rate of growth of the money supply. If you get too much money going into the economy without an increase in goods and services you're going to have an inflationary pressure. You're saying that isn't here now. When does it arrive?

Mr. WEINTRAUB. All right, Senator. You're going to have larger deficits unless you keep the price level under control. The Federal Government outlays are going to go up if average wages—civil servants too—and I'm just taking numbers—if they go up by 10 percent per annum then in about 6 or 7 years it's about a 100-percent increase, and your expenditures for Government employees will double. Your expenditures for defense, military procurement, will likewise double and the \$50 billion total will be a \$100 billion total.

You can keep that deficit in hand only if you keep the price level in hand and the price level occurs in the private sector of the economy.

Senator SCHMITT. Professor, I'm afraid that an awful lot of that price level is due directly to Government intervention in the economy. The cost of regulation is estimated at varying figures. I just saw one today in the newspaper in the New York Times, a quote that Dr. Miller made, that the estimate now is that the total cost of EPA regulations is going to be about \$670 billion. I don't know whether you agree with that or not. There are a number of other cost figures that are given for regulation and I think everybody agrees they are tremendous. Also, the increase in payroll taxes, the direct input on the price structure because of institutionalized wage increases, some of which are a reaction to inflation, have been institutionalized; the fact that we have done nothing to decrease our dependency on foreign

oil which is artificially high priced, although there are still some limits on how high it can get—it is a future price structure rather than a present.

So I'm afraid that until we see the relative proportions of these price increases it's hard for me to accept that Government doesn't have a major role in creating its own problems.

Mr. WEINTRAUB. Senator, let me reply to that in this fashion, and it permits me to make a comment to Dr. Bosworth's remarks.

Suppose you remove all of the pollution controls. This is what economists would call largely a one-shot affair. If you did this—you also have to clean up the environment—in my terms, this lowers average productivity of labor. This would mean you would have to run a tighter incomes policy, rather than a looser one.

Suppose I followed this sort of view in general. Suppose we agreed we abolish all of these controls.

Senator SCHMITT. Professor, I must interrupt because I have not said we have to abolish them. I'm with Dr. Bosworth. I think we have to understand what we have done and see if we can't mitigate the effect, but you can't abolish things like that.

Mr. WEINTRAUB. I take the extreme case just as an illustration. This afternoon, suppose we eliminated all of the controls, all of the safety regulations. I then ask, tomorrow, what do we do for an encore? We will still be faced with the question of bringing money wages and salaries in line with productivity. These are particular cost-raising measures.

I have argued that it is necessary to demonstrate, for the price level, that phenomena affects either "w", the average money wage, or "a", average productivity, or "k", the average markup. The average markup has been trending down. The big jump, as the chart reveals, has been in average wages and salaries relative to productivity. That's the problem.

Again I say, if I'm mistaken, why should we ever have a strike? Why should we ever say no to labor? Whatever they ask for, double, treble, or quadruple it. This is the issue. Average rates of pay have been moving too high and too fast; I want to insist TIP is not anti-labor. It's not anti-business. It's anti-inflation. It is pro-employment. I will make the same talk to a labor group that I will make to a business group.

Senator SCHMITT. Professor, I agree with your analysis of the wage structure, that it has moved much beyond increases in productivity, but you have to admit there's been an inflation push concerning those wage demands, that one reason wage increases have become more periodic is because of an inflationary push.

Now you're saying that's because of wage increases, and all I'm saying is that there's a component in there that's due to excessive wage increases but there's a major component that's due to what we're doing here in Washington.

Mr. WEINTRAUB. Senator, I have had some ailments. If I were to argue with my doctor as to the ultimate causes, I'd long ago have been dead. He knows something about symptoms and treatment. Whatever the reasons for a wage push, we've got to somehow keep those movements in line.

Senator SCHMITT. You just used exactly the wrong word. You said symptoms and what we have to get at is the disease. We can treat symptoms and have been for decades but we haven't gotten to the root causes of the disease, and I think that's what we have missed in this particular set of hearings.

Mr. WEINTRAUB. I'm content with my treatment, Senator.

Senator SCHMITT. Well, unfortunately, the diseases is going to continue unless we realize that it's far more than just the wage and price push. That is there. There's no question about that. But the list of things that I read I'm afraid swamp whatever benefit we can get from TIP. I'm not saying that we shouldn't consider TIP and try to see if we can figure out some way to manage it—I'm not sure we can—but I'm afraid it's going to be swamped unless this Congress and this administration are willing to make some other gradual but major longterm commitments toward the reduction of the deficit, reduction of taxes, particularly payroll and risk capital related taxes, and do something about this energy business and a number of other things that make TIP almost ineffectual if we don't do them.

Mr. WEINTRAUB. I'd say those other things are relative prices which are individual and smaller icebergs, to use your analogy, within this big gigantic ice mass and the ice mass consists of money incomes moving faster than productivity and it so happens that the big 75 percent component of national income does consist of wages and salaries, and that's where our problem is.

Senator SCHMITT. Maybe we created too much money, Professor. Is that what you're saying?

Mr. WEINTRAUB. If you must, Mr. Chairman, you will lead me into monetary theory. We must have the money. Is it surprising that in the 1930s, for those of us who are old enough, rarely had a \$20 bill. When our average income was \$30 a week we had a \$1 and a \$5 and this sort of thing, and we were well off with this assortment. When our income is \$200, \$400 or \$500 a week, why is it surprising we hold more money? The money must be there if money incomes are larger.

Senator SCHMITT. Professor, you have become an artist and a chartsmith, as all of us have, and one of the charts that I think is interesting—and I will get to as I get to my next round of questioning—is the relationship between the rate of growth of money supply and the inflation rate and there are some very illuminating charts if you're willing to put in about a 2 years' lag time of when inflation takes off relative to the rate of growth of the money supply.

Mr. WEINTRAUB. I'd like to answer that, Mr. Chairman.

Senator SCHMITT. My time has been up for almost as long as the time of the chairman was up.

Mr. WEINTRAUB. Mr. Chairman, perhaps we can get a chart in on the total relation between my aging process and the aging process of the Federal Reserve. You will find a 100-percent correlation.

The CHAIRMAN. Senator Stevenson?

Senator STEVENSON. Mr. Chairman, I apologize for being late and trust if I go over any ground that's already been plowed that you will stop me.

The council on wage and price stability has its origins in this committee. We gave it a very broad charter and we have gradually increased its authority over the years. This administration began its treatment of the council on wage and price stability by subordinating it to the council of economic advisors.

We have in the past tried to make it somewhat independent, at least within the executive office of the President, and an important council. And as far as the budget goes, I believe the administration insisted on allowing no real growth for the council. Am I right?

Mr. BOSWORTH. It was left the same size it was.

Senator STEVENSON. Was there any increase for inflation?

Mr. BOSWORTH. Just the same percentage increase for inflation as that which is allowed for the other agencies. I think there was a supplemental for all of the agencies.

Senator STEVENSON. Do you remember how much that was?

Mr. BOSWORTH. No. I don't know my budget very well.

Senator STEVENSON. Well, I have a feeling that the council on wage and price stability hasn't been monitoring its own budget to account for the full effect of inflation on its own activities.

Mr. BOSWORTH. I would think right now our biggest problem is a shortage of ideas rather than shortage of money.

Senator STEVENSON. You're getting ahead of me. I haven't got there yet. How many professionals do you have, Dr. Bosworth, to monitor the entire U.S. economy and all of the actions, programs, policies, and activities of all of the departments and agencies of the U.S. Government?

Mr. BOSWORTH. Right now we have about 18 people on the staff.

Senator STEVENSON. Is that enough?

Mr. BOSWORTH. If we had more people we could do more. Obviously, there are many things that we miss.

Senator STEVENSON. That's all I was trying to get at.

Mr. Chairman, that's appalling and it says something about the seriousness which this administration, like its predecessors, has viewed inflation.

Now beyond the staff resources with which to monitor both the public and the private sectors which are grossly inadequate, how about the Council's authorities? We gave you with very little enthusiasm as I recall subpoena powers. Have you used those?

Mr. BOSWORTH. We used them in two cases, but in both cases at the request of the company.

Senator STEVENSON. For protective purposes?

Mr. BOSWORTH. For protective purposes.

Senator STEVENSON. What about pre-notification? Do you have that authority now? Would you like authority to require pre-notification of wage and price increases in large, heavily organized industries?

Mr. BOSWORTH. In the current situation we have gotten around that problem a little bit because we stopped doing this cost pass-through, saying if you've got cost increases you're going to have price increases. Instead, we've set for each industry an annual target for price increases that we expected them to hold to. So we have been more interested not in pre-notification of each individual price action but in prior discussions about whether or not they are going

to be able to reach the target rate of price increases for the year as a whole.

The trouble with pre-notification—and we have it with some on a voluntary basis that have been coming in and prenotifying us—is that they are nickelng and diming us to death. They come in and pre-notify us of a 1 percent price increase on 10 percent of their product line and a lot of staff resources then go into what is not really a big issue.

Senator STEVENSON. Instead of letting them nickel and dime you to death, why don't you target pre-notification on a large increase in wages or prices where it isn't nickels and dimes, and you have particular information that you want to acquire?

Mr. BOSWORTH. In most of the basic industries—on a voluntary basis—we have worked out exactly that sort of arrangement. On several industries where we believe the impact of a significant price change would be of major importance to us we have asked them to let us know ahead of time and come in and discuss it.

Senator STEVENSON. And you haven't had any problems?

Mr. BOSWORTH. No. As far as asking for the pre-notification, in fact they do it.

Senator STEVENSON. Would you have the pre-notification authority that I have mentioned if you needed it?

Mr. BOSWORTH. No. If they told us they did not want to pre-notify, they would not have to pre-notify.

Senator STEVENSON. "They?" What's your position? Would they?

Mr. BOSWORTH. It depends upon the individual circumstances. So far, whenever it's come up, I have found that prenotification on this voluntary basis has been adequate.

Senator STEVENSON. You don't want the broom in the closet?

Mr. BOSWORTH. I have no objections to having a broom in the closet. Let's put it that way.

Senator STEVENSON. An enthusiastic statement of support.

Now let's come to Dr. Burns' on and off again proposal. I don't like putting words in Dr. Burns' mouth, but I understood him to say that he supported deferral authority, but he didn't always support it publicly, and was on and off depending on the timing. It wasn't always timely to suggest deferral authority. There have been such recommendations. They originated with Dr. Burns. The recommendations are to give the Council on Wage and Price Stability authority to defer for short periods of time—45 days, perhaps two consecutive 45 days' deferral—of large wage and price increases in the large, heavily concentrated, heavily organized sectors of the economy in order to give such increases the spotlight of public opinion and some time for cleansing and also to give Government some time, if necessary, to look into the matter to determine what, if anything, should be done before it is too late.

I'd like to address this question to all the witnesses. How do you feel about Dr. Burns' suggestion?

Mr. WEINTRAUB. Senator Stevenson, I would tend to think this is just a one-step toward controls—45-day notification and then approvals, and perhaps court hassles and field days for attorneys. So I would oppose it.

Further, this sounds like our present problem is just a temporary one—it supposes that if we get over the next 3 or 6 months and then everything will be all right. No. I think our problem is to create a policy for the decade rather than for the day, not to just look at whether this month's inflation number is going to turn out better. We have a more durable problem.

We have waited 10 years and I don't think this particular recommendation of Dr. Burns would assist us much in what I regard as the deeper problem.

Mr. REES. Senator Stevenson, I think the Council on Wage and Price Stability can get deferral of price increases by major corporations without it having legislative authority for it if it requests it.

There is a case on record in the summer of 1975 when I was sitting where Mr. Bosworth sits now. We requested the aluminum industry to delay a price increase for 30 days while we held hearings and they did delay it for 30 days and we did hold hearings. I think they would have been willing to delay it longer if we had requested an extension.

I think the difficulty, the place where you cannot get delays voluntarily, is on the wage side, not on the price side.

Mr. SEIDMAN. Senator Stevenson, concerning the pre-notification problem and also your earlier questions about whether the Council on Wage and Price Stability has adequate staff, I think this gets into one of the fundamental differences between a tax incentive or a tax-based incomes policy and a controls program.

Under a controls program or moving towards a controls program you would have to add enough staff in the Government overseeing regulatory body, whether you call it the Council on Wage and Price Stability or a pay board or price commission, to match—

Senator STEVENSON. Let me interrupt. Nobody is suggesting a controls program.

Mr. SEIDMAN. No, but let me see if I could point out the advantage of the tax incentive approach. Without any central staff in Washington every company and every group of employees would know that there will be tax penalty if they come in above the national target—suppose it were 6 percent—and a tax reward—a tax cut if they come in below. There would be no need for a staff in Washington to try and match the knowledge of each firm and industry, case-by-case, to try and stay ahead of them, to try and stay ahead of the schedule. Without any of that, each of them would know that there will be tax consequences of their own action at the end of the year.

So without that kind of central bureaucracy, I think you will have been more effective, much more flexible, if we go the tax-based incomes policy route than to try and beef up—as much as I admire Dr. Bosworth—the Council on Wage and Price Stability and its staff under the current approach.

Senator STEVENSON. Dr. Bosworth, how do you feel about it?

Mr. BOSWORTH. I, in part, agree with Professor Weintraub, that if you think there's going to be some major solution to the problem, the answer is no.

On the other hand, as Professor Rees points out, in some cases with some firms we can get them to agree voluntarily to delay. In other cases where we have asked about delay, it has not been possible.

Where we would like to use delay once in a while—and they do come up occasionally—is on the labor side. I believe that certain wage negotiations do set patterns for others, and influence other people. Sometimes you get a breakthrough because out of your own ignorance you did not realize something was going on in a specific negotiation and all the sudden they settled before you knew what happened. We'd like a chance before that settlement went into effect to hold it up and examine before the public the economic reasons that that particular benefit was given. Certainly the public's interest in the negotiation is at its height when it's being negotiated. They're not interested in getting the facts afterward.

Senator STEVENSON. Would you be unopposed to deferral authority? Do you support that with equal enthusiasm?

Mr. BOSWORTH. With about equal enthusiasm. I don't feel very strongly about it.

Senator STEVENSON. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, I'd like to ask you, starting with Dr. Bosworth, each to comment on two of the proposals by Dr. Burns that he gave us just this morning. They are difficult for Members of Congress to judge themselves because it affects us directly.

I'm talking first about the proposal—he says: "To emphasize Federal leadership in unwinding inflation, I would suggest the President cut his own salary by, say, 10 percent and call on all Presidential appointees and Members of Congress to do likewise."

My colleagues are leaving at this point. He also says: "The President should call on top corporate executives to refrain entirely from any increase in their compensation over the next 2 years."

I'm pretty serious about this. I can imagine introducing this kind of amendment and a lot of Senators voting for it for obvious political reasons and maybe for conviction. I'd like to have you give us your opinion as to whether this kind of dramatic action by Congress would represent a signal to the public, an effective signal, that the Government really means business and is making the kind of sacrifices to prove it.

Mr. BOSWORTH. I'll give you two comments. One, I resent the point Chairman Burns suggests because it's symbolic.

The CHAIRMAN. It's entirely symbolic.

Mr. BOSWORTH. The notion that it's going to combat inflation is false. On the other hand, I do believe in the area of wage restraint that such a demonstration affects the public's willingness to take the risk, and the chance that others will go along is very important.

It's very difficult to ask labor for restraints when they can point to some chairman of the board of some major corporation and say: "He got a 15-percent wage increase. Why can't I?" And you must admit, the public was upset about the increase in Government salaries. While Dr. Burns' suggestion goes in the right direction to build some public support, I don't think it's terribly dramatic or that it's a turning point. It's a small effort. I don't think he's willing to face up to the fundamental underlying pressures, and that some of these ideas are rather cheap gestures.

The CHAIRMAN. Dr. Rees.

Mr. REES. Senator Proxmire, I hate to disagree with Dr. Burns. He was my boss for 1 year when I was on the staff of the Council of Economic Advisors in the 1950's and I have never had a better or more demanding boss, but I do disagree with this suggestion, I think partly because it is symbolic and partly because it just overlooks the realities of the Federal pay schedule.

The one place in which Federal pay is below the pay in the private sector is for the top executives in the Federal Government. Where the Federal Government pays much more than the private sector is for the low-paying employees of the Federal Government, that is, the least skilled employees of the Federal Government up through most of the middle ranges.

So I think a proposal to hold down the general level of Federal pay increases of the kind that the President has made is vastly to be preferred to this dramatic gesture of cuts at the top which will make it harder to recruit able Federal executives which we very much need.

I can say that in good conscience because I'm no longer a Federal executive and have no plans to come back.

The CHAIRMAN. Professor Seidman.

Mr. SEIDMAN. Well, I agree. If this is to be a substitute for a tax-based incomes policy and fiscal and monetary restraint, then I think it's just diversionary.

Now if he meant that together with taking on what's politically more difficult, enacting a penalty-reward innovative tax proposal, coupling it with gradual reduction in monetary growth, gradual reduction in the Federal budget deficit, if he then wanted to add this as a dramatic gesture, I don't know. I think the key element that's missing from his proposal so far is any reference to a new tax-based incomes policy. I think his proposal would be seen for what it is—escaping the difficult political issues that have substance and putting symbolism first.

Mr. WEINTRAUB. Senator, far from being partisan, but I think Democrats might ask Governor Burns why he didn't propose this in previous administrations.

I would say, with my colleagues, the entire group, that this would be substantially a gesture. We're talking of a wage salary bill of \$1.4 trillion and I think what is involved here might come to \$5 million or \$10 million and is minor, if you work out the percentages.

The CHAIRMAN. There's no question the amount is very, very small. It would be symbolic. It would simply be an indication.

It might have one other effect, and that is, obviously, if Members of Congress would do this—and I would doubt very much if they would—but if they would do this, it would reinforce their determination to fight inflation perhaps on other fronts and they would probably be more inclined to make it tough everywhere.

Mr. WEINTRAUB. Suppose we carried the logic of this through. Suppose we did not raise any incomes but actually cut them by 10 percent. Dr. Burns is really asking for roughly a 7-percent fall in the price level and none of us want to go quite that far.

Second, after you have done it for the first year, as I said before, what you do for an encore—it's not a permanent policy and I think that that's what should concern members of this committee.

The CHAIRMAN. I'm not suggesting this is the only policy that occurs. It's just part of other things.

There's one other proposal that he makes that I think is well worth your comment because there's been less emphasis on productivity and what we do about productivity than there probably ought to be.

You all recognize the fact that it's wage costs that we're concerned about. Substantial wage rate increases can be accepted and would not be as inflationary if productivity increases. This is what Dr. Burns says here. He says that the Federal Government should establish promptly a national productivity center to assist business and labor leaders in each of our sizable cities to form productivity councils within individual factories, offices, with the objective of raising output per man hour. He's been pleading for this for many years and some members of Congress support it, but we don't seem to do more than just token efforts in the direction of productivity. We bow to it, but then we don't really take action. Dr. Grayson has pointed out that his experience in pushing productivity is that a very large number of people in the business sector, very fine and able businessmen, didn't understand it, didn't know what it was.

Mr. WEINTRAB. Senator, this sounds like the program for many, many years in Russia to increase productivity. It would be nice if it could be done. If it could be done we would have no poor countries in this world. An increase in productivity from 2 to 3 percent per annum is not just 1 percent; it's 50 percent, as a bank clerk with the compound interest table knows. From 3 to 4, it's $3\frac{1}{3}$ percent. Why don't we cut the running time of 100 and 200 meters, cut it in half? It would be a great nice record, but it's not easy to get individuals or have them do more than they can. I wish it could be so. I'm not opposed to it. It's just that I tend to think it's likely to be more of a gesture and a hope and a wish rather than a fact. I'd be all for it if it could be done. We could life all standards of living enormously.

The CHAIRMAN. Dr. Seidman.

Mr. SEIDMAN. Once again, I think that this proposal is just symbolic. The real determinant of the growth rate of our productivity is whether we are able to run this economy with sufficient aggregate demand so that it is profitable for business to undertake a sufficient rate of investment in capital formation which is where we get our productivity growth from, and the reason that we have had to ride the brake in our fiscal and monetary policy is because of the fear of inflation.

The whole point of the tax-based incomes policy is to enable us to exert downward pressure on wage increases to counter upward pressure coming from the labor market so that we can run the economy at a permanently lower rate of unemployment, higher rate of aggregate demand, higher rate of real output, real investment, real capital formation, and growth of real productivity.

So I think the proposal here of Dr. Burns gets it backwards. We have to find a way to get the incentives on business and labor such that we can run the economy with a higher level of demand and have that greater rate of increase in investment which would bring us our productivity.

Now, as Professor Weintraub pointed out, we should not expect miracles from this. It's a major accomplishment for society to raise productivity growth from 2 percent to 3 percent per year and we'd be kidding ourselves if the solution to our inflation problem is not to get money wages down from 8 percent, which is where they are now, to 2 or 3 percent but, rather, we are going to somehow get productivity up to the 8 percent. We've got to find a way to say: Whatever our productivity growth is, we have to get incentives on business and labor to keep wage increases in line with it and, again, we are ducking the issue. Everybody would be for raising productivity. That's not politically difficult to propose. What's difficult to propose is a tax penalty-reward combination which will affect business and labor. I bet everybody will nominally be for raising productivity through a commission, if that's the issue.

The CHAIRMAN. Dr. Rees, before you respond, I hope you will recognize that I'm not doing anything else. You like TIP. You might do many, many other things, but this is just one measure to put more emphasis on it and see that productivity isn't a matter of a statement in Washington or a commission that looks at it and makes a report to Congress but, as Dr. Burns has said, in every factory, in every substantial office, and so forth—so that productivity focus is understood and that some progress is made.

Mr. REES. I agree with what Professor Seidman has said about the basic source of productivity. I think the place where you get productivity growth comes largely through new investment and more productive kinds of capital facilities and I think the most important way to go that probably, in addition to keeping the economy at reasonably full employment, is to remove some of the disincentives to investment. One particular one that bothers me is we're not making any allowance for inflation in computing capital gains. I think I would be willing to have a sharply increased rate of tax on capital gains provided that in calculating the capital gains you don't count the fictitious part which is just due to the rise in the price level.

There is, of course, the Federal agency called the National Center for Productivity and Quality of Working Life. I suppose it could be expanded.

The CHAIRMAN. It's very small.

Mr. REES. It is very small. I'm not convinced that simply by expanding that agency you would have a noticeable impact on the rate of growth of productivity.

The CHAIRMAN. You see, my problem is: Isn't this exactly what a productivity council would do? It would point out the great advantage of investment and point out in specific terms and specific areas. We found, for example, that in some Government operations where they didn't have the incentive you have in the private sector that by mandating that—GAO discovered this—by mandating they

spend a million in capital equipment in a period that they were able to get that back in less than 60 days because of the enormous savings that they developed there.

Now many small businesses and many rather large businesses operate with some of the same naivete, lack of information, misunderstanding about productivity, and what Dr. Burns is trying to do is to do all we can to bring to business everywhere we can in the country and bring to labor an understanding of how they can be productive, pointing out the kind of investments they can make, pointing out the way that they can save labor and save costs and cut down their cost of their operations.

Mr. BOSWORTH. I have mixed emotions about it. I would agree, first of all, that it's not easy to find a way to raise productivity. On the other hand, our own examinations of the problem have made us more and more concerned. It's now definitely determined that the rate of productivity in this country in the last decade has slowed dramatically from previous decades. You say it's 1 percentage point. That doesn't sound like much, but remember when we only get 3 percent per year you're talking about a 30-percent reduction in real income gains.

One of the problems we face in trying to do something about inflation in this country is that people naturally expect that living standards will grow. When there's no productivity growth there's no room for any real improvements, and then you get into these fights over I want more and that means somebody else has to take less.

The difficulty I have with the Burns proposal is that he doesn't recognize the productivity slowdown. Earlier this year we published a report where we looked at why it has slowed down, but we can't tell you why. We're at a loss to explain the reasons for it, outside of economic regulation because that's where a lot of the regulatory costs show up. They don't raise profit margins. They don't raise wages. They show up in productivity. We're going to be doing some work over the next few months of a slightly different type that may get at the same thing that Burns is after. We're trying to focus on a couple of specific industries with respect to work rules and other factors that hold down productivity growth.

I'm a little worried about a national program of having a bunch of worker committees, and I'm not very impressed with the performance of the National Productivity Center. They have tended to be a group of academics that talk about capital stocks and we never really get anything else, but there is a problem with work rules that you run into when you talk to individual industries, both on the labor and business side. In industries like railroads and steel work rules are becoming a major problem. On the labor side, naturally they are afraid of losing their jobs. In the type of economy we have had in the last decade, with its very high levels of unemployment, they are not about to give up that job protection in those work rules.

It's a difficult problem that I don't think is going to be handled by setting up a lot of committees in individual plants, because another term for productivity with a slightly different connotation is

automation, and if you don't have a growing economy it means a loss of jobs. People don't think automation is a good idea. They oppose automation. They like improvement in their living standards. It all depends on which side you're on.

I think right now many industries are like this, and steel is a good example. They fear the loss of a good job. A little committee isn't going to solve that problem. Rather, the solution lies with collective-bargaining negotiations between union and management and the working out of some job guarantees, et cetera.

The CHAIRMAN. Senator Stevenson.

Senator STEVENSON. Mr. Chairman, I'd like to take this closing opportunity to try to provoke our witnesses with some observations.

First: The causes of inflation are basically twofold, both represented here. One, politicians; two, economists.

Let me start with politicians and with an observation that Mr. Bosworth made earlier about all of us finding out too late. This is only partially true. Where was the Council on Wage and Price Stability when we were all going along with the coal settlement? Talk about a case of declining productivity and increasing wages. Where were you when we were debating the minimum wage and exemptions for teenage labor, or mandatory retirement, the substitution of low-cost jobs for the jobs of more senior workers which, without that legislation, might have taken place? Where were you when we were considering the social security tax increase last year when a couple of us were trying to stem that tide? Where were you just a couple weeks ago, right here in this committee, when the room was full, wall-to-wall with poor people, sick people, crippled people, the handicapped, who were there to oppose my suggestion that it was unwise for their sake and for the economy to insist that this administration's proposal that every mass transit facility in the United States be retrofitted to provide full accessibility—that is to say, every train station, every train car, every bus be replaced, retrofitted, made fully accessible to the handicapped at the expense of the handicapped, at the expense of efficient transportation for everybody, at a cost of over \$6.5 billion?

If politicians are to act responsibly, they have to know in advance and there are opportunities. There is an opportunity, for example, right now to focus on the regulatory process within the Transportation Department which is working on this.

Mr. BOSWORTH. So are we.

Senator STEVENSON. Good, and with 19 employees you could do even more. Now that's rhetorical. I want to be fair and give you an opportunity to respond if you like. My main observation is going to be on the economists, but you will have a chance to rebut at this point.

Mr. BOSWORTH. On the whole, I think you're right. If you take coal, we followed it. We talked to people ahead of time and they said the best idea was to keep out. I think in retrospect it's clear that it wasn't. Those negotiations got to the point where management offered such extremely large wage increases in return for the work rule issue that it was a disaster. We at the council suspected that the economic effects of the coal strike would not be nearly as severe as

many people thought ahead of time, but we did not have the courage of our own convictions. So we are very silent on the coal situation.

I don't feel that way about the minimum wage. I was not at the Council at the time, but when I was in the administration in the Council of Economic Advisors I did prepare a study that illustrated specifically what the cost of the minimum wage proposal was.

Senator STEVENSON. Was it made public?

Mr. BOSWORTH. Several copies of it leaked. I don't think there was a public release, but I think it was very influential. The inflationary issue was a major issue for the President with regard to the minimum wage. You could have had a better outcome, in my view, on minimum wage than we did. We compromised, it was not a great compromise, but it was not so terrible in many respects.

On mandatory retirement, I don't know. I just didn't see that as a major inflationary issue.

Senator STEVENSON. It's not major but they all add up.

Mr. BOSWORTH. On social security taxes, within the administration there was an effort to get to propose a social security tax proposal that would reduce the reliance on employment taxes. It got nowhere before the House Ways and Means Committee and at that point it was dropped.

I was involved in that, again before I came to the Council on Price and Wage Stability, and we have had several publications since then illustrating that employment taxes are a major source of inflation. I mentioned one this morning.

On mass transit, I have heard the same story that you just mentioned. We have just recently gotten involved in that issue. I was not aware the hearings you mentioned but somebody just said a couple days ago to us that that regulation had been proposed. That certainly has to be looked into.

I guess you're right. In many situations, we miss them. In retrospect it's always easier to see them, but we did get into several of them. We were involved in the farm bill.

Senator STEVENSON. I forgot to mention the farm bill. There are a lot of things I forgot to mention. My point is, the Government is, to a large extent, the cause of inflation. We all know it but our habits are uncontrollable and the Congress and also the President need help. They need an opportunity to know and they also need to have it made easier to do what is right. If the inflationary consequences of these well-intentioned acts, such as replacing all the buses, could be made public and known to the public, it might even be expedient to do the deflationary thing.

Now I, myself, feel, therefore, Mr. Chairman, that in addition to increasing the authority and the resources of the Council on Wages and Price Stability, we should seriously consider getting it out from under the Executive and giving it visibility, prominence, and above all, independence, so that it can make its decisions with respect to priorities and also make them public without any political pressures or political temptations, and in such a completely independent setting that the integrity of its work would entitle it to greater public confidence and attention.

Now to the economists. Economists, in case you haven't noticed, Mr. Chairman, break down into roughly four groups. There are the monetarists who subdivide into the string pushers and the string pullers, and the Keynesian demand management—aggregate demand management economists, who subdivide into two groups, one wanting to increase demand in order to decrease unemployment, the other wanting to decrease demand in order to control inflation. That's about it. All of them pretty much work with a model that was created by Adam Smith. It hasn't changed much since Adam Smith. Everything has changed except the assumptions of the economists about the marketplace and that "invisible hand."

The problems are, as we just indicated, Government—Government interference in that marketplace and structure. They are very much on the supply side, as opposed to the demand side, and require an entirely new emphasis on microeconomic, selective supply management. The oil price changes in 1973 were symptomatic. They should have been seen then for their larger significance. In Government are all the captives of the economists and the captives of economic orthodoxy, and so we react as a Congress with monetary string-pulling and pushing, or at least we try to push Bill Miller or pull him, or we increase taxes or decrease taxes to fool around with demand management.

We might recognize that some increases in expenditures can be deflationary, such as increasing expenditures for R. & D. Mr. Chairman, since I've been here I haven't heard a word about the trade deficit which is causing inflation. The only response that I have seen in the Government has been to decrease oil consumption, and we are not going to do that. We are going to increase the consumption of foreign oil. We might be increasing exports as other countries have done and recognize that that in turn requires some new solutions. One of those I think has to do with R. & D. and an increase through Government expenditures for R. & D. Take a look at our industries. The most export-oriented are the high-technology industries. They are Government-supported industries. Government expenditures for aerospace made it the most export-oriented of all the industries. So why don't we put Adam Smith behind us and recognize, as Dr. Keynes probably would have, that the world has changed and that the time has come for some new ideas, not just fooling around with taxes. Many of those high costs originate in foreign countries, not just oil either. Why don't we start developing a new demand-supply management theory on a selective, micro basis instead of causing everybody to subsidize everybody else with still more burdens to the entire economic system to absorb. Any reactions to that from our panel.

Mr. SEIDMAN. Senator, I agree with you completely that we have got to get out of the limitations of traditional macromanagement policies, whether fiscal or monetary, but from your comments my hope would be that you would be extremely interested in the tax-based incomes policy proposal. The whole idea of it is to use the taxes in a very different way from traditional use of the taxes as part of macromanagement.

The aim is to provide a micro incentive on each individual firm and employees at that firm—to give them an incentive which they do not now have to weigh the cost they are imposing on the larger society every time they grant wage increases that are in excess of productivity. So as a matter of fact, one of the reasons that it's only been recently that we have begun to receive support within the economics profession is that this approach is very different from the traditional policies and a very different use of the tax system, and it's taken time for economists to begin to open towards it and give support.

I think the same is becoming true among the larger public. I agree completely with you, we need new microsupply oriented approaches and that's exactly what TIP is. So I hope that will be one of the approaches you will look carefully at.

Senator STEVENSON. You give me more hope for the economists.

Mr. WEINTRAUB. Senator, I suspect you didn't expect me to agree entirely with your remarks. I think this might be the first time I have ever been lumped with monetarists or even Keynesians.

Senator STEVENSON. I wasn't being personal about this.

Mr. WEINTRAUB. I am aware, however, this is very personal to me. 20 years ago when I suggested that it was unit labor costs that were important there was much abuse. The position has become somewhat respectable and I feel somewhat at a loss; I feel maybe I should reconsider it now that others have taken it up.

I've also, with an 8-year time lag, seen this discussion of TIP and I regret we haven't gotten deeper into the details of TIP.

With respect to Dr. Adam Smith, I think the world has changed and if he were alive I suspect he would have changed. As you know, Lord Keynes never did take a doctorate. He was above that.

Senator STEVENSON. They are disciples.

Mr. WEINTRAUB. I regard myself as a different sort of disciple. I think there has been some ground swell because the old policies haven't worked.

Now you refer to our trade deficit. It's of enormous size, but this too is a result substantially of inflation. Earlier I said inflation is "the one in many." It determines in large part the value of a dollar on the world markets. It does affect our ability to export and, given the cost of our imports, if we can solve the inflation problem much of the trade deficit will take care of itself.

With respect to research and development, I hope that there isn't just the view of only throwing more money at these things and that it will mean enormous advances in productivity. Dr. Bosworth has spoken of the difficulty, and I think if we create a lot of these councils or create research and development staffs you will find just another way to expend money. Much of the research and development that you refer to of the largest corporations have just been used to take our technology and put those firms, as multinationals, overseas, in other countries and with less than full benefit to our own economy.

With respect to politicians as causing inflation, I do not subscribe to that view. Perhaps expenditures are higher than they should be, but expenditures and what you do does reflect the wishes of the constituency, imperfectly no doubt, but you do largely what your constituents expect.

As to economists, I have been unhappy with them for so long, I can say over this period you have in mind, sir, I have protested. I think now we've got to get on to new policies for this new day, and the only one—and I hope it would stimulate other thinking—the only new one is TIP with the several variants—the only one that's come forward other than the old-fashioned controls which can't work, and I do not necessarily intend to stay until death with the acronym TIP.

I'm interested in the new ideas; I think if you cannot lick the inflation issue I don't think you're going to be able to solve any of the other problems. Inflation does complicate everything. You say, "Simply do this." "Oh, no, it means inflation." "How about that?" "Oh, inflation" and so it goes.

For 10 years we have been in this position through both Democratic and Republican administrations. It doesn't happen to be a partisan inflation. It's a very nonpartisan affair and I think that your observations have reflected economists, and my profession, who have in effect said: "Don't worry about wages. Let collective bargaining proceed. Let's not do anything there. Let the Fed worry about it." It has worried me for it has continued to create the inflation and I'm afraid events are moving in that direction again.

There is then some new thinking on the economic front about the question, and of its impact on the political level.

Mr. REES. Senator, I'm afraid I'm going to have to disagree a bit with Professor Weintraub. I have been smarting a little bit under some of the things he's been saying this morning. I think, as I said in my prepared testimony, that this notion that inflation is a simple problem with a single cause and that cause is the relationship between wages and productivity is just grossly oversimplified. This is a complicated problem. There are lots of contributors to it. It has both a supply side and a demand side. Sometimes the demand side is predominant and sometimes the supply side is predominant. We have been through a period in recent years where clearly the problem was not excessive demand and one wanted to concentrate on the supply side. That I think is what the Council on Wage and Price Stability has been doing to the limit of its resources, which as you pointed out are not terribly great.

But all this got started with excessive demand in the late 1960's and if we hadn't had excessive demand in the late 1960's maybe this whole ball would never have gotten rolling. It got another push again from the demand side in 1971 and 1972 because I think the people who were responsible for demand management relied overly on the existence of wage and price controls to contain inflation and they didn't, and then excessive demand broke through the wage and price controls and they became unstable at that point.

So there are times when one has to worry about the demand side and when both the Keynesians and the monetarists have something proper to say in terms of what the monetary and fiscal policies should be like.

Now Professor Weintraub said earlier on that budget deficits weren't inflationary because we had a huge budget deficit in 1933 and we had prices going down, but we also had 25 percent unemployment in 1933. I'm perfectly willing to concede that budget deficits

are not inflationary when unemployment is 25 percent. I'm not willing to concede that they are not inflationary when unemployment is 4 percent and I'm not sure about 5 or 5½.

So I think if you're looking for an economist to come up with a single explanation and a single cure, you can look for centuries and I don't think you will ever find it. It may be that this TIP policy has some advantages, but to present it is the be-all and cure-all of the inflation problem I think is misleading this committee.

The CHAIRMAN. Gentlemen, the hour is late. We could continue for a long time. I would like to spend a few minutes getting into the ingredients of TIP. We have neglected that and I want to get into that.

Dr. Rees, you indicated that various versions of TIP have surfaced and only the Wallich-Weintraub version is administratively feasible.

My major concerns about that are this: No. 1, would it work to short-cut the inflation spiral? No. 2, is it needed to complement our other inflation policies? You said it's not a be-all and end-all, but would it work to complement our other inflation policies? Third, could it be implemented at reasonable costs?

First, would it work to shortcut the inflation spiral in your view?

Mr. REES. I think it might make some contribution to reducing the rate of inflation, but at a cost that might be very high. I'm not sure that, on balance, it would be a desirable policy.

The CHAIRMAN. Well, Dr. Okun presented it yesterday as the tax cut in effect; instead of having some of the other tax cuts that have been proposed, use this as the tax reduction—his carrot version. So the cost in that sense would be a cost that we're going to have anyway in the sense we're going to have a tax reduction.

Mr. REES. There's a much simpler way to use the tax reduction to reduce the rate of inflation, and that is simply to take some of the programs now financed by payroll taxes out of the payroll tax financing and substitute a cut in payroll taxes for a cut in the income taxes.

The CHAIRMAN. Would it be as effective? There's a reward if you comply, if you hold down your wages. There's not necessarily a reward if you simply reduce payroll taxes.

Mr. REES. I think that the reduction in payroll taxes would have an impact on unit labor costs and, therefore, on prices.

The CHAIRMAN. Well, it would have, yes, but my point is, you don't have the discipline. You don't have the force. You don't have the direct relationship. You still have these power elements of labor getting all it can get and management trying to make the highest profits it can in its pricing system. You don't have the incentive explicitly spelled out as you do when you put TIP in effect.

Mr. REES. Well, the other side of that coin, Senator, is I think it would be much simpler and quicker to implement than TIP. It would require, even for the feasible Wallich-Weintraub proposal, a while to get that in place. The other could be done very quickly.

The CHAIRMAN. Well, maybe we can do both. There's no reason why you couldn't act as far as payroll taxes are concerned now this year and move toward TIP maybe in 1980 or something of that kind.

Mr. REES. Well, I certainly have no objection to its being studied further, but I think a lot of the practical aspects of it are just beginning to be looked into and much more work is needed before anybody

is ready to adopt it. I'd like to see draft legislation, for example. I'd like to see what the Internal Revenue Code would look like if we were to enact TIP. Obviously, the Congress wouldn't enact it just the way the draft legislation is proposed, but just that discipline would be good for the proponents.

The CHAIRMAN. Professor Seidman, you said in your statement the most crucial ingredient in the TIP is the penalty on the employer that grants higher wages. What's the evidence that indicates when profit rates decline below normal business firms grant below normal wage increases?

Mr. SEIDMAN. Well, I have an article coming out where I do an econometric wage equation study trying to relate changes in wages for U.S. manufacturing over a 20-year period to see what causes movements in the rate of wage increases. Traditionally the unemployment rate has been an important variable in that wage rate and it seems to have been an important cause, I find that result; but what I also find is that the profit rate also seems to have a statistically significant effect on the rate of wage increase.

In other words, in the data it appears—now again, I should certainly want to repeat the caution that this is an econometric study subject to uncertainty, like all other empirical studies in economics, but it appears that if the profit rate is below normal for a period of several months that that in itself has an independent effect on reducing the rate of wage increase relative to what it had been in the last 2 or 3 years.

The CHAIRMAN. Will you make that study available to us?

Mr. SEIDMAN. Sure. [See reprint of study at p. 440.]

The CHAIRMAN. We'd like to study it.

Mr. SEIDMAN. Now one thing, though, I should repeat here, the penalty version of TIP would not cause an actual reduction in the profit rate of firms. It would threaten to squeeze the level of profit if the firm ignored it and gave the same eight percent wage increase. But if it comes down to the target there would be no actual reduction in profit rate. So it's only the threat of it.

The CHAIRMAN. So there's a direct relationship there, to the extent they comply, to the extent they hold down wages. If they don't, there's a penalty.

Mr. SEIDMAN. That's right.

The CHAIRMAN. Now in your statement you say under TIP the monetary growth rate prescribed by monetarists economists would be easier for the Federal Reserve to achieve.

Mr. SEIDMAN. That's right.

The CHAIRMAN. How would that be possible?

Mr. SEIDMAN. Well, I take the view that TIP is a complement, not a substitute, for reducing the rate of growth of the money supply and moving the Federal budget towards a full employment balance.

The CHAIRMAN. Simply because it would ease inflation and in the process would have that effect?

Mr. SEIDMAN. Right. In pages 15 through 17 of my testimony, which I would hope you would look at later, I try to explain the difference between what happens if you slow monetary growth without TIP versus if you slow monetary growth together with TIP.

The basic idea is simple. As most monetarists who themselves don't support TIP would admit, such as Professor Friedman, if you merely slow the rate of monetary growth, and Professor Friedman concedes this—wages and prices will continue to increase at almost the same rate for 1 year or 2. Therefore, with the rate of inflation continuing, the slowdown in monetary growth for the first few years—he's said a few years—takes the form of reduced ability to buy real output and the reduction in real output and production causes a rise in unemployment. Now he then says after several years unemployment will apparently get so high and profit rates so low that wage increases will moderate.

What I'm suggesting is let's add TIP to the slowdown of monetary growth. What will then happen is you will get a slowdown of wage increases and price increases immediately from TIP and the slowdown in monetary growth will still enable people to buy as much real output, so there will not be the slowdown in production and employment. So the two need to work together in tandem.

The real issue is not which would you prefer but—

The CHAIRMAN. Did you talk to Dr. Friedman about that? Did he accept that?

Mr. SEIDMAN. I haven't talked to him personally, but monetarist economists—

The CHAIRMAN. Do you find support for your TIP from the monetarists on this basis? I would think they would be enthusiastic.

Mr. SEIDMAN. I would think they should be, but I think that they seem to be more cavalier about the several year transition than I think many—

The CHAIRMAN. That's the reason they can't achieve it. They're very bright people. They understand that. If they really want to achieve their end and they think your system would work they would embrace it with open arms, with enthusiasm.

Mr. SEIDMAN. I would hope they would. We'll see. This is a new proposal. Maybe they will decide that it complements them. I think it complements their approach.

The CHAIRMAN. Dr. Weintraub, a fundamental question is how far we want to go in using the tax system for social ends. I think that's one of the objections here. We are using it for everything. We use it to promote employment, stimulate investment, provide home ownership. It's being proposed now for many other things, to reward college attendance, provide retirement to a greater extent than now and so forth. And we get frustrated frankly here in the Senate because it seems Russell Long runs the whole operation. He determines most of our social programs as well as our tax programs because so much is funneled through the tax system.

Aren't we going to end up, if we use TIP, with the tax system abused, overused even more than it is now, more complicated, and in greater disrepute?

Mr. WEINTRAUB. Senator Proxmire, I run the risk of troubling my dear friend, Al Rees. I have enjoyed his company through the years and I upset him a little bit.

We have two levers to affect the economy, apart from the law listing penalties and prohibitions, and so on. We can affect the economy through the tax side or we can affect the economy through the ex-

penditure side. There is some view of "let's simplify the tax system." Well, let's simplify everything. Some things can't be simplified.

We have the tax system. It should be used as a lever to affect the market economy in ways that are regarded as desirable. Why throw it away? I don't object to tax deductions. If you do want to influence home ownership we have every reason to use the tax mechanism. Of course we might disagree on the particular deductions.

The CHAIRMAN. Could you do it this way: Could you confine the use of TIP to the larger firms so you don't have every small businessman in the country in a quandary as to what he does to figure out his product price and so forth and all the fringe benefits involved in wages and so on?

Mr. WEINTRAUB. Senator, I appreciate your raising that question. I have only argued for TIP for 1,000 or 2,000 firms. With 1,000 firms you would cover or recapture about 55 percent of the gross business product. With 2,000 firms the estimates I have seen suggest that you would affect 85 percent of gross business product. There has been the earlier remark—and I think it was my friend Al Rees here, who said Government was excluded. With respect to Government employees, you could say for 1 year or 2 years—I take 2 years—2 years, limit average wage increases, salary increases, to the number that—5 percent seems to be the magic number—and perhaps if at that time Government salaries have lagged behind you could make the corrections. So quickly you could bring in the pacesetters in the economy, ultimately through TIP; this hasn't come out adequately in these discussions. You could not include the construction industry because that consists largely of small firms. You could not include the trucking industry for much the same reason. And it is for this reason that I referred to CAIP. Now these are identifying initials for the contract authorization incomes policy.

I think this could do something in construction by controlling costs in Government construction, Government assisted construction; it is a subject that has interested you through the years, and on which you have done so valiantly on cost overruns in procurement, where the salaries get entirely out of hand for doing jobs in the private sector that perhaps an admiral or a colonel does at the same level in the Government sector.

The CHAIRMAN. As you know, we have a very complicated procurement policy now. Wouldn't this complicate it further if we applied TIP to establish a form for defense contracts?

Mr. WEINTRAUB. I don't see it—we have Davis-Bacon largely on the construction side; I don't know what you do on the procurement side, but I don't see that it would be complex. It's a complex society and inflation is a complex problem. TIP has been criticized as being an oversimplification. Well, at least it's a simplification. It's not a complex approach, using taxes.

We can stay up waiting for the latest article on monetary theory, and at the end of it what do we have? Somebody argues you should increase the money supply or decrease it or keep it constant. Well, now, on taxes, this is the same sort of phenomenon.

No, I don't see it as complex or beyond the abilities of accountants for 2,000 of our largest firms. They can handle it easily.

The CHAIRMAN. Dr. Seidman, yesterday Governor Lilly said in his testimony that the TIP's are a mild form of wage and price control. Your statement emphasizes that TIP is not a form of wage and price control. How would you dispute Governor Lilly? It seems to be the perception, too, of many people in business.

Mr. SEIDMAN. What TIP would do is let each firm and each group of employees make their own decision as to what wage or price increase is to take place at that firm. They would not have to clear it with any regulation or any regulatory body.

Under controls, that isn't the case. Any collective bargaining agreement has to be in line with particular regulatory guidelines.

The CHAIRMAN. Let me just interrupt to say you're saying for many of the firms in this country the Congress' decision as to what level of wage increase would be permissible—6, 7, 5 percent. That would be an enormously important collective bargaining decision made by members of Congress or made by the Congress and the President, not made on the basis of the marketplace, not made on the basis of negotiations, taking labor unions and management with their know-how and experience just out of the act.

Mr. SEIDMAN. That's right. If the penalty under TIP were severe and prohibitive, then it would be the same as controls. In other words, if you were saying to firms: our guidelines—

The CHAIRMAN. It's pretty severe if you go up to 60 percent corporate income tax.

Mr. SEIDMAN. No. I just gave those numbers as a particular example. There's no good study yet as to what would be the appropriate number. That was only for illustration.

What you need to try and estimate is what level of penalty would be significant to a firm.

The CHAIRMAN. I think Dr. Rees pointed out he would like to see draft legislation so he would have something specific to zero in on and criticize and understand. Here's a point that it seems to be most useful. You said you haven't made a study as to what level you would go to, whether it would be 54 or 64 percent. Those were just tossed out as illustrations.

Mr. SEIDMAN. That's right.

The CHAIRMAN. If you're really serious—and you're one of the prime authors, and Dr. Weintraub and Dr. Okun and Dr. Wallich—you're the four men that probably know more about this than anybody in the country—it would seem to me you should come forward with specific legislation drafted available for us to look at, and see, and criticize, and understand. Can you do that?

Mr. SEIDMAN. I think we should try and—

The CHAIRMAN. When do you think you could do that? Do you think you could do that? Would you like to comment, Dr. Weintraub?

Mr. WEINTRAUB. Yes, Senator. It is most difficult to get any assistance. I can say I have been working alone on this for a long, long while and if you look at the typing job on my statement you can see I'm not the world's best typist either. To suggest immediately a legislative kind of proposal, I think that those are available. Those are available in any number of the statements of my own, the one of Dr. Wallich's, the three chapters in my book on inflation and employ-

ment and prices. It's a new book and from the present references at these hearings it should be one of the rare books in economics—unheard of.

The CHAIRMAN. Well, with all this discussion—and I would agree this is one of the very few options we have to combat inflation. It's the only one that seems to have substantial stature with support by very able economists and seems to move us in this direction, but as I say, to discuss it is fine and I think these hearings have been most useful in that respect, but we would like to get draft legislation so we can know whether we have something or whether we'd better get to work on something else.

Mr. WEINTRAUB. I'm eager to help. Until this morning there has been no serious discussion of this in Washington and I commend the committee for being a lert to the existence of this. As I say, this has taken 7 or 8 years and it's been newspaper discussions that has led this on. Yet there has not been any support for any kind of study project.

The CHAIRMAN. What would be a reasonable deadline? Do you think we could have draft legislation available by September 1?

Mr. WEINTRAUB. By the middle of July.

The CHAIRMAN. I'm serious. The middle of July?

Mr. WEINTRAUB. I'm serious. Yes.

The CHAIRMAN. All right. Try and do that then by July 15.

Gentlemen, I want to thank you very, very much. You have been most helpful and you have made a fine record and we appreciate it.

The committee will stand adjourned.

[Whereupon, at 12:35 p.m., the hearing was adjourned.]

[Additional material received for the record follows in the appendix:]

APPENDIX

THE RETURN OF THE PROFIT RATE
TO THE WAGE EQUATION (Revised)

by

Laurence S. Seidman

Discussion Paper #363
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ABSTRACT

After showing statistical significance in most wage equation studies in the early 1960's, the profit rate disappeared from most wage equations, as researchers focused their attention on the adjusted unemployment rate. This paper reopens the issue of the influence of the profit rate on wage inflation. It tests the performance of the profit rate and the adjusted unemployment rate in the wage equation against time series data for U.S. manufacturing. It concludes that the result is a draw: the profit rate does as well as the adjusted unemployment rate. The data are consistent with the hypothesis that the profit rate influences wage inflation. Economic theory or policy that postulates an impact of the after-tax profit rate on wage inflation is not contradicted by empirical evidence for U.S. manufacturing.

ACKNOWLEDGMENTS

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In the early 1960's, several econometric wage equation studies concluded that the profit rate significantly influences the growth rate of money wages. Among these were studies by Eckstein and Wilson (5), Bhatia (1), Schultze and Tryon (15), and Perry (11). While there were also wage equation studies that either omitted, or specifically rejected, the profit variable, it was clearly regarded as an important contender for inclusion in the wage equation by many economists.

In the late 1960's, however, the profit variable began to disappear from most wage equations. Occasionally, it was specifically rejected, with the assertion that it was no longer statistically significant (23). More often, it mysteriously disappeared, without explanation. For example, Perry's 1970 wage equation study simply omits the profit variable, although it had been significant in his earlier studies (13). Most wage equation studies since 1970 have ignored the profit variable.

Why did the profit variable vanish from the wage equation? One possibility is that, while researchers still believed that its inclusion was theoretically plausible, the data rejected it. Another possibility is that most researchers did not believe, *a priori*, that the profit variable belonged in the wage equation. Studies in the late 1960's and 1970's reflected a growing conviction that proper measures of excess demand in the labor market, and price expectations, could satisfactorily explain wage changes. Creativity and ingenuity were exhibited in adjusting the unemployment rate, and constructing proxies for price expectations (13, 7, 25).

This paper reopens the issue of the role of the profit

variable in the wage equation. Do the data reject, or support, the inclusion of the profit variable? Given the improved measures of excess demand in the labor market, do these adjusted unemployment variables work better, or worse, than the profit variable? According to the data, which should the wage equation include: (1) the adjusted unemployment rate (2) the profit rate (3) both (4) neither?

I A Comparison of Wage Equations

Six wage equations are presented in Table 1. The first three are of the form:

$$(1) \dot{w}_t = a_0 + a_1 \pi_{t-i} + a_2 (1/u_{t-i}) + a_3 \dot{w}_{t-i}$$

\dot{w}_t = percentage rate of change of the wage variable

π_{t-i} = distributed lag of the profit variable

$1/u_{t-i}$ = distributed lag of the reciprocal of the
adjusted unemployment rate

\dot{w}_{t-i} = distributed lag of the percentage rate of change
of the wage variable

The three equations differ solely according to the adjusted unemployment variable that is used.

The second three equations are of the form:

$$(2) \dot{w}_t = a_0 + a_1 \pi_{t-i} + a_2 (1/u_{t-i}) + a_3 \dot{p}_{t-i}$$

\dot{p}_{t-i} = distributed lag of the percentage rate of change
of the price variable

Again, these three equations differ solely according to
the adjusted unemployment variable that is used.

TABLE 1
WAGE EQUATIONS

(1-M)	$\dot{w}_t = -5.58 + 5.58\pi_{t-i} + 2.00(1/u_{t-i}) + 0.94\dot{w}_{t-i}$			
	(-4.08) (4.19) (1.45) (8.58)			
	$\bar{R}^2 = .73$ S.E.=1.21 D.W.=2.03			
(1-P)	$\dot{w}_t = -6.26 + 6.10\pi_{t-i} + 3.24(1/u_{t-i}) + 0.94\dot{w}_{t-i}$			
	(4.43) (4.26) (1.23) (8.82)			
	$\bar{R}^2 = .73$ S.E.=1.20 D.W.=2.08			
(1-W)	$\dot{w}_t = -6.60 + 6.12\pi_{t-i} + 6.07UGAP_{t-i} + 0.88\dot{w}_{t-i}$			
	(-4.71) (4.43) (2.00) (8.06)			
	$\bar{R}^2 = .74$ S.E.=1.18 D.W.=2.11			
(2-M)	$\dot{w}_t = -1.99 + 3.13\pi_{t-i} + 3.38(1/u_{t-i}) + 0.96\dot{p}_{t-i}$			
	(-1.22) (1.82) (2.50) (7.42)			
	$\bar{R}^2 = .72$ S.E.=1.23 D.W.=1.83			
(2-P)	$\dot{w}_t = -2.61 + 3.25\pi_{t-i} + 6.21(1/u_{t-i}) + 0.98\dot{p}_{t-i}$			
	(-1.49) (1.65) (2.32) (7.71)			
	$\bar{R}^2 = .72$ S.E.=1.23 D.W.=1.88			
(2-W)	$\dot{w}_t = -3.01 + 3.37\pi_{t-i} + 8.91UGAP_{t-i} + 0.90\dot{p}_{t-i}$			
	(-1.76) (1.81) (3.02) (6.92)			
	$\bar{R}^2 = .73$ S.E.=1.20 D.W.=1.94			

All equations were estimated using ordinary least squares. The numbers in parentheses are t-statistics. \bar{R}^2 is the R^2 corrected for degrees of freedom. S.E. is the standard error of the estimate. D.W. is the Durbin-Watson statistic. Each variable is described in section I-A of the text. Equations (1-M) and (2-M) use the prime age male unemployment rate; (1-P) and (2-P) use Perry's weighted unemployment rate; (1-W) and (2-W) use Wachter's UGAP. Decimal points are positioned as follows:
(a) a wage or price inflation rate of 7% is entered as 7.0
(b) an unemployment rate of 6% is entered as 6.0. Each variable is a polynomial distributed lag (of second degree). π_{t-i} and u_{t-i} are lagged four quarters (constrained to zero in the fifth); \dot{w}_{t-i} and \dot{p}_{t-i} are lagged twelve quarters (constrained to zero in the thirteenth). The coefficient shown above for each variable is the sum of the individual distributed lag coefficients; the t-statistic applies to the coefficient sum.

TABLE 2
DISTRIBUTED LAGS FOR EQUATION (1-M)

<u>Period</u>	<u>Coefficient</u>	<u>t-Statistic</u>
t-1	4.75	3.33
t-2	1.67	4.19
t-3	-0.14	-0.19
t-4	-0.70	-0.97
	<u>Prime Age Male Unemployment Rate (1/u_{t-i})</u>	
t-1	-7.18	-2.27
t-2	0.60	1.45
t-3	4.39	2.61
t-4	4.19	2.55
	<u>Wage Inflation Rate (w_{t-i})</u>	
t-1	0.13	2.24
t-2	0.12	3.16
t-3	0.11	5.01
t-4	0.11	8.40
t-5	0.10	7.51
t-6	0.09	4.65
t-7	0.08	3.22
t-8	0.07	2.47
t-9	0.05	2.01
t-10	0.04	1.70
t-11	0.03	1.48
t-12	0.01	1.32

These are the distributed lag coefficients and t-statistics for the variables in equation (1-M) of TABLE 1

(A) Data

The equations were run on quarterly data for the U.S. manufacturing sector from 1955:02 to 1975:02. The wage variable is the "hourly earnings index" which the Bureau of Labor Statistics regards as the best available measure of wage-rate movements (2). The price variable is the non-farm price deflator; it is used in several studies that feature the adjusted unemployment rate (24,25).

Three different adjusted unemployment variables are used. Each tries to correct for the changing composition of the labor force that occurred over the sample period. The first is the prime age male unemployment rate. The second is George Perry's weighted unemployment rate, described in detail in his 1970 article (13). Both the prime-age male rate, and Perry's rate, are entered as $(1/u_t)$. The third is Michael Wachter's UGAP, which increases as the labor market tightens, as described in his 1976 article (25). In general, the results proved to be substantially the same for all three.

The profit variable is the ratio of the actual after-tax profit rate on equity to the "normal" profit rate for that quarter. The "normal" rate is given by a simple linear trend. It seems plausible to conjecture that what matters for \hat{w}_t is whether the profit rate has been above or below normal. As it turned out, the equations in Table 1 would have been largely unchanged if the profit rate itself, rather than the ratio, were the profit variable. The actual profit rate on equity is given in the Federal Trade Commission's Quarterly Financial Reports for U.S. Manufacturing.

It may be objected that the accounting profit on the book value of equity differs from the "real" profit rate in an inflationary period. Nevertheless, the reported profit rate may

be the appropriate variable for wage determination. The relationship between the reported and "real" profit rate is complex (22). Management, stockholders, and union may not know the real profit rate, or even whether it is greater or less than the reported rate. If stockholders, and union, are likely to judge according to the reported rate, it becomes rational for management to do the same. In a study of U.S. profit behavior, Nordhaus concludes that firms seem to set prices with reported, not real profit, in mind. He concludes, "When in Rome,..." (10).

(B) Lag Structure, Simultaneity, and Autocorrelation

All variables are entered as polynomial (of second degree) distributed lags. The profit and unemployment variables are lagged four quarters (constrained to zero in the fifth); the wage and price variables are lagged twelve quarters (constrained to zero in the thirteenth). Any influence of more distant profit or unemployment rates is assumed to be reflected in the lagged wage or price variable; if a past profit or unemployment rate affects past wage inflation, it also affects past price inflation through the price equation relationship. The wage variable is lagged twelve quarters to allow for the impact of three-year contracts. The price variable is lagged twelve quarters to allow for a gradual impact of past inflation rates on current expectations. Higher degree polynomials, and longer lags, were tried but appeared to make little difference (although obviously not every permutation was attempted).

In both the lagged profit and unemployment variables, the first quarter is $(t-1)$, not t . This is done for two reasons. First, wage increases that occur this quarter have almost always been decided upon at least one quarter ago. Thus, π_t or u_t is not

known when the decision for w_t occurs. Second, including π_t or u_t would introduce the problem of simultaneous equation bias. If a stochastic disturbance raises \hat{w}_t , this will affect π_t and u_t in a complete macromodel. Unfortunately, in many wage equation studies, π_t or u_t is included, unlagged, in the wage equation, but no mention is made of the simultaneity problem, or its implications for tests of statistical significance, or parameter estimates. Thus, for both theoretical and econometric reasons, π_{t-i} and u_{t-i} are entered beginning with $t-1$.

Another potential econometric problem is created by the lagged dependent variable, \hat{w}_{t-i} . As long as there is no serial correlation, the OLS estimators are still maximum likelihood estimators, and are consistent and asymptotically efficient, although they are biased in small samples (9). Since ours is a large sample, with 81 observations, the desirable large sample properties are most relevant. If there is autocorrelation, however, then the disturbance, e_t , will be contemporaneously correlated with the right hand variable, \hat{w}_{t-i} , and the OLS estimators will not be consistent.

In contrast to some models that result in a lagged dependent variable—such as a Koyck scheme, or adaptive expectations—an inertia hypothesis does not require a serially correlated disturbance. Nevertheless, serial correlation may be present, as it often is, in time series. With a lagged dependent variable, the standard Durbin-Watson statistic will be biased towards the conclusion that there is no autocorrelation. It will underestimate the probability that autocorrelation is present (9).

Fortunately, Durbin has proposed a large sample test for serial correlation when lagged dependent variables are present (3).

According to this test, it is still true that if the standard Durbin-Watson statistic is close to 2.0, the probability of serial correlation is low. With our D.W. equal to 2.03 in equation (1-M) in Table 1, it is still correct to infer that autocorrelation is unlikely. More precisely, Durbin asserts that h has a standard normal distribution:

$$(3) \quad h = r \sqrt{\frac{n}{1-nV(c_1)}}$$

$$(4) \quad r \approx 1 - \frac{1}{2}d$$

d = standard D.W. statistic

n = number of observations in the sample

$V(c_1)$ = the estimate of the sampling variance of c_1 , the coefficient of \hat{w}_{t-1} in the least squares regression

If the null hypothesis is no serial correlation, it can be rejected with 95% confidence if h exceeds 1.65 in absolute value. If the standard D.W. equals 2.00, then r will be zero, and therefore h will be zero, so the hypothesis of no serial correlation will be accepted. In equation (1-M) in Table 1, h is (-0.16), much closer to zero than to (-1.65). Thus, autocorrelation is unlikely. This means that OLS estimates should be consistent, and the t-tests substantially correct.

(C) Regression Results

The results are presented in Table 1. All equations are estimated using ordinary least squares. In all six equations, the sum of the coefficients on the lagged wage or price variable is close to 1, and highly significant. This supports "accelerationist" behavior. A permanent increment in π_t or $(1/u_t)$ will continue to raise the wage inflation rate indefinitely, through subsequent feedback that will occur through the lagged

wage or price term (feedback through the price term occurs because of the price equation relationship, in which price inflation is a function of wage inflation). If the coefficient sum is approximately 1, the wage inflation rate will be constant only if π_t and u_t are at their "natural rates." If π_t is permanently raised above its natural rate, and u_t , below its natural rate, the wage inflation rate will rise gradually without limit. Conversely, the wage inflation rate will decline gradually if π_t is held permanently below its natural rate, and u_t , above its natural rate.

In all six equations, either π_t or u_t is highly statistically significant. Since a change in aggregate demand will influence these two variables, the influence of aggregate demand on wage inflation receives strong support. The response of wage inflation, though reliable, is gradual. In equation (1-W), if \dot{w}_{t-1} has been constant at 8%, then a prime age male unemployment rate of about 4% (corresponding to an official unemployment rate of 5.5%-6%), and an after-tax profit rate on equity of about 12% (which would make the profit ratio about 1, since the "normal" profit rate was about 12% in 1975), would keep the wage inflation rate approximately constant at 8%. If the profit rate were raised to 13%, and the male unemployment rate lowered to 3%, then by the end of the first year, \dot{w}_t would be roughly 9% (the distributed lag weights for the variables are given in Table 2). Subsequent feedback through the lagged wage term, however, would continue to raise \dot{w}_t almost indefinitely ("almost," because the coefficient sum is 0.94 instead of 1).

It is also true that aggregate demand is not the only important influence on \dot{w}_t . \dot{w}_t is affected by stochastic dis-

turbances, which are then incorporated in the lagged wage or price term. It is therefore incorrect to conclude that, since these wage equations have an R^2 near 75%, aggregate demand explains 75% of the variation in wage inflation. The long-run effects of aggregate demand do operate through the lagged wage or price term. But so do the lagged effects of other influences. Thus, this study supports a "moderate" view concerning the influence of aggregate demand on wage inflation.

We now turn to the comparison of the profit rate, and the adjusted unemployment rate. Based on t-statistics, the profit rate outperforms the adjusted unemployment rate in the first three equations, with the lagged wage term; but the adjusted unemployment rate outperforms the profit rate in the second three equations, with the lagged price term. A wage inertia hypothesis would support the specification with the lagged wage term. A price expectations hypothesis would support the specification with the lagged price term. To a researcher without strong a priori convictions concerning which specification is more appropriate, the verdict of the data is surely a draw.

The data, therefore, do not reject the hypothesis that the profit rate influences wage inflation. The profit hypothesis is as consistent with the data as the unemployment hypothesis. The disappearance of the profit rate from wage equation studies over the last decade was not mandated by the data. Economic theory or policy that postulates an impact of the after-tax profit rate on wage inflation is not contradicted by the available empirical evidence for U.S. manufacturing (16,26).

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The Financial Analysts Federation

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Theodore R. Lilley, C.F.A.
President

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STATEMENT BY THE FINANCIAL ANALYSTS FEDERATION

May 26, 1978

The Financial Analysts Federation is the professional association for security analysts, investment managers and others involved in the investment decision-making process. It consists of 48 societies with over 14,000 members in the United States and Canada.

As investment professionals, we are perhaps more concerned over inflation than other segments of our society. Inflation increases uncertainty and risk in the economy, limits growth and makes it more difficult to achieve full utilization of our resources. We know from experience that developments in the general economy are transmitted directly - but with a leverage effect - to financial markets. Experience has also shown that what is good for the economy is very good for the investor; what is bad for the economy is very bad for the investor.

There are many sources of inflationary pressures and a number of approaches might usefully be employed to reduce

these pressures. Indeed, these hearings are examining in detail one particular concept, the tax-based incomes policy. We will concentrate our comments on the critical importance of a sustained high level of capital investment as a means to ameliorate the price and wage increase pressures of inflation. Investment is the focus of our knowledge and experience and the area in which we are most likely to make a contribution to these proceedings.

Critical Role of Investment

Capital investment influences the rate of inflation in two principal ways. First, the level of investment is the critical determinant of whether we will have ample supplies of goods and services and competitive restraints on business pricing or whether we will have shortages, sellers' markets and rapid price markups.

Second, investment is the key element influencing the rate of gain in labor productivity, which provides a direct offset to increases in wage costs. The relationship of growth in capital spending (after adjustment for inflation and for outlays for controlling the environment) to growth in the labor force has deteriorated in the 1970's, and annual gains in output per worker have fallen almost a full percentage point from the average experience in the 1950's and 1960's.

Over the next several years, investment needs will be enlarged by a series of special factors which are largely unrelated to expansion of capacity or improvement in the efficiency of the capital stock. These include increased spending to provide for the development of new energy sources and for facilities to meet environmental and safety standards. As a consequence, there is a broad consensus among economists that total capital spending will have to increase faster than general economic activity if shortages are to be avoided and the historic pattern of productivity improvement restored.

Limits on Debt Financing

The increase in investment requirements, unfortunately, coincides with a reduced ability of business to raise capital through debt financing. From 1965 through 1977, net additions to debt supplied 88% of total outside funds raised by non-financial corporations, with equity financing providing only 12%.

Because of this buildup in the debt burden and an accompanying steep rise in interest rates, the coverage of interest charges by earnings (which is the essential test of the safety of a debt security) has worsened significantly. Interest coverage for non-financial corporations

has narrowed from an average of 10x in 1965-1967 to 4.5x in 1975-1977.

	Earn. Avail. For Interest*	Interest Charges	Interest Coverage
	(\$ bil.)		
1977	\$169.2	\$36.7	4.6x
1976	152.4	32.4	4.7
1975	123.5	30.8	4.0
1974	96.1	29.0	3.3
1973	97.6	20.5	4.8
1972	88.3	17.4	5.1
1971	76.6	16.5	4.6
1970	70.6	16.2	4.4
1969	80.8	12.7	6.4
1968	81.1	10.9	7.4
1967	74.3	9.1	8.2
1966	75.8	7.2	10.5
1965	70.0	5.9	11.9

*Pre-tax earnings (after inventory valuation adjustment) plus foreign branch profits and interest charges.

Source: Federal Reserve Board, Flow of Funds

Graham, Dodd and Cottle in the standard text

"Security Analysis" recommend a minimum coverage of interest charges for high quality bonds of 7x for industrial companies and 4x for utilities. Weighted for relative size, this would represent an overall figure for non-financial corporations of about 6.5x.

The inadequacy of present coverage ratios is even worse than the above figures would suggest. The earnings figure recommended by Graham, Dodd and Cottle for use in calculating coverage is the average for the prior 7 years rather than the latest year alone. Using this approach, coverage in 1975-1977 would fall to just over 3x. In

addition, because of a lack of data no allowance has been made for the interest component of lease rental charges, which realistically is part of the interest burden. Finally, the use of aggregate figures obscures the very high coverage ratios for many leading companies, e.g., 88x for IBM in 1977 and 36x for Johnson & Johnson. These are necessarily offset by ratios for many other firms—particularly smaller firms—that are below the aggregate level.

Importance of Equity Capital

A reduced emphasis on debt as a source of capital seems clearly indicated; this will just as clearly require a corresponding increase in equity financing if overall investment needs are to be met. Calculations we have made based on the assumption that earnings coverage of interest charges will stabilize at present levels indicate that the required level of equity financing in the 1976-1985 period will be almost four times as great as in the prior ten years (an average of \$23 billion a year versus \$6 billion in 1966-1975 and \$8 billion in 1977).

Prospects for raising a much larger supply of equity funds, however, are not promising, given the poor experience of equity investors since the mid 1960's. The current level of 858 (as of May 17, 1978) for the Dow Jones Industrial Stock Average compares with a mean annual price of 911 as far back as 1965. Equity investors have made no progress

in nominal terms for approximately thirteen years. In terms of real purchasing power, overall equity values have shrunk by 50%. Real GNP, on the other hand, increased by 44% from 1965 to 1977.

			--- Change ---	
	Current Price*	1965 Mean Price	As Reported	Adjusted for Inflation
Dow Jones Avg.	858	911	(6)%	(51)%
S&P 500	100	88	13	(41)
Value Line	107	124	(14)	(55)

* as of 5/17/78

The consequences of this weak performance have been about what could have been expected. The number of individual shareholders declined 18% from 1970 to 1975, equity-oriented mutual funds have been in a net redemption phase in 5 of the past 6 years and the flow of pension fund money has shifted from stocks to bonds.

Case for Tax Reduction

The lag in stock prices has been caused in large part by a faster pace of inflation, which has pushed up interest rates and thereby depressed the value of all income-producing assets. At the same time, business profitability has not increased so as to provide an offset

to higher inflation and interest rates. For the Dow Jones Average, return on equity investment or net worth has remained relatively constant at around 12% throughout the postwar period, while interest rates on high-grade bonds have risen from around 5% in the mid 1960's to 8.6% at present. As a consequence, the difference between the rate of return realized on equity investment and the return available on relatively risk-free, high quality bonds has been cut in half over the past 10 - 12 years.

	Return on Average Equity*	Bond Yields**	Difference
1977	10.8%	8.0%	2.8%
1976	12.2	8.4	3.8
1975	9.9	8.8	1.1
1974	13.7	8.6	5.1
1973	12.9	7.4	5.5
1972	10.7	7.2	3.5
1971	9.3	7.4	1.9
1970	9.1	8.0	1.1
1969	10.7	7.0	3.7
1968	11.6	6.2	5.4
1967	11.3	5.5	5.8
1966	12.4	5.1	7.3
1965	12.3	4.5	7.8

* Dow Jones Average

**Moody's AAA Corporates

Since inflation itself is the problem being addressed, a reduction in inflation cannot be offered as part of the solution. The attractiveness of common stocks and the availability of equity funds for investment can be enhanced,

on the other hand, by Government actions (especially in regard to taxes) that are designed to raise returns on investment. Treasury Secretary Blumenthal stated on May 8 at the Annual Conference of the Financial Analysts Federation, "The chief drag on investment, however, is low profitability, an inadequate real rate of return on capital. For this problem one of the important remedies has to be tax policy."

A wide range of proposals have been made to reduce the tax burden on business and investors and the adoption of any or all of these proposals would be expected to have a positive influence on investment. We would, however, like to single out for particular emphasis the benefits that could be derived from a reduction or elimination of taxes on capital gains.

The Securities Industry Association has studied the effects of various tax proposals on the capital formation process based on econometric models prepared by Dr. Otto Eckstein's firm, Data Resources, Inc. These models indicate that over a five-year period elimination of the capital gains tax would have the most positive influence on investment, real GNP, employment and Government revenues of any of the proposals examined. Relative to what would otherwise be expected, the projected impact on these economic

variables as a result of elimination of the capital gains tax is as follows:

Aggregate Increases
1978/1982

Capital Formation (1978 \$)	\$ 81 bil.
GNP (1978 \$)	\$199 bil.
Employment (man years)	3,136,000
Federal Tax Revenues (current \$)	\$ 38 bil.

Arguments against a lowering of the capital gains tax typically emphasize the first-year loss of Government revenues, but this objection seems unrealistic. The problems of lagging investment and high inflation developed over a long period and are not likely to be resolved other than by an approach extending over several years. Similarly, criticism that only a few would benefit directly from this method of tax reduction miss the main point - that benefits from an increase in investment, production and job opportunities would spread over all segments of society.

* * * * *

To summarize, a sustained high level of capital formation is an essential element in any program to limit inflation due to the influence of investment on the supply of goods and on the productivity of labor. Because of a

reduced ability of corporations to finance with debt, a substantially higher level of equity investment is needed. The availability of equity capital, meanwhile, has been impaired by the prolonged period of poor market performance by common stocks. One of the most promising ways to stimulate equity investment would be to increase rates of return through a reduction in taxes on business and investors.

prepared for the Federation by Walter McConnell, Senior Vice President and Director of Wertheim & Company

The following letter was mailed April 26, 1978 to numerous experts on inflation and taxation to get their views on tax based incomes policies. The list of individuals the letter was sent to and the responses received follow:

Dear _____:

The Committee on Banking, Housing and Urban Affairs has scheduled two days of hearings, May 22 and 23, 1978, to consider the merits of new anti-inflation programs such as "TIP" -- Tax Based Incomes Policies.

The tentative witness list for those hearings has been set, and I am enclosing a copy of it with this letter. Clearly two days of hearings on this subject will only be a beginning of considerations of the pros and cons of "TIP" or any other new anti-inflation program that may surface.

In order to assure the Committee of a wide range of views, I am writing to experts on inflation and taxation to get their views in "TIP". Given your background it would be beneficial to the Committee if you could provide your views on "TIP" in writing so that they may be included in the hearing record. I believe that the following questions about "TIP" should be raised, although you need not feel constrained to answering them:

1. Are special types of programs such as "TIP" needed to combat inflation in general, and the type of inflation currently afflicting our economy in particular?
2. What benefits would be gained through "TIP" that cannot be derived through other types of anti-inflation programs? What are the costs to the economy that would accrue through "TIP"?
3. What type of "TIP" program would be best, such as a penalty or rewards approach, applied to both wages and prices or only one or the other, instituted for a limited period or permanently?
4. Can an effective set of tax based incomes policies be devised that would treat everyone fairly?
5. What problems should the Congress be mindful of as it considers proposals for "TIP"? What safeguards would, therefore, need to be built into a workable version of "TIP"?

"TIP" Letter (cont.)

6. Would "TIP" best be implemented by applying it to large firms only, to all corporations, or still more broadly?
7. Can and should the tax system be used to implement anti-inflation guideposts? What special problems would this cause for the tax system, and are solutions possible and at what cost?
8. What would be the cost to the Treasury of implementation of "TIP"?
9. Do you view "TIP" as being related to mandatory wage and price controls, or to a social contract among government, labor, and business?

I hope that you will find time to take a careful look at "TIP" proposals so that you will be able to share your views with the Committee. Should you have any questions about the Committee's hearings or about the submission of material for the hearing record, you may contact Steven M. Roberts of the Committee staff at (202) 224-0893.

With all best wishes.

Sincerely,

Enclosure

William Proxmire
Chairman

WP:srl

NAMES AND ADDRESSES OF PEOPLE TO RECEIVE LETTER:

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3. Mr. Allan H. Meltzer
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29. Professor Michael L. Wachter
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Addresses (cont.)

30. Professor Maria v.N. Whitman
Department of Economics
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31. Mr. Richard Slitor
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32. Mr. Milton Friedman
Hoover Institute
Palo Alto, California 94302



CENTER FOR THE STUDY
OF AMERICAN BUSINESS

May 12, 1978

Senator William Proxmire
Committee on Banking, Housing, and
Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Senator Proxmire:

In response to your letter of May 1, I am pleased to offer the following comments on the proposals for Tax Based Incomes Policies (TIP):

No Need for TIP

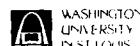
In my view, incomes policies--including those that would use the tax system to influence private wage and price decisions--are not a useful way to deal with the problem of inflation. The basic shortcoming of the incomes policy approach is that it deals with the symptoms of inflation rather than the underlying causes. The basic causes of the inflation facing the American economy are in the public sector itself--excessively large budget deficits, tax policies that dampen the incentive for saving and investment, too rapid a growth in the money supply, and various governmentally-imposed institutional rigidities and limitations (especially in the regulatory area) which give an inflationary bias to the economy.

Benefits and Costs

It is hard for me to see the benefits that would arise from incomes policies, but the potential costs are substantial. "TIP" would place business between labor and government. "Lucky" companies, facing cooperating or weak labor unions who settled for compensation increases within the government's guidelines, would tend to receive windfall tax benefits or avoid penalty tax payments, depending on whether the carrot or stick type of TIP would be utilized. Similarly, "unlucky" companies, facing uncooperative or strong labor unions, would tend to be hurt by having penalty tax payments imposed upon them or forgoing tax subsidies because they granted wage increases above what the federal government determined were appropriate.

Thus, the results of TIP would be determined by the relative power of a company and the unions with which it deals, with the tax payment or rebate being incidental. The administrative costs, moreover, could be very substantial, including the deflection of the Internal Revenue Service from fulfilling its traditional functions.

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The Size of Companies

The great variety in the size and nature of business firms would present a host of operational difficulties. The suggestion to limit the program to the larger economic units would present many issues of equity for the employees, owners, and customers of the affected firms. The administrators of TIP would be faced with a "no win" situation. If they exempted the smaller organizations, they would be omitting many of the sectors of the economy which have been experiencing the most rapid price increases. If, alternatively, they included all companies, the enforcement burdens would be most severe.

Prior Experience With Incomes Policies

The Congress would be well advised to examine prior experiences with incomes policies, both in the United States and in other industrialized nations. It will be apparent, I believe, that these policies do not represent a durable solution to the problem of inflation. At best, they postpone and usually in the process exacerbate the underlying inflationary pressures.

The Need to Consider Alternatives

The interest in incomes policies arises because of the dissatisfaction with the operation of conventional macroeconomic policies. In my view, monetary and fiscal instruments are necessary but not necessarily sufficient mechanisms for dealing with the severe inflationary pressures facing this nation. The answer, however, is not to increase further the government's intervention in economic matters but, rather, to reverse the trend of recent policy.

We need to recognize the basic reason that incomes policies--both voluntary and compulsory, both here and abroad--have been resorted to. It is hardly because we as a nation like to interfere with private decision making. Rather it is that citizens and policy makers have not been satisfied with the results of indirect measures such as monetary and fiscal policy. Attempts to reduce unemployment by expanding demand often lead mainly to greater cost and price pressures, with unemployment staying uncomfortably high. Moreover, when we attempt to check these rapid cost and price increases, those efforts often lead to still higher levels of unemployment.

The fundamental cause of this state of affairs lies in the numerous departures from the free market model, the numerous concentrations of private economic power in the United States. The result is that various factor and product markets in good measure have become insulated from the influences of monetary and fiscal policy. Cost-push inflationary pressures are the most obvious manifestation of this structural condition.

The alternative to incomes policy can be called the "free market" approach--a greater reliance on the competitive forces of the business system to keep down inflationary pressures while providing higher levels of production, income, and employment. This in turn makes the access to many products and markets by the rest of the economy less difficult and less expensive. Specifically, we need to reduce that massive array of government laws, rules, and regulations which give an inflationary bias to the economy and often also reduce job opportunities in the process.

What is the answer? We need a fundamental change in the prevailing attitudes towards government involvement in business decision making. The Congress should take a new and hard look at that massive array of government regulation that has accumulated over the past century. It should eliminate those, such as in the transportation field, that interfere with the effective functioning of competitive market forces. The others, such as in the health and safety areas, should be required to meet the rigorous standards of a benefit-cost test. This approach is not a guarantee for less government intervention in the economy, but it will help to ensure less costly and less disruptive regulation where government action is necessary. Thus, progress will be made to reduce inflation and unemployment without expanding further the role of government.

The obstacles to change should not be underestimated. The politically relevant criterion hardly is that the cost to the nation of each of these special provisions may exceed the benefits to the nation. Of much greater political relevance is the fact that the benefits to some particular group are likely to far outweigh the costs to them. Thus we find that a powerful clientele exists to oppose the reduction of each special benefit.

An effort to reduce or eliminate these impediments to a free market is more likely to be taken seriously if it is evenhanded. It may be relatively easy, of course, to obtain business support for eliminating legislation favorable to labor unions or to obtain labor's backing for an effort to curtail subsidies to business. Both business and labor might readily unite behind a proposal to reduce price support payments to farmers. Yet such attempts are so obviously self-serving as to be ineffective. Hence effort to identify and remove these special protective devices must be broad and comprehensive. It must cover union powers, business and farm subsidies, and restrictive practices in the services sector, including medical and other professions.

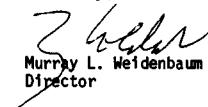
One unifying approach which might be used is the desire to remove the influence of "the dead hand of the past." Many of the specific protections were instituted to deal with depression conditions of the 1930s or the wartime period of the 1940s--situations which hardly correspond to the current reality. Certainly, a rereading of the original arguments for many of these special benefits brings to light anachronisms lingering on from a different age.

Unless the underlying institutional problems are dealt with, we may experience bursts of inflationary pressures and subsequently additional experiments in wage and price controls or other varieties of incomes policy. Although generalizations are frequently treacherous, the choice facing the United States is likely to be either creating more competition in private markets or relying more heavily on government controls over private decision making. This may well be the most enduring lesson emerging from our recent experience.

I appreciate the opportunity to present these views and I hope that they will be of help to you and the other members of the committee.

Best wishes.

Sincerely,


Murray L. Weidenbaum
Director

rk

FEDERAL RESERVE BANK OF NEW YORK

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MAY 22 1978

PAUL A. VOLCKER
PRESIDENT

May 19, 1978

The Honorable William Proxmire
Chairman, Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for soliciting my views on Tax Based Incomes Policies and other new anti-inflationary proposals that are to be the subject of the Banking, Housing and Urban Affairs Committee hearings on May 22 and 23.

While I am not prepared to endorse the so-called "TIPs" approach at this point, I do think it is highly constructive for your Committee to examine these ideas more closely. The need for new ideas in the inflation field is clear. Our inflation problem has obviously not improved. Indeed it is threatening to get worse as a result of deteriorated supply conditions in agriculture, the decline in the dollar, a range of Government actions affecting costs and prices, the re-emergence of some scattered signs of tightening in the labor market and rising business confidence that market demand will support efforts to strengthen profit margins through higher prices.

The recent signs of stronger inflationary pressures and, indeed, our whole experience with inflation in this recovery have pointed up limitations of the traditional aggregate demand policies, including monetary policy, to cope with inflation by themselves without difficult side effects. The problem arises from the fact that for a variety of reasons, the wage and price setting mechanisms in this country (and in other modern industrial economies) seem to be (or to have become) rather rigid and subject to a substantial amount of inertia. As a result, once inflation becomes established, prices and wages seem to respond more to ongoing inflationary

expectations than they do to current demand conditions. This fact produces a self-sustaining and hard-to-break core rate of inflation.

Thus changes in nominal aggregate demand in our economy tend to have relatively little effect on prices in the short run. This means that policies operating primarily on aggregate demand such as monetary policy, while absolutely essential to restore a climate of price stability, cannot move very rapidly to contain inflation without excessively restraining needed real economic expansion. Putting it another way, it means that aggregate demand policies by themselves can realistically be expected to reduce inflation only over a long time horizon without substantial risk of impairing economic growth. These features of our economy explain why the Federal Reserve has had to move so gradually over the past three years in reducing its long-term monetary targets and, to some degree, why, despite this approach, the actual path of monetary growth has not in fact been one of steady deceleration. I remain convinced that the Federal Reserve's long-run strategy of gradually reducing monetary growth will be an essential element in beating the inflation problem, but our experience of the last three years does clearly raise the question of whether it will be enough by itself.

It is this very painful situation in which we find ourselves with regard to inflation and the apparent limitations of traditional tools, coupled with the widespread (and amply justified) aversion to mandatory wage and price controls that make it desirable to debate new and as yet untried ideas such as the TIPs proposal as possible supplements to monetary and fiscal policy.

At this point, I confess to considerable skepticism about that approach, and my ideas on exactly what form a possible TIPs approach might best take are by no means fixed. It is, however, fairly easy to draw up a list of desiderata for the ideal TIPs plan. Obviously, a TIPs plan should be significant in its quantitative impact, should involve minimal distortion of the price and wage mechanism's allocative function, should be able to attract widespread support as equitable, and should involve only moderate administrative problems. My skepticism reflects the difficulty in devising a program that successfully embodies all these objectives. On grounds of administrative simplicity, for example, a TIPs plan aimed at wages would appear preferable to one aimed at prices or at both wages and prices. Moreover, such an emphasis on wages would be justified on the grounds that profit margins are not currently

high and have not themselves been a significant source of our inflationary problem. On the other hand, it is quite likely that a plan aimed solely at wages would have difficulty in attracting the support of organized labor (even though the actual tax were levied on profits) without some means of assuring that moderation in wages would be matched by moderation in prices rather than simply by widened profit margins. But if the result would be an artificial squeeze on profit margins, prospects for growth and investment would be stifled. This seems to me indicative of the kind of political/economic problems that the approach raises.

Similarly, it could be argued that ease of administration would argue for confining TIPs to penalties for above-target wage (or price) increases since it might be easier to limit a pure penalty system to a relatively small number of large firms whereas any "reward" for lower-than-target increases would probably have to be made available to all firms meeting the standards. But the inclusion of both penalties and rewards in a TIPs program would have a desirable broadening effect on its impact since a penalty-only program would involve incentives to moderate wage increases only for firms whose increases would have been above the norm in the absence of TIPs.

I am not suggesting that it will prove impossible to reconcile these various competing objectives, but they are obviously problems requiring some satisfactory resolution before a specific TIPs program could be accepted as workable and effective. The theoretical value of a satisfactory TIPs program is that it could facilitate the adjustment of the economy to a gradually lower rate of inflation through the use of the traditional monetary and fiscal policy tools while maintaining acceptable patterns of real growth and employment in the economy and without major distortions in the allocative functions of the price mechanisms. I regard the TIPs proposal as essentially an effort to use tax incentives in conjunction with the market mechanism to achieve certain effects; it is neither related to mandatory controls nor to voluntary "social contract" ideas and is in principle, at least, within the mainstream of our traditional approaches to economic issues.

Broadly, the problems with TIPs seem to relate to gaining widespread acceptability for it without introducing excessive administrative complexity and rigidity. I do not know whether these problems can be ironed out well enough to produce a satisfactory program. But I am convinced that the

bind we find ourselves in with respect to inflation is serious enough to warrant careful study of the TIPs proposal and I welcome the efforts of your Committee in this respect. I only hope that the approach in any event, not be viewed as a panacea that distracts attention from budgetary problems and the need for prudent monetary policies.

Sincerely yours,



Paul A. Volcker
President

Carnegie-Mellon University

18 MAY 24 1978 OS

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Allan H. Meltzer

Maurice Falk Professor of
Economics and Social Science

May 17, 1978

Senator William Proxmire
 United States Senate
 Committee on Banking, Housing
 and Urban Affairs
 Washington, D. C. 20510

Dear Senator Proxmire:

I am in receipt of your letter of May 1 inquiring about the merits of Tax Based Incomes Policies. I am of the opinion that such policies should not be adopted. Policies of this kind are based upon the mistaken notion that inflation rises because some groups raise their prices or wages faster than others. Inflation is principally an aggregative phenomenon and can be solved only by aggregative policies.

Let me turn to your questions.

1. Discussions of special types of inflation are generally based on the confusion between one-time changes in the price level and changes in the maintained rate of price change. Inflation is a maintained rate of increases in the price level.
2. No benefit can be obtained through TIP but substantial distortion of individual wages, prices and taxes can occur. These will have important allocative effects on the economy without having very much affect on the measured rate of price change.
3. Neither.
4. Of course not. Canons of equity require that individuals receiving the same real income should repay the same taxes. Tax based incomes policies distort the tax structure.

5. The Congress should not enact any type of TIP. There are no safeguards that can prevent the distortion between workers who receive current versus future wages, workers who elect to take vacations rather than money income, workers who receive substantial increases in their pension or health insurances instead of money income, etc.

Questions 6, 7, and 9 imply that TIP is to be adopted. I believe that any policy of this kind is inefficient and inferior to a general policy of gradual reduction in the budget deficit and in the rate of monetary growth.

Sincerely,


Allan H. Meltzer

AHM/jep

Comments on Tax Based Incomes Policies

Frederic S. Mishkin*
Department of Economics
University of Chicago

May 1978

There are several issues that should be raised in a discussion of Tax Based Incomes Policies (TIP):

1. Important political issues arise with a TIP program or any other type of wage-price controls. Such programs will, for a time, make the inflation situation appear to be better than it is, because the inflation rate may be artificially low when the program is in effect, but will jump back up again as soon as the program is eliminated. As a result of an illusory improvement on the inflation front, politicians may be prone to pursue more expansionary monetary and fiscal policy. This would lead to a build-up of inflationary pressures, resulting in a rise in the inflation rate in the future. Thus, these programs might even end up worsening the inflation rather than containing it. Such a scenario is not unreasonable considering our experience with the last round of wage and price controls.
2. A point which cannot be understressed is that inflation can only be killed by appropriate monetary and fiscal policy. A TIP program with overly expansive policy must be doomed to failure. If an inappropriate full employment target for unemployment is chosen--and there is substantial evidence that a four percent unemployment target is far too low--then our inflation problem will not be solved.
3. There is absolutely no serious evidence supporting the view that a TIP program will lower the minimum unemployment rate that is consistent with price stability. A TIP program by itself cannot lead to a situation where full employment is reached at a lower unemployment rate. Thus, there is little, if any, support for a TIP program that is permanent.

*The views expressed here are solely those of the author and do not reflect the opinion of the Department of Economics or the University of Chicago.

4. Use of a TIP program to combat inflation will not be without cost to the economy. First, there might be heavy costs and distortions as a result of the administrative difficulties of implementing such a program. Dildine, Sunley, and Rees have discussed some of these issues in the forthcoming volume of the Brookings Papers on Economic Activity and are far more qualified to discuss these administrative difficulties than I. Secondly, a TIP program which is administered fairly should not allow firms to escape TIP penalties (or alternatively get TIP subsidies) by increasing the proportion of their labor force who are low quality, low wage workers in order to lower the firm's overall wage bill per worker. Hence, one result of a fairly administered TIP program would be the imposition of an additional distortion on the economy, which is explained below. Expanding industries would want to attract more workers of a given quality by offering them a higher wage. These industries would thus be more likely to incur TIP penalties (or lose TIP subsidies) as a result. On the other hand, industries which are experiencing a decline in demand will not want to attract more workers and would have lower wage increases. Declining industries will thus not be as subject to TIP penalties and may even be entitled more frequently to TIP subsidies. In a sense, a fairly administered TIP program will be imposing a heavier tax on expanding industries than on declining industries, resulting in a shift of resources from expanding to declining industries. This of course imposes a distortion on the economy which, along with other distortions created by a TIP program, should be weighed against the possible benefits of such a program.



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May 4, 1978

1978 MAY -8 PM 12:07

The Honorable
William Proxmire
United States Senator
Chairman of the Committee on Banking,
Housing and Urban Affairs
United States Senate
Washington D.C. 20510

Dear Senator Proxmire:

Thank you for your letter of May 1 in which you ask me for my opinion concerning policy proposals that have come to be known as TIP, that is, Tax Based Incomes Policy. In what follows I will briefly express my views.

(1) The advocates of TIP are motivated by the desire to achieve by means of taxation and/or subsidization the objectives which others would want to accomplish by the harmful method of subjecting the wage and price-setting processes to administrative controls. The objective to which these proposals are directed is that of preventing cost and price developments that might lead to continued inflation coupled with an increasing degree of underutilization--so-called stagflation--when monetary and fiscal restraint is introduced with the intention of curbing inflation. Attractive though the general idea is as compared to direct controls, I do not believe TIP programs to be workable.

(2) Before turning to TIP, let me say this: I see no reason for assuming that, in the absence of incomes policies of any sort, consistent and credible monetary and fiscal restraint, expressing itself in a gradual reduction of the rate of increase in money GNP, would have the consequences the advocates of incomes policies fear (stagflation). A consistent and credible policy of gradual disinflation by monetary and fiscal means would have a significant effect on price expectations and thus on money-cost trends. Such a policy could, of course, not make the economy recessionproof (no policy could), but it would have a very good chance of avoiding major bumpiness on the road to price stability. In contrast to this, continued adherence to the policy of accommodating the underlying inflation rate would be figured out by the markets with great ease, and it would lead to continued upward flexibility of inflationary expectations. Therefore such a policy would lead to having to accommodate increasingly high "underlying" inflation rates in the successive rounds and, after a short while, this would lead to a truly severe recession.

The chances of a consistent and credible policy of monetary-fiscal disinflation cannot be appraised by examining the experience of the post-1965 period. In these years the decision makers in the private sector have had excellent reason to expect that the occasional brief periods of

anti-inflationary restraint will soon be followed by the resumption of inflationary policies. Under erratic and inflation-biased policies of that sort demand restraint will obviously result in the contraction of output rather than in the reduction of the steepness of price expectations and of the cost and the price trend. But this proves nothing whatever concerning the outlook under a consistent and credible policy. It does not support the kind of skepticism which the proponents of incomes policy have concerning reliance on consistent monetary-fiscal policies without the additional measures they favor.

(3) In my appraisal TIP would prove unworkable for at least two reasons. In terms of basic principles the main reason is that the policy inevitably implies some arbitrary conception of the wage structure, the price structure, or of both. Setting the same standards for all sectors would come near to a policy of trying to freeze these structures as of the time when the measure goes into effect, and this is one of many arbitrary decisions that could be reached. If it were reached at that time, the decision would soon have to be modified. Subsequently the modified decision would have to be modified again without becoming less arbitrary, and so on. All these arbitrary structures would get a very low mark for efficiency as well as for equity.

The other major reason for unworkability is that for a very large number of important firms it is impossible to ascertain, with the accuracy on which the IRS would have to insist, the rate of wage increase (or increase in compensation) for the identical kind of labor; and the difficulties are surely no smaller for the prices charged by multiproduct firms. One surely would not want to penalize firms for changes in their input mix or in their output mix nor for being unable to carry out mix changes which differently located firms, or firms in rival industries, are able to carry out. At the same time one does not wish to induce practices that give merely the artificial appearance of mix changes. I do not see how any version of TIP could guard against these unwanted consequences of major importance.

(4) Except for the involvement of the IRS, all these grave disadvantages are shared by mandatory wage and price controls and by euphemistically described equivalents of these. Indeed, such controls have significant additional disadvantages, and suspicions that we shall once more start experimenting with them is at present one of the major causes of the uncertainty surrounding business decisions. The advocates of TIP are aware of this, and they are trying to find an alternative, but in my appraisal their alternative is not a workable one. I feel convinced that disinflation, as I described it in (2) above, is the policy we shall have to adopt. While at present that policy still could be made one of gradualism, it would be much more difficult to do so after further flare-ups of inflation.

I remain, Senator Proxmire,
Very sincerely yours,

William Fellner
William Fellner
American Enterprise Institute
Sterling Professor of Economics Emeritus,
Yale University

Comments of Alan Greenspan;
Brookings Panel on Economic Activity
April 21, 1978 10:30 AM 12 PM 1:17

I have never been terribly persuaded that income policies, if one can generalize that term, can work for any protracted period of time, or leave any permanent effect on the wage and price structure. Nonetheless, it is clear that the TIP proposals try to confront some of the basic problems most incomes policies have.

Since there is a great deal of incentive, carrot or stick, involved, one would assume the TIP proposals simulate, in many respects, market processes. Thus, if TIP were not employed as a substitute for conventional, fiscal and monetary policies, some anti-inflation impact might be achieved. Certainly in the abstract, as a model of the type developed by Seidman illustrates, it is not difficult to construct fairly general conditions in which TIP would appear to have some marginal advantage.

The difficulty I have had, and still have, especially after these meetings, is that, while we can construct a simplified model in which a tax based incomes policy could work, the abstraction can never fully capture the complexity of a TIP in application. On this point I find myself in agreement with Pechman. No one questions we are dealing with a problem in which administration is difficult. But is that difficulty merely something that could be overcome with operational experience, or are we confronted with an issue where the very complexity of administration itself is its fatal flaw?

I suspect there is no solution to the administrative problem. Dildine and Sunley did an excellent job on their paper. However, it strikes me that they barely scratched the surface of the problems we would confront with a TIP in full scale operation.

They would not be significantly different from the administrative nightmare of our wage-price control experience following August, 1971. What struck me about that period was the inconceivable complexity of what the controllers were attempting to do, firm by firm, product by product, wage by wage, and how the whole thing held together, largely because the controllers really never attempted to confront market forces head-on.

There was an accusation at the time that the people who ran the control program did not have their heart in it and, therefore, the program did not work. In fact, every time they attempted to make the control system work -- in the sense of trying to prevent companies and unions from doing what they would ordinarily do -- the program ran into extraordinary problems and, the controllers backed away.

One very important aspect of Phases Two and Three of the control program to remember is, that although price and cost data were submitted in tremendous detail, they were never really audited. There was no effort to actively administer the program. It was de facto a voluntary program characterized by a huge paper flow, frenetic committee meetings and vague pronouncements. It was fundamentally wheel-spinning.

But, if we were to go to a legal TIP, in any of the versions, legislation would require auditing and verification of the elements of the system, at least to the same degree our tax system is audited. This would create an insurmountable administrative

problem. Litigation would quickly swamp the courts and make TIP politically infeasible almost immediately. That does not mean it may not be tried. There is a growing sense of desperation which could easily trigger risk laden policy initiatives. If the cost of failure of this type of program were zero, or there were only inconveniences associated with it, there would be no reason not to try. If worse came to worst, we would end up with an administration mess but with no permanent damage. However, there are significant costs to every policy failure; and in constructing policy initiatives, it is essential to be aware of what happens if the policy initiative goes wrong.

That is certainly true of fiscal and monetary policy. In the case of TIP, if it failed, we would still have in place a control-oriented bureaucracy and I fear the political pressures that would emerge to employ it. When government in effect says that certain price or wage relationships are appropriate, and a quasi-voluntary program fails to induce them, there is very strong political pressure to mandate them.

If a TIP were put into place, judging from what has happened in the past during control programs, the participants would very rapidly learn how to beat the system. Because it would be almost physically impossible to maintain an appropriate audit of wages and prices, the extent of avoidance, if not evasion, would become far greater than anything even remotely contemplated in the income tax system itself. This could be quite disruptive to economic policy.

Obviously, to the extent that a TIP program is narrowed and limited, the problems I outlined above are, themselves, narrowed. Thus, a limited form of "stick" TIP restricted to wages and to large companies only would, of course, sharply reduce administrative and auditing requirements. The requirements would still be voluminous

and wrought with problems, many of them unforeseeable, but it is unlikely that the system would be swamped by them.

However, to the extent that TIP is narrowed, whatever positive benefits one would expect to get in theory, would be lost. A priori it is very difficult to effectively judge the tradeoff between administrative simplicity and anti-inflation benefits.

My suspicion is, however, that the impact on wages from a limited program is likely to be much too small to be worth implementing such a major initiative in economic policy. For even a limited TIP is a big program with large administrative burdens. Unless we have a reasonable expectation of a significant anti-inflation pay-off, it is difficult to make a case for going ahead with even a limited TIP.

That is not to say I see a simple solution to the current type of chronic inflation. I am not persuaded we are stuck at a 6% or 7% inflation rate and that the unwinding which started in 1975 and lasted through late 1976, is necessarily over.

If it is, I would be gravely concerned that we might now be running up against some form of unsuspected capacity restraint. At this stage it would seem that we still have the room to continue unwinding the inflationary pressures, provided we maintain reasonable macro-policies. I think it is much too soon to throw in the sponge on macro-policy, especially if we are looking at TIP as the alternative.

This conference has made a great contribution in airing a number of the problems confronting TIP. But it may be even more complex than those of us who have been involved in similar undertakings suspect and, hence, more analysis is needed. I am most concerned that we will too easily dismiss the administrative problems. If we do, we are in for some very serious policy difficulties.

ISR

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SURVEY RESEARCH CENTER / INSTITUTE FOR SOCIAL RESEARCH / THE UNIVERSITY OF MICHIGAN / ANN ARBOR, MICHIGAN 48106

May 15, 1978

The Honorable William Proxmire
 Chairman, Committee on Banking,
 Housing and Urban Affairs
 United States Senate
 Washington, DC 20510

Dear Senator Proxmire:

Thank you for the invitation to register my views on the efficacy and desirability of "TIP"--Tax Based Incomes Policies. In general this note follows the format of the questions raised in your letter of May 1, although on some I have no expertise and therefore no opinion to offer.

Let me begin by stating that I view "TIP" as only one of a number of devices whose purpose is to make it possible to achieve a deceleration in the rate of price inflation by impacting directly on costs and the supply side of output rather than on the demand for output, profit margins, and eventually costs. And "TIP" may not be the most effective such program, although it may well play an appropriate role in a set of programs designed to reduce costs and thus prices. As you doubtless know, empirical studies of the impact of costs on prices suggest that cost changes are dominantly passed on through into price changes, with the price impact having some interaction with the strength of product demand.

The following points refer to your specific questions:

1. Special types of programs such as "TIP" are essential to an effective inflation control policy, unless one is prepared to pay a very heavy price in terms of the amount of fiscal and monetary restraint needed to reduce inflationary pressure by operating solely on the demand side. Lags in adjustment to past increases in prices, lags in contracts, considerations of equity, and expectations relating to future costs and prices all mean that the principal short-run impact of aggregate demand restraint is on output and employment and not on prices and costs. It is of course possible that a really severe set of fiscal and monetary constraints might be able to ring out inflation much more quickly than is typically supposed, but we have no direct empirical evidence (of recent relevance) on that issue.

2. It is necessary to distinguish benefits gained through "TIP", and other policies that work on costs, from benefits gained through conventional (aggregate demand restraint) types of anti-inflation programs. The benefit of the cost-focused programs is that they hit directly at cost-push inflation pressures, which are the ones that tend to make inflation reduction so difficult. Thus the benefits from "TIP" and similar programs is that they have the potential for reducing inflationary pressure without the excessive costs that seem to be associated with reducing inflation with conventional policies--those costs being very slow response, very high cost in terms of real output forgone, etc. Thus the principal benefit from "TIP" and related programs is that they have some prospect for producing a deceleration of inflation at reasonable social costs, while conventional policies seem to have little effect except at very high social costs.

The costs of "TIP" and related programs focused on cost-push are that they are likely to create inequities because of administrative difficulty in application, and are likely to result in hidden costs in the form of unforeseen side effects which cannot really be fully ascertained until the program is actually tried. "TIP" would also be ineffective in significant areas of the economy (the public sector, the nonprofit sector) where tax incentives cannot be applied because taxes are not paid.

3. I do not have an opinion on the merits of penalty or rewards approaches, although errors caused through administrative shortcomings are likely to be more serious under a penalty system than a reward system--or at least they are likely to be perceived as more inequitable.

I would not generally try to apply "TIP" or related systems to prices, but would limit it to wages. This is largely because the difficulty in administering a "TIP" system applicable to prices is much more serious than even the formidable difficulties involved in applying the system to wages. Moreover, I am persuaded that the provision of price-based incentives would be largely redundant to the beneficial effects from applying "TIP" or similar programs to wages. It is a reasonable expectation that an effective cost deceleration

program focused on wages will be carried through into prices without excessive lags.

Since a "TIP" or other cost-control system does have social costs in the form of administrative difficulties, inequities, etc., one would not like to see it installed as a permanent feature of the American economic system. On the other hand there is no obvious reason why it could not be seen as a stand-by device, to be used when the inflation rate needs to be decelerated and dropped when the inflation rate has been brought under better control. That would suggest that it be neither temporarily nor permanently installed, but installed for periods of time when the social benefits of bringing down inflation rates are high enough to outweigh the costs.

4. I doubt that an effective set of Tax Based Incomes Policies could be devised that would treat everyone fairly. I would argue that some inequity is inevitable, that the more comprehensive and detailed the system the less the inequity but the greater the cost, and quite possibly, the less effective the policy. Hence I think that one should view these systems as ones which buy one social good (deceleration of inflation) by trading it off against another social good--equity in relative income position.
5. The principal problems that should be kept in mind in considering "TIP" proposals seem to me to be two:
 - A. As indicated above, "TIP" is only one of a number of cost-decelerating programs that the Congress might well wish to consider. "TIP" is usually interpreted as a system which gives business firms incentives to hold down rates of wage increase in return for tax benefits. But the Congress itself has legislated significant cost-increasing programs, and these could be modified and/or reversed. For example, recent payroll tax, agricultural, and trade legislation or administrative decisions have clear tendencies to push up the basic inflation rate, rather than cause it to decelerate. Other people have pointed to a long list of governmental actions and programs which have the effect of pushing up costs for the private sector, and I see no reason why these should not be considered as candidates for policy change in conjunction with "TIP."

B. The second principal problem is that a workable version of "TIP" is almost certainly going to be less than universally applicable, and therefore will create inequities. Attempts to expand the coverage of "TIP" are likely to improve equity, but to greatly increase its administrative burden and probably to reduce its overall impact. As indicated before, I think you have to trade off inflation deceleration gains resulting from "TIP" and related programs against some disruptions and inequities.

6. The comments above suggest that "TIP" is likely to be more effective if applied in limited areas where it can be fairly easily administered and where its effects would be visible. Both those criteria suggest limitations to large firms.
7. I see no reason not to consider use of the tax system for the implementation of anti-inflation policy. The tax system is now used for a variety of social purposes--distributing the cost of public services among the population, promoting full employment, etc. If inflation control is an important objective, as it clearly seems to be, and the tax system can be used to aid on that front, I see no reason not to use tax incentives.

The particular problem that this causes is probably best reflected by the use of the tax system to create equity in the financing of public goods. Use of the tax system for anti-inflation purposes will probably result in some deterioration of equity. As indicated above, whether that deterioration is worth the anti-inflation benefits is a judgment that the Congress will have to make.

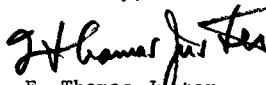
8. I really have no idea how costly implementation of "TIP" would be. A program that is content not to be comprehensive would clearly cost less than an alternative system, one limited to rewards and not penalties would mean less implementation cost (because you are likely to get less requests for review of what is seen as an inequitable impact), etc.
9. I see "TIP" as more attuned to the social contract notion than to wage and price control ideas. The attractiveness of the social contract notion is that a simultaneous decision to lower the rate of increase in wages and prices will lead to a lower rate of price inflation with no one losing out in the process.

But simultaneous agreements like that are difficult to obtain, since everyone is always looking backwards to the most recent inequity and looking for an adjustment which brings them back up to where they ought to be in the wage/price spiral. That process, coupled with strong expectations of continuation, constitutes the vicious circle that either a social contract or a "TIP" policy might be able to break. Social contract does it by informal agreement without specific financial penalties, while "TIP" achieves something of the same result by instituting penalties or rewards.

An important dimension of any such program is the impact that it has on expectations about wage and price decisions. Evidence of what determines wage rates indicates that emulation of the wage increases of others is the most important single factor. Similarly, price decisions that meet the decisions of others are not perceived as creating competitive disadvantages. Thus a policy of decelerating inflation that is widely perceived to be effective will have far-reaching influences on the wage and price decisions of people who are not directly affected. For example, even a "TIP" restricted to large corporations would have an impact on the wage decisions of everyone else, since it will affect the comparison base for wage decisions.

I appreciate the opportunity to share these views with the Committee.

Sincerely,



F. Thomas Juster
Director, ISR

mg

Abba P. Lerner for the Brookings seminar on measures to slow inflation.

I want to discuss not the sons of TIP but what is perhaps a grandson toward which the TIP family was developing. It is a Wage Increase Permit Plan (WIPP) of which I have written briefly in Challenge and Social Research.¹ Although I considered WIPP more logical, more manageable and more effective than any of the TIP's, I said there that I would support some form of TIP which seemed more likely to be acceptable and implemented. But the discussion here has convinced me that the objections to the various TIP's are much more serious than I had supposed, that most of them would not apply to WIPP, and that it is not at all so clear that a TIP would indeed be more likely of acceptance. I have also been thinking more about WIPP, developing it further and becoming more fond of it, so I want to restate it.

WIPP is based on a view of the economy on the lines suggested by Perry. I see our inflation as not due to excess demand (there is more than 5 percent unemployment), but as the result of self-fulfilling expectations, with prices rising at about 6% to keep up with cost of production, wages rising at about 9% to keep up with the cost of living and increasing productivity, while the government keeps increasing total spending in the economy to prevent catastrophic unemployment. We are caught in a vicious cycle of rising prices, rising wages, and rising total spending in which none of these can stop because the others are going on. And yet we are in a new kind of fairly stable process equilibrium--a 6 percent expectational inflation.

1. "Stagflation - Its Cause and Cure," Challenge, August 1977 and "From Pre-Keynes to Post-Keynes", Social Research Fall, 1977.

This condition of our economy is the result of a flaw in the market mechanism. We can learn some very important lessons from the natural history of another flaw. During World War II there arose a "shortage" of some essential items which led to intolerable price increases. Poor people were deprived of vital necessities which rich people were using wastefully.

The natural history begins with price control. That leads to black markets and to arbitrary and discriminatory informal rationing by shopkeepers. The informal rationing is then replaced by official formal rationing. This is still found bothersome and wasteful and is greatly improved by point rationing under which the same ration points can be used for several substitutes. Then come ration points valid for wider ranges of goods which diminishes illegal trading of rations and ration-tickets. The final stage takes the form of Michel Kalecki's general rationing. This uses just one set of points expressed in money, which essentially serve only as permits to limit the amount of money any individual can spend on the "scarce" essential commodities.

As the scarcity abated after the war, the prices of the scarce items fell so low that the allotted permits (which had had valuable black market prices) almost permitted the purchase of more than people wanted to buy. They would have become redundant and quite worthless, and simply have faded away, but the whole system was scrapped before this happened so as to provide a more dramatic (if somewhat synthetic) occasion for celebrating Decontrol.

TIP is a similar development, not quite completed, of procedures for correcting a flaw in the market mechanism, and most of the objections to TIP raised at this meeting owe their validity only to the incompleteness of the correction of the flaw. The flaw in the present instance is a mutation of the flaw responsible for the great depression of the 1930's.

That flaw was diagnosed by Keynes, and its cure prescribed, in the more elementary chapters of his General Theory of Employment Interest and Money in 1936. It was the failure of wages to fall far enough and fast enough, in response to a deficiency in demand for labor, to maintain a satisfactory level of output and employment, given the level of total spending. The cure was made easy by the availability of a free variable--increases on the level of spending. This could be adjusted to take the place of the lacking decrease in wages and prices. It was costless because of the great scope for continuing government deficits and growth of intra-national debt, and the unlimited scope for costless increases in the quantity of money.

The mutation is that wages not merely refuse to fall but keep rising, caught in a self-fulfilling expectational inflation (however it was initiated). Governments, and business, seeming to have an incurable propensity to treat our inflation as if it were due to too much total spending, hold down total spending as long as prices are rising, but desist from this when the resulting unemployment threatens to reach double digits. This is what creates the Stagflation but avoids catastrophic depression.

To deal with this mutation the simple Keynesian remedy is no longer effective. The task is now a two-fold one. It is necessary (1) to stabilize the average price (the price level), with average wages rising at the national average productivity increase, and (2) to adjust relative wages and relative prices to the continuing changes in tastes and techniques. To do this the vicious cycle must be broken of wages, prices and total spending all rising, each having to keep rising because the others are rising. Stopping any one of them could break the spell. But stopping

the spending (which the government could do) only works through catastrophic depression and severe unemployment. Prices or wages could be regulated. Prices are much more complicated than wages and price regulation is more easily evaded by quality changes. The best bet seemed the regulation of wages, which are already largely administered by collective bargaining and other large-scale decisions.

In the 1940's I developed some rules for wage regulation to achieve the two objectives, and published them in my Economics of Employment in 1951. Later this was attempted in practice by Wage-Price Guidelines and Guideposts, which included price regulation for cosmetic political purposes. Objective (1) was achieved with some success by a freeze of prices and wages, but it was soon eroded by the regulations for adjusting relative wages and prices.

This turned out to be an "administrative nightmare", parallel to the use of price control against the intolerable price increases caused by World War II "scarcities". The administrators were unable to handle the complexities or to deal with the resistances. The bureaucratic, administrative decision mechanism broke down. The task required local decisions by local people who knew the local conditions, so that something more like a decentralized market mechanism was called for.

A great step forward was made by Weintraub and Wallich in proposing such a device in Tax Incentive Plan, TIP. Weintraub used the analogy to laws against speeding, laws which people can break if they are prepared to pay the fine. The analogy is faulty because a speeding law which succeeded in keeping everyone below the speed limit would be regarded as successful.

What we need in this case is a rule--if you could call it that--which would normally and properly be broken half the time.

To fulfill our two-fold task of keeping the average price constant while leaving individual prices free, we have to keep average wages rising at a norm equal to the national average rate of productivity increase while leaving individual wage rates free. For this we need a discouragement to the granting of wage increases (or an incentive to resist wage increases) that will still permit some wage increases to exceed the norm by as much as other wage increases fail to reach the norm.

If TIP is adjusted (1) to eliminate all subsidies,² and (2) to provide equal tax incentives at all levels for equal reductions on the amounts of wage increase, with no lower or upper limit (no minimum threshold and no maximum of any kind), it would solve the incentive problem efficiently. (These are indeed the adjustments I suggested in proposing to yield WIPP in favor of TIP in my Challenge article, condition (2) is similar to adjustments suggested by Seidman). But TIP would still be left with much of the "litigation nightmare" of unlimited disputes about the appropriateness or the equity of the charges and the subsidies on different situations, because it is left with the problem of deciding how strong to make the tax-

2. Subsidies are proposed only because of a confusion of the necessity of offsetting the effects of taxes on total spending with the desirability of ameliorating hardships. Hardships apply only to people, not businesses, and their amelioration calls for income benefits, not changes on prices or wages. Similarly the word penalty is very unfortunate because it suggests a punishment imposed for doing something wrong. It is really more like the proper use of a price, which, as always, discourages people from buying something because they would rather keep the money for something else, but is not a punishment for any improprieties. This does not rule out the grants or tax reductions required to increase total demand so as to offset the effect of the charges in reducing total demand.

incentive. It would have corrected only a part of the flaw.

It would have mobilized the essential functions of price in the market mechanism namely, to discourage whatever activity calls for a price to be paid and (its mirror image), to encourage whatever enables a price to be received. Still missing would be the other half of the market mechanism, the guide to the free decisions in the social interest by setting the price at the level which equates supply to demand. WIPP, unlike TIP, uses the market mechanism to provide this guide and to adjust the incentive to the strength required.

The Wage Increase Permit Plan (WIPP), works as follows:

(1) The government grants "Wage Increase Permits" to every employer who qualifies by employing more than (say) 100 workers--or any workers whose wages are fixed by an agreement that covers more than (say) 100 workers--one permit for each (say) \$1000 of his total costs of employment (called his Wage-Bill but including all fringe benefits, etc.³). Record is kept of his Wage-Bill from a base date, including each employee's Wage (his pay plus his share of the other costs of employment⁴).

3. "It is now uniformly recognized that payments to common benefits trust funds providing, pension welfare, vocation and vocation training and other benefits represent a substantial economic portion of employee wages" (Statements and Reports Adopted by the AFL-CIO Executive Council, Bal Harbour, Florida, February 20-27, 1978, pp. 57-58).

4. These data are required by the IRS or by the Social Security Administration, with whom the Permit Authority would cooperate. The firm can allocate its total fringe benefits among the employees any way it likes as long as the total cost of all the fringe benefits is included in his Wage Bill.

(2) Newly hired employees (including all employees of new firms) entitle their (qualified) employers to additional permits--also one for each \$1000 of the Wage. Conversely, on the separation of an employee from a firm (which includes all the employees of a firm that closes down) the corresponding number of permits must be returned to the Permit Authority. This adjusts the total number of permits to changes in the Wage Bill that are due to changes in employment, not to changes in the wage level.⁵

(3) Each permit gives the employer in possession of it the right (by raising wage rates) to raise his (adjusted) Wage-Bill by (say) \$30 per annum per permit (3% of the face value of his Permits, 3% being the estimated national average rate of increase in output per employee--"productivity").

(4) The permits are freely tradable on a perfectly competitive market--like a share of IBM on the stock exchange. Any employer who wishes to increase his (adjusted) Wage Bill by more than 3% by raising wage rates must acquire correspondingly more permits. He can obtain them only by buying them or renting them from others, who have to reduce the increase in their Wage Bill by the same amount below the 3%. Any employer who reduces his wage bill would qualify for a grant of additional permits for the corresponding amount (1 Permit per \$30 of Wage Bill cut) which he can sell or rent out. The national total Wage Bill is thereby always raised by just 3% per annum by the different firm Wage Bill increases. Since the

5. Care would have to be taken to prevent evasion by firing and rehiring at higher pay so as to get free permits for an "employment increase" instead of buying permits for what is really a wage increase; and related collusions between firms and unions or among firms to switch employees for this purpose.

Wage Bill (firm and national), with the corresponding number of permits, is adjusted for changes in employment, this keeps the national average Wage rising at 3% per annum. The price of the permit is set by the market at the level where supply equals demand, which is where it just offsets the pressure, powered by the inflationary expectations, for raising wages by more than "productivity".

(5) A year later each permit would correspond not to \$1000 but to \$1030 of Wage Bill, and there would be a continuing and exponential rise in the adjusted face values of each permit. A simplification would be to issue 103 new, dated, \$1000 permits once a year for each 100 old ones turned in. The national total number of permits would then keep up with both components of the National Total Wage Bill: the volume of employment and the national average Wage.

WIPP would thus indeed "Whip Inflation Now" by achieving the two tasks attempted by wage-price regulation. It would (1) keep the average wage rising at the same rate as output per man, thus eliminating price level inflation, and (2) it would leave each particular wage free for determination by individual or collective bargaining. All other prices would be left for such free market determination as ruled before WIPP was installed. The money paid or received for permits would now be just one more of the many considerations that influence the agreements.

Wage bargaining, individual and collective, could proceed just as before, and the same is true for the setting of prices by the market. TIP and WIPP do nothing about other market imperfections, restrictive practices, monopoly, monopsony, cartels, oligopolies, etc. They do nothing to prevent monopsonistic exploitation of workers in company towns or to prevent

strong unions from forcing their employees to grant exorbitant wage increases or even from getting the government to pressure the employers to cave in where a strike threatens to endanger the economy or the health or safety of the public. As far as WIPP is concerned no individual wage or average firm wage or wage increase is "excessive" or "too little." WIPP is concerned only with the national average rate of wage increase.

One very important thing that WIPP does do --and none of the TIP's does--is to make the pressure on the employers take the form of forcing them to buy the required permits from other employers. The gains from the pressure is they clearly seem to have to be at the expense of other workers, (whose employers sell these same permits).

This is the elementary economic lesson that the economic profession has failed to teach effectively. Made clear by WIPP's permits, the pressure groups will not be able to recruit the support of the victims of their extortion. The other workers whose wage increase permits are being taken away, will be more reluctant to support the extortion under the fraudulent slogans of working class solidarity or to honor the picket lines, that are picking their own pockets.

But not this is the basic insufficiency of TIP. TIP (as modified) simulates price in using the tax as a uniform incentive for resisting the pressure for wage increases but it provides no guide to indicate how strong the tax must be to offset this pressure or to monitor the changes in the pressure.

If the pressure were fairly stable, one could rely on trial and error. But the pressure is nothing but the impact of the inflationary expectations. At present these seem to be about 9% for average wages and 6% for average

prices. If either TIP or WIPP is applied, these expectations and the consequent pressures would decrease, and the incentives would have to be reduced. Legislative and administrative adjustment of the taxes are much too slow. They would work like legislative or administrative decisions required to change the price of IBM on the stock exchange.

In speaking of WIPP as "Internalization the Inflation externality," I was shortchanging it. The adjusted TIP also internalizes it, but the "legislative nightmare"--though diminished by making the TIP tax uniform, can be exorcised only by WIPP's completion of the correction of the flaw in the market mechanism.

"Internalization" is borrowed from Pollution Theory, where Pollution Permits are an improvement on earlier anti-pollution cries like "prohibit it" or "limit it". But modern economists, prodded by Coase, understand that government fixing a price for a permit to pollute is justified only if a proper market cannot be established.

If it can, which requires the defining of a previously undefined, or inadequately defined, property right and the settlement of clear ownership, there is no longer a "pollution problem." There is just one more scarce commodity on the market. The externality has not merely been internalized by a charge, tax or permit and turned into a cost at a level decided by an administrative or, as here, by a legislative authority. Something more has been done. It has been made to reflect the value of the damage as indicated on the market by the damaged party. The full-blown market mechanism now serves as a guide to the proper intensity of the incentive. No litigation is called for. The market determines the correct price. Clarification of property rights is the euthanasia of litigation.

This completion of the corrections of the flaw corresponds to Kaleckis general rationing, which prevents the rich from wasting the necessities of the poor, plus its missing crowning perfection - making the general ration points legally tradeable.

WIPP thus automatically adjusts the wage increase permit price to the level of the current self-fulfilling inflationary expectations. As it offsets the expectation of inflation, it diminishes the inflationary wage increase, the cost increase and the price increase. This decrease in actual inflation reduces expectation of further inflation and this decreases further actual wage-, cost- and price-inflation. The inflation is automatically deflated. The self-fulfilling expectational inflation becomes self-liquidating.

Since the power of WIPP lies in the price of the permit, and the permit price is equated in the market to the pressure of the inflationary expectations, and the inflationary expectations rests on the experience of actual inflation, the price of the permit and the power of WIPP run down parallel with the inflation. In making the inflation self-liquidating WIPP also makes itself automatically self-liquidating.

The falling of the WIPP permit price to zero, when the inflationary pressure, the inflation and WIPP itself are all liquidated, corresponds of course to the eroding of the "scarcity" and the consequent fading away of the general rationing permits.

My yielding WIPP to TIP was partly due to the belief that WIPP would seem to too many people a wild-eyed revolutionary dream too good to be true. But it is indeed a most conservative device that is operating under our eyes a million times a day. It leaves each one of the large number of

quantities of some item unregulated--for free determination by a large number of people concerned with it--while the average of all these quantities stays fixed. What makes WIPP seem strange is only that the item is a new one and has not been treated in this overwhelmingly familiar way in the past.

One example of the familiar miracle will suffice. The number of oranges per consumer is freely chosen by him when he takes the equilibrium price into consideration. This price, reached by the market, automatically makes the average number of oranges demanded per consumer just equal to the average number available per consumer because the total numer demanded is equal to the total number supplied.

For this miracle to work, society, at one time, had to decide to make the ownership of oranges a legal property right of individuals. This undoubtedly was an impious, revolutionary and "antisocial" idea when first suggested to the head of an unindividualized tribe.

The new property right that needs to be created unfortunately is very different from an orange. It is the right of an employer to raise his Wage Bill and thus his average Wage. The property right comes in units of \$30, its ownership registered by the possession of one \$1000 permit. Its (uniform) price and its annual rental is determined by supply and demand in the market on which the permits (rights) are freely bought and sold and borrowed and loaned. This corrects the flaw in the market mechanism to which our inflation is due.

Let me conclude by touching briefly on a few questions about WIPP and TIP that have been raised here and elsewhere.

(1) The relatively stable 6% per annum price inflation that we have experienced in the last few years has as much right to be called an equilibrium state as the Keynesian unemployment equilibrium with stable wages. This may seem strange to those who have learned from the textbook that price rises only when there is excess demand - not in equilibrium, when demand is equal to supply. But that rule relies on a hidden (perhaps unnoticed) assumption that stable prices had been expected. It is only a special case of a more general rule. The more general rule says that if there is excess demand, the previous expectation is raised and price will rise faster than had been expected. In the special case where the expectation of price rise was zero, excess demand would cause price to rise faster than zero, and the words "faster than zero" were omitted as understood. After all, rising seems to mean rising faster than zero.

If, however, the expectation was not a zero price rise but a 6% price rise, then an excess demand, which always makes price rise more than expected, would now make price rise at more than 6%. Demand equal to supply, with no disappointed buyers or sellers, would mean no change but again it means no change in the expectation, i.e. a confirmation of the previous expectations and a continuing of the equilibrium 6% rate of price inflation. This equilibrium is the vicious cycle that TIP and WIPP have to break.

(2) The strategy of TIP and WIPP is to put a price on the granting of wage increases (over and above the actual wage increases) that would make inflationary wage increases too expensive. The use of expressions like "penalty" instead of price, or charge, is responsible for proposals of progressive punishment for more heinous "crimes" in the form of more than proportional charges for larger wage

increases. But price does its work properly only if the total paid is proportional to the amount bought, and this also applies to the price paid for granting a wage increase.

(3) More recent estimates have reduced the rate of increase of output per man from 3% to 2%. I think this is partly a reflection of the state of depression in our stagflation in which output declines in a larger proportion than employment, so that the figure would return to the previous 3% or so if TIP or WIPP succeeds in conquering the stagflation. The reduction may also be due in part to more of our resources going to produce benefits which do not appear in the measure of output--such as improvement of the environment for which only the costs are shown in the figures for output per man.

However, it will not make very much difference whether the figure adopted is 3% or 2% or 4%. Any one of these will give a stable rate of inflation between +1% and -1% and none of the serious inflation or stagflation problems.

There have also been suggestions that instead of setting the wage increase norm at the final goal of 3% (or 2%, or 4%) one should only gradually lower it from the current 9% to reach the final figure only after a number of years. One reason given for this is that a sudden end to the inflation would give an unfair advantage to those whose wages have recently been raised at the inflationary rate of around 9% as compared to those who have been waiting a year or two for their raise when the imposition of TIP or WIPP will reduce theirs to around 3%. But to continue Stagflation for years in order to soften this effect seems much too expensive a way. It is easier and far less expensive to give even the most generous compensation to those who feel they may have been harmed by the sudden and unexpected end to the inflation.

More importantly, a gradual reduction in the rate of inflation is bound to be

obscured from time to time by incidental increases and decreases in cost due to changes in circumstance. These would hide the effect of the TIP or WIPP only temporarily, but could easily lead to feelings that the inflation is not being reduced by the Plan and it would be dismantled before it had finished the job.

(4) There can be no real distinction between incentives to employers to increase their resistance to wage increases and incentives to workers to reduce their pressure for wage increases. In either case the incentive is the same tax on the same transaction. The remaining issue in all the TIP's is who should pay the tax and who should get it (as "grant"). This is the source of the "litigational nightmare". WIPP solves this problem in its allocation of the property rights involved. The "tax" is paid by those who buy or rent the permits and the "revenue" is received by the sellers or lenders of the permits. A clear title to the property rights eliminates this litigation.

(5) Cutting excise taxes, or any other taxes that enter into cost, would reduce costs and the price level. So also will any reductions of monopolistic restrictions or of restrictions on imports. There are excellent reasons for such measures to increase economic efficiency, but they do not touch the core of our inflationary process. They lower the level of prices, but only once. They do nothing to prevent the continuing and exponential inflationary trend from continuing to rise and soon more than make up for the one-time drop. Such windfalls could affect the inflationary trend only if there were a serendipitous succession of them which flatten out the actual average price movement for a period long enough to establish expectations of further stability. Although such expectations would have to be based on unwarranted anticipations of continuing windfalls, they could establish a self-fulfilling expectation of stability -

a zero rate of self-fulfilling expectational inflation - but such a happy concatenation of windfalls is not to be relied upon.

(6) If we have an efficient TIP, i.e. one with the same incentives (tax or grant deduction) to hold down wage increases at all levels, the basic grant (before the deductions) would have to be equal to the sum of the taxes and the deductions, so that the remaining part of the grant would just counterbalance the deflationary effect of the taxes. If the grant is given only to the workers who get wage increases less than the norm (as seems to be implied in Seidman's "carrot (and stick)" to induce workers to moderate their wage increase demands so as to reduce the "stick" - the deductions from the grants, we have a problem. The grants would amount to twice the total deductions. Some way would have to be found to prevent workers from doing anything at all to qualify for some of the grant or to prevent themselves from being disqualified. Otherwise, the grant would no longer be "lump sum" - i.e. independent of the wage increase.

(7) It would not be possible for departments of government to compete with private industry for permits to raise the wages of their employees. This is because the decision between public and private economic activity is a political one and cannot be left to the free market. However, the same principles are valid within the government sector. There would therefore have to be a separate set of government wage increase permits which operate within the government budget. This would check the inflation of government wages while permitting the different departments to compete with each other for employees. It would also yield the same demonstration that wage increases by any department would have to come at the expense of wages in the other departments from which the government

wage increase permits must come.

To have the same permits for government and for private industry would impose too great a pressure on the government to expand the budget in response to an increased price of permits and would result in an unconsidered shift from private industry with its limited budgets to the government with its elastic budget.

(8) WIPP does not induce any shift from employing higher paid labor to lower paid labor. I would not consider it an objection if it did. As long as there is greater unemployment among low wage workers such a shift would be socially most desirable (though full employment is of course much better). With full employment the effect would be to reduce income inequalities and this too is socially desirable. It is not even certain that efficiency would be sacrificed to equity in this case. Higher earnings are largely not rewards for investment in training but the result of privileged opportunities from ones parents in education, money, connections, and good advice or just good luck in chance opportunities.

Anyway, the complaint is not valid, and any of the benefits just mentioned should be pursued directly. WIPP does not cause such a shift because the permits are proportional to the wages and the charges for wage increases are proportional to the wage increases. Relative costs are unaffected.

The complaint does hold for TIPs with upper or lower limits to the range requiring wage increase subject to the incentives, or with different rates of charge at different levels of the firm's average wage.

(9) WIPP will not add to average cost to be passed on in additional price increases because the increase in cost to those who buy permits is exactly balanced by the decrease in cost to those who sell the permits; and in any balanced TIP the taxes which add to cost must be balanced by the offsetting

grants which do the reverse. There remain only what effects there are in the reduction of the cost due to the reduction in the wages paid.

(10) A frequent objection is that the price of the permits would be too high for practical purposes. It cannot be "too high". The price cannot be higher than what the buyers are willing to pay!

Frightening figures are obtained by counting the capital value of a permit (which would allow wage increases to be paid forever) and assuming that the inflationary pressure would last forever. The appropriate measure is the current cost of the renting of a permit for a year, and that depends on the current inflationary pressure which WIPP will reduce and eliminate.

The permits could also be used to work in the reverse direction if there should ever arise again a self-fulfilling expectation of falling average prices and wages, such as we had in the 1930's. We would then need an incentive against decreases in wages, and a requirement of permits for raising the Wage Bill less than the 3 percent required for price stability (and of course of still more such permits for actually lowering the Wage Bill). This would have served to cure the self-fulfilling deflation of the 1930's it could be what was being groped for in the pre-New Deal NIRA attempts to raise prices--e.g. by "Blue Eagle" appeals to patriotism and ideology or by raising the price of gold.

(11) I have come across concern that there would be speculation and hoarding of permits. I can see no harm in speculation, but if it should be felt desirable to prevent fluctuations in the price of the permits in order to make it easier for firms to plan, it would be possible for the government to engage in "counterspeculation"--buying and selling permits in pegging their price at what it would guess to be a longer period equilibrium price. The problems here are identical with those of fixing the rate of foreign

exchange. (The concept of "counterspeculation" is developed in my books Economics of Control (1944) and Flation (1971). Here as in the case of foreign exchanges, I think the argument for a free market price is the most convincing one.

There is no "hoarding" problem. Any permits purchased for speculative permits would be loaned out and still perform their function. The owner of a permit can gain nothing by holding it unused.

(12) WIPP does require monitoring, to see that there is no cheating. This has been considered equivalent to the problem of monitoring compliance with the wage and price regulations of the guidelines and guideposts. However, in that case what had to be checked for compliance were the innumerable prices of different products as well as the different wages, to see if they are following the guidelines, with all the problems of checking quality of products and grades of labor. None of these apply to WIPP. There is only the problem seeing that people do not claim to have permits which they do not have or give false wage statements. These involve only the detection of fraud. They do not seem to be different in kind or volume than those which are currently being handled by the IRS in connection with auditing the income tax.

(13) WIPP does not require any calculations by anyone of any average wage, classified or unclassified (although the information required for monitoring TIP, and for the IRS and for Social Security, do provide data for compiling statistics of any kind of average wage in which anybody might be interested).

(14) It is certain that WIPP and most forms of TIP would be denounced as anti-labor because they regulate wages and not prices. Workers might fear that holding down wages would not result in a corresponding holding down of prices so that real wages could fall. The government could alleviate such fears by a

guarantee to compensate all employees for the average real wage falling, or even failing to increase by a considerable amount. There would be little risk in this for the government. If in fact there should be an increase in the mark-up, so that real wages would increase by less than the increase in productivity, enormous profits would have been made on which the government could collect very high taxes.

The proposal to win the workers' support by the government granting them an initial tax rebate equal to the wage increase which is prevented by TIP or WIPP (giving them such a guarantee in advance, as it were) is most inadvisable. It would give the workers a large increase in real income. The pay raise, based on anticipated inflation, would be used to buy goods at the disinflated prices. It would pre-empt a major part of the benefits from the possible increase in output coming from the success in combatting the depression. Although it would be worth paying this for the sake of getting the future benefits, there is the danger that it would establish a precedent for the workers to expect to continue to get more than the economy provides for them in wages, and it could turn into a permanent and economically devastating subsidy to wages entailing heavy taxation and drastic reductions as government services to prevent demand inflation.

(15) It is frequently implied, and occasionally even actually stated explicitly, that the workers must really want the inflation or else they would not insist on the pay increases which are responsible for it. But even if it were conceded that all the workers are very good economists and understand this, it does not follow that they want the result. No workers are deciding to raise wages in general. They only decide to push for the increase in the wage of their particular group. The purpose of TIP and the primary purpose of

WIPP is to internalize the externality by putting into the particular pay envelope the effects of the wage increase decision on the economy as a whole. To say that the workers make the particular demands because they desire the collective result is similar to saying that the people who individually rush toward an exit in the case of a fire in a theatre, knowing that if they all do this the exits would be blocked and would all collectively perish in the fire, must be desirous of this result or else they would not rush towards the exits.

Richard Eaton Seltor, Economic Consultant
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May 16, 1978

Enclosure 17 24 Q 10

The Honorable William Proxmire
 Chairman
 Committee on Banking, Housing, and Urban Affairs
 United States Senate
 Washington, D.C. 20510

Dear Mr. Chairman:

Thank you for your letter of May 1, 1978, with enclosed tentative witness list for hearings scheduled by your Committee for May 22 and 23, requesting a submission of views on the subject of the hearings - new anti-inflation programs such as TIP (Tax-Based Incomes Policies).

The enclosed memorandum has been prepared in response to your request. The discussion in the memorandum is organized under headings which correspond to the nine questions posed in your letter for purposes of eliciting a comprehensive range of views for the hearing record on this important area of public policy.

I appreciate the opportunity to submit this material for the use of the Committee and others assisting them in the examination and analysis of constructive new policy approaches to the role of taxation in anti-inflation programs.

With best wishes,

Sincerely,

Richard E. Seltor

Enclosure

Memorandum for the Hon. William Proxmire
Chairman, Committee on Banking, Housing, and Urban Affairs
United States Senate

Subject: Questions and issues raised by "TIP" (Tax-Based Incomes Policies)

From: Richard E. Slitor
9000 Burning Tree Road
Bethesda, Maryland 20034

This memorandum is submitted in response to your request for views for inclusion in the hearing record on TIP. The discussion of TIP and its merits as an anti-inflation program is presented here under a number of headings reflecting specific economic, technical, and policy areas in which the Committee is understood to want a variety of views from those who have given particular study to inflation and taxation.

1. Type of inflation to which TIP is addressed

Various types of inflation and combinations thereof have figured in the inflationary developments and public discussions of the problem in recent years. These include the familiar classic quantity theory focussing on money supply, the Keynesian aggregate demand pull concept, the cost push process, and various sometimes related structural, bottleneck, and wage-price ratchet-effect concepts. Let me state briefly the interpretation of the current inflation problem to which I believe TIP is appropriately directed.

TIP is not designed to cope with an inflation problem stemming from a gross overexpansion of the money supply in relation to supplies of goods and services or in relation to credit needs or the amount of money work to be done.

TIP is not, in other words, a form of disguised direct control of the type almost conventionally relied upon in war or similar severe emergencies to suppress the powerful impact on the wage-price structure of huge deficit spending, monetary expansion, and the diversion of supplies of goods, services, and productive factors to national uses.

TIP is effectively designed for conditions like those which have materialized in the American economy in which expansionary and supportive fiscal and monetary policies intended to maintain and bolster the level of economic activity and increase employment have been absorbed and consequently frustrated in part because money wages and other labor compensation and therefore costs have outpaced productivity. These conditions have led into what is simplistically described as cost-push inflation. Whatever its origins, some of which will be discussed in a moment, this process is centered in the large corporate sector of the economy, where a few giant or near-giant firms with entrenched oligopoly positions and reserve market power have engaged in periodic inflationary wage settlements with powerful unions. The participants in

these confrontations hold differing views as to which a given compensation increase would merely reflect productivity or past price and profit increases or would have to be translated into new rounds of price increase by employers. In actuality, however, whatever the relative timing of the wage-cost and price increase cycles, the stakes in these confrontations have been not so much the sharing of rewards between capital and labor as the wresting of income shares away from labor and consumers in general by the strategically stronger organizations - of both labor and business - in position to exploit their economic power.

From the centrum of big business and big labor, the wage-cost-price inflation process is propagated into other other areas, including government.

One can sympathize fully with the goal of labor to get and protect its fair share and the response of business to maintain profits by passing on substantial cost increases to customers. But more than the direct distributional effects of the interplay of wages and prices is involved. The efficacy of macroeconomic policies to cope with unemployment and lagging economic progress is weakened. Additional spending by government and by beneficiaries of liberalized credit and fiscal policies is partially at least squandered on the support of inflationary price increases. More and more is spent on higher prices for the same flow of goods and services and higher wages for the same volume of production by already employed people. A pervasive side effect is the not-so-creeping expropriation of fixed dollar savings and incomes that are not adjusted to the continuing process of inflation. At some early stage, monetary and fiscal policies dedicated to aiding employment and production hesitate in the face of the employment-inflation dilemma and in the light of traditional counsels to go slow in the shadow of accelerating trends. Complacency over a chronic low annual rate of price rise gives way to reasonable concern that the process will get out of hand. After all, there is even the possibility that fueled and accommodated by fiscal and monetary concessions the process of inflation may destroy real purchasing power as fast as it is created.

There are other aspects of the present inflation problem that need to be mentioned. One of the basic realities that monetary and fiscal policy must take into account is the hierarchy of employability. The existence of what has been termed hard core unemployment is only one aspect of the range of labor differences reflecting variations in energy, character, skill, intelligence, connections, and plain likeability. Monetary and fiscal expansion to absorb the unemployed and upgrade the conditions of the lowly almost inevitably spill over into greater demand for the services of those better placed in the hierarchy of employability. Their compensation is bid up or pushed up contributing to the spiral centered in the big wage

settlements. This side process absorbs purchasing power intended to expand employment. The unemployed and the less strategically placed in the employability hierarchy may be left out or benefit little. The unemployment, welfare, and other benefits paid them to assuage the social conscience may have some adverse effect on the process of getting them back on board and on the effort to absorb the new supplies of skill and talent that flow into the economy each year.

Another aspect of the present inflation process is the inertial force, the perseverative or repetitive features of the spiral - reinforced by self-fulfilling expectations. Wages chase prices, and price increases are triggered and justified by wage rises. Fiscal and monetary policies become chained to the chariot of the perseverative process.

TIP can make a contribution in dealing with all these aspects. TIP is designed to help decelerate the process of wage determination in excess of any reasonable productivity increase standard. It also increases the attractiveness of labor receiving no more than productivity-based wage increases relative to those elements in the labor force that are already in good demand or strongly placed in the system to obtain greater compensation rises.

TIP would also serve to deal with the inertial process. It would apply tangible braking incentives and symbolize the national recognition that the present spiral is an evil, that it requires remedial attention, and that the imposition of a tax reflecting the social costs which the economy as a whole must bear as a result of excessive wage-cost settlements is a restraining instrument that will help forestall an elaborate system of controls toward which the economy may be headed if the present deteriorative process is not treated and slowed.

2. Benefits and costs of TIP

The benefits gained from TIP as against other types of anti-inflation programs are tangible and substantial. It avoids the increase in unemployment and decline in output which would result from resort to traditional restrictive fiscal and monetary approaches which buy price stability or a measure thereof at the cost of jobs, waste of economic potential, social disarrangements, and discredit to the free enterprise system. Under the conditions which have developed in the American economy, it can be argued very plausibly that moderate restrictionism previously practiced when inflationary trends threatened would now fail to curb and might even exacerbate rising prices even though employment suffered.

It is more difficult to compare TIP with voluntary approaches, including jawboning and broad social contract types of voluntarism. The evaluation of the prospects of the latter approaches under present circumstances is bound to be subjective.

When the forces of inflation are as strong and persistent as experience of recent years has demonstrated, it is difficult to place great faith in the various versions of jawboning, which have a history of ineffectiveness. Only a more substantial coming together of labor, business, and government in a serious, good-faith compact to adhere to real restraints, under the pressure of alert, aroused public opinion, could escape the label of temporizing.

As compared with a wage-price freeze or more elaborate direct control systems, TIP enjoys the advantage of being more flexible. The application of a substantial economic incentive to restrain wage and cost increases moves firmly toward the objective of deceleration of the wage-price spiral, but it avoids absolute prohibitions which tend to be effective only for an emergency period and which soon tend to call for numerous modifications, exceptions, relief features, and similar adaptations - some of doubtful equity and all dependent upon the operation of a complex bureaucratic machinery. In contrast with the direct control approach, TIP permits the parties to wage settlements to decide in the light of the TIP tax incentive structure whether it is worthwhile exceeding the anti-inflation guideline. In short, it provides incentives rather than an all-or-none, rigid, regulatory standard, which draws hard and fast limits. The elasticity of the TIP approach within the framework of the free market system is the key to its superiority over control alternatives. Such an elastic approach should be as effective as controls in bringing a halt to the destructive process of repeated rounds of wage-price inflation and would accomplish the result without the abrupt confrontation of rival economic interests over the question of who stands to gain more from the constellation of wages-costs-prices at the moment the anti-inflation system goes into effect.

Both the administrative-compliance and the economic-impact costs of TIP would be relatively low. The administrative costs of an effective program can be kept very low, as discussed under a later heading of this memorandum. The departure from the free market system would be insignificant, an appreciable advantage over the direct control alternative.

In certain situations TIP may have the effect of moderating wage increases of the type called for by particular labor shortages due to redirections of economic demand and activity. This might slow the process of resource reallocation to meet the new conditions. Even in such situations, where there may seem to be an allocative inefficiency, TIP would tend to have the salutary effect of putting some pressure on hirers of labor in the expanding area of the economy to utilize labor resources which are more abundant, possibly unemployed and needing some training and experience which would cost less than the payment of above-guideline compensation to bid the scarce labor away from existing employments.

Whatever costs are entailed in the slower adjustment and substitution processes just described are counterbalanced by

by the gain in terms of overall stability of the economy as well as the better employment opportunities for the substitute labor. The stabilization contribution of TIP in this kind of adjustment can be real in an economy in which wages and costs in economic sectors in which demand may recede do not decrease owing to the floor or ratchet restraints that characterize the system. Thus, pressure of greater demand in one area creates bottleneck effects without wage and price offsets elsewhere, so that the "local" pressure becomes tantamount to some measure of overall wage-price inflation.

3. Penalty versus rewards approach to TIP and other options

The design options reviewed under this heading have been explored elsewhere recently, notably in the Brookings Institution panel meetings on the subject of TIP, April 20-21, 1978. Consequently, my comments on these matters are brief.

Rewards approach calls for universality of application of TIP

A major drawback of the rewards approach is that its desired contribution to the palatability and "saleability" of a TIP program is more than offset by the fact that it almost necessarily requires that the availability of the TIP reward for non-inflationary behavior be made universal. Thus the coverage of the program would include all corporations large and small, sole proprietorships, and partnerships. Possibly other employer organizations which pay some form of tax on income would press for entrance. No one would very willingly consent to be left out of a special tax reduction program for which a large number, probably the vast majority, would almost automatically qualify. Nevertheless, all would have to be made subject to compliance requirements, with corresponding processing of returns by the government.

By contrast, the penalty approach may be applied to limited economic sectors that play a key role in the wage level determination process, with simplifying exemptions for small companies and unincorporated business.

Apart from the obvious revenue consequences of the rewards as against the penalty approach, there are other design problems and dilemmas in the rewards method, such as the commitment to two tax levels for all business sectors, with a differential between conformers and non-conformers which would be somewhat difficult to make consistent as between corporate and non-corporate business and which would have to be built into the tax structure from one revision episode to another.

Wages-TIP versus prices-TIP

The consensus among economists seems to be that a wages-TIP is administratively practicable, especially if confined to the large corporation group, but a prices-TIP would probably have to take the form of a tax related to some form of profit margin behavior or limitation, the definition of which would involve some sub-options. I am inclined to agree with that consensus. The prospects of administering a prices-TIP involving the application of individual business price index calculations would be too formidable.

If a tandem wages-TIP and prices-TIP system were to be implemented in order to provide a balanced package acceptable to both business and labor, it would seem likely that the profit margin approach would need to be followed with relaxed profit margin concepts in the interest of economic and administrative workability.

Limited period versus "permanent" TIP program

If it is to be effective, TIP should not be viewed as a temporary or one-shot initiative. If introduced as a temporary restraining measure, it would invite a very temporary suspension of the wage-price spiral, during which preparations and negotiations could be carried on looking toward the post-TIP relaxation and resumption of the familiar rounds of inflation.

The pressures of macroeconomic stimulation of growth and employment, the security which a high employment commitment by the Federal government offers to organized labor, and the persisting condition of upwards flexibility, downside floor or ratchet support for industrial wages and prices - all these factors - suggest the need for adding a TIP instrument to the armory of economic policy for growth and progress with reasonable stability.

The potentiality for spiralling inflation, chiefly of the cost-push variety, is present where economic stimulation for progress and high employment is a must, and the tone of the wage-price structure is set by a continuing confrontation between big business and big labor, with government, consumers, unescalated passive income recipients, small and moderate-size business, and farmers all called upon in some degree to pick up the tab.

4. Is universal fairness under TIP a realistic goal?

The fairness of the treatment of individuals, businesses, and economic interest groups under TIP may be judged by varying sets of standards. One set of standards applies tax equity criteria. Another, broader set relates to TIP in terms of its broad social and economic policy effects and implications.

Particularly as judged by tax equity standards, TIP presents three specific issues:

- the fairness of the base or starting-point wage from which increases are measured
- the fairness of interfering with the worker's ability to extract and the employer's willingness to pay above-guideline compensation, either by collective bargaining or individual wage negotiation
- the ultimate incidence or burden of the TIP tax: does it get paid ultimately by the worker, the employer, or the consumer?

Even within the relatively narrow view of tax equity standards TIP would compare favorably with tax measures such as the excess

profits tax, which has been found necessary for economic stabilization and public morale purposes in several past periods of war and related public finance and inflation emergencies. Another analogy is the interest equalization tax of 1963-74, the equity and rationale of which was supported in terms of the defense of the international balance of payments. In concept and spirit, TIP is also analogous to taxes on pollution which internalize the social costs or adverse "externalities" of pollution-causing activities which are not reflected in the marketplace - measures which have been actively discussed and in some cases employed here and abroad. Inflationary behavior at the expense of the stability of the whole economy and the welfare of millions of people outside the direct ambit of the particular wage settlement is an especially dangerous form of economic-environmental pollution. It hurts nearly everybody. Its clean-up costs for the various levels of government are great, and the costs to society which are not cleaned up because they are beyond the corrective power of government possible greater.

This country has a lengthy history and tradition of sumptuary, regulatory, and user charge taxation - typically in the form of excise taxation designed to discourage, restrain, or assist in the regulation of manufacture, use, or consumption of items which are unwholesome, dangerous, or deemed socially undesirable. The basic rationale and equity of this tax approach are generally accepted. They may be rejected by an extremist few whose philosophy is: Anything goes!

There are indeed those who do not wish to resist inflation by TIP or any other means. They even express the viewpoint that inflation may be regarded as fair - a legitimate instrument of national policy. They invert the traditional view that inflation is the cruelest, most disorderly form of taxation so that it becomes: Inflation on a systematic basis is a logical extension of ordinary tax financing that serves to commandeer resources and carry out purposes that are important for government but not important enough to the electorate to win support for straightforward tax financing. Without attempting to examine the motives for this extremist view, it is necessary to point out that much if not most of the current inflation - being of the cost-push, inertial process variety - does not serve as an extension of public finance by taxation. It represents essentially a redistributive process that helps the strong and alert to the detriment of the less favored; it weakens government and complicates its tasks, in spite of some illusory, short-lived gains.

Like any tax which measures an excess over a prior or base period figure, TIP may involve adjustments for potential inequities such as initially low compensation or initial catch-up wage settlements. Since TIP would apply each year to excessive compensation increases over the prior year, and the tax applicable to any one year's excess would presumably not be of indefinite duration, impacts on a particular year's abnormality and resulting inequity would be limited. In this regard, TIP would

compare favorably with arbitrary wage freeze and control approaches, particularly since TIP does not seek rigid control or determination of compensation levels or adjustments but merely applies a tax incentive designed to moderate abrupt, inflationary increases and make them pay for the social costs they entail if they occur in spite of the tax deterrent.

If the application of TIP to substandard or other low wage areas is deemed unfair or inappropriate, an exemption might be provided for excessive average wage increases for a firm to the extent attributable to very low wage adjustments.

5. Problems and safeguards

Since I have written extensively elsewhere on the design problems of a TIP program, particularly of the Wallich-Weintraub type, and these materials are available to the Committee, my comments on these aspects here will be brief. Apart from the question of coverage, these aspects include definition of the TIP taxpayer or TIP accounting unit, comprehensive definition of compensation for TIP purposes, the mode of applying the tax, the calculation of average rates of compensation increase or equivalent index procedures, and assorted problems of avoidance and hardship relief.

Two specific suggestions are offered here:

- a. The design should avoid excessive cost-of-living (COLA) supplements to the basic productivity component of the TIP guideline standard. The purpose of TIP is not to "exonerate" all COLA adjustments. It is to decelerate the wage-price spiral until COLA adjustments are no longer necessary. Some COLA may be necessary initially to supplement the true productivity factor (probably in the vicinity of 3 percent), but it should be moderate at the start and should be phased out on a relatively short time schedule. Too great or prolonged a COLA factor would erode the effectiveness of TIP.
- b. The design should avoid morale-weakening special concessions to highly compensated elements in the labor market, including executives, highly skilled, and highly organized or strategically placed labor elements. TIP should apply equally and with significant incentive force to all elements, particularly those affecting large and critical segments of the price structure.

6. Coverage

The most critical area for the application of TIP deceleration incentive is the large corporate industrial sector. Here compensation determinations tend to be pushed upward by reliance upon oligopoly-type pricing power of the employer and a similar type of market power of the employee organization. Here also inflationary compensation arrangements ramify throughout the cost-price structure.

Coverage-design decisions cannot rest at this point, however, with the assumption that the job is done in this manner at relatively low administrative and compliance cost. Some attention must be given to those industries characterized by relatively small business units but strong labor organization and important implications for the wage-price structure. These include trucking, construction, and possibly others in the service area, as well as mining, where the giant firm is not wholly dominant.

The development of means of reaching businesses without taxable income should also be given special consideration. In recent years some 35 to 40 percent of all active corporation income tax returns have reported no net income. In 1975, the deficit corporate group accounted for about 15 percent of total corporate receipts. As of 1973, about 13.5 percent of all corporations with assets of \$250 million or more had deficits.

7. Use of the tax system to implement anti-inflation guideposts

Use of the tax system to discourage compensation increases in excess of a reasonable noninflationary guideline or guidepost, and thus to decelerate the present spiral process through moderation of the wage-cost inflation factor is feasible and constructive. The extension of the same approach to some form of price guidepost enforcement - sometimes termed wages-TIP - would be more difficult in terms of administration and compliance. On the other hand, some assurance should be given labor that guidepost enforcement is not a one-way proposition, limited to wages, which would permit widespread price increases at the expense of a compliant and cooperative labor force.

The chief problems in a full-fledged prices-TIP geared to price increases as such seem to be the greater volatility of prices in response to specific commodity supply-demand relationships, the factor of product variation, and the difficulties in determining average price change or price indexing on an individual company basis.

Granted that problems exist, the price aspect of dealing with the inflation spiral under conditions of substantial unemployment calls for attention not merely as a counterbalance to wages-TIP but also because of the potentialities of persisting price movements in an upward direction due to structural factors, price maneuvering to maintain a perceived market-profits position, and the proliferation of one-way price changes without offsetting decreases due to the prevailing ratchet effect.

The price aspects of the inflation problem may call for measures other than TIP to help maintain stability without basic interference with market mechanisms. If a prices-TIP were to be adopted as a companion to wages-TIP, the most feasible approach would seem to be a special tax based on appropriately defined increases in profit margins.

8. Cost to the Treasury of implementing TIP

The most economical or cost-effective approach to implementing TIP would be to apply it on the basis of a size exemption which include only some 2000 to 3000 of the largest corporations. This might be amplified by extension of coverage below the standard exemption in a few critical industries, mentioned earlier, characterized by relatively small corporate units. Such a coverage would include a portion of the economy accounting for about half the total receipts of American corporate enterprise, some two-thirds of the assets and net income, but a considerably smaller fraction of employment. Nevertheless, this coverage would deal with the crucial sectors involving key wage settlements from the standpoint of decelerating the inflation spiral.

The dollar costs of implementation would, of course, vary with the scale and intensity of audit and monitoring operations and the consequent quality and thoroughness of administration. They would also vary with the inflationary pressures in the corporate economy and would be expected to ease off as the inertial movement of the prevailing spiral was brought under control. Economies of administration could be achieved since some of the TIP audit would seem to be combinable with regular income tax audit of the large companies.

We are aware of estimates that implementation on the basis of kind of large corporation coverage described above would cost only several millions of dollars. This may be too optimistic although not impossibly low. Before passing judgment, it would seem helpful to go through a simple exercise of calculating what might be regarded as a reasonable maximum cost figure.

If we assume that the administration of TIP is integrated with that of the corporate income tax, that some 1000 of the large corporations covered by TIP are selected for TIP audit on a fairly intensive basis in a particular year year, and that the additional audit-enforcement effort involves personnel and back-up services and support averaging \$20,000 per selected corporation, the total cost per year would be some \$20 million. A relatively small amount might be added for routine processing and statistical tabulation of TIP schedules and for the usual development of regulations, rulings, and review procedures. This kind of estimate would seem to give a very outside figure, based as it is on an assumed quality audit of a very large portion of the affected companies each year by skilled personnel.

A more reasonable estimate, which assumes a quality level of audit focussed on selected areas of the large corporate coverage in which wage settlement pressures were greatest for the particular year, would be half the outside figure developed above. Thus, a rough but conservative estimate would place the cost to the Treasury at about \$10 million in an initial year. As inflation pressures eased in response to the decelerating impact of TIP,

the initial costs could appropriately be reduced. Even if the TIP program were only moderately successful in bringing the inflationary spiral under control, the ratio of benefits to cost would be remarkably high, the benefits here being counted in terms of inflation-free growth of output and employment with associated restoration of confidence in the strength and durability of the free market economy. With substantially full success, the payoff by TIP in terms of restructuring and reinforcing the present fiscal and monetary tools for achieving a high-level economic effort would be enormous.

Extending the coverage of TIP to smaller corporations and possibly to sizeable unincorporated units, particularly businesses occupying a field of strategic wage determinations, would involve some addition to administrative costs for a given level of administrative effort. In general, however, the costs of expanded coverage would be far less than proportionate to the economic magnitudes affected. The reason for this effect would be the smaller frequency of smaller enterprises in which wage or salary increases averaging near or above the guideline, particularly in an environment in which wage-price spirals in the large corporate sector were decelerated and the more passive compensation adjustments of the smaller enterprises - less frequently excessive to begin with - consequently moderated.

Another point should be mentioned. If upward pressures on the wage structure should be heavy, so that numerous instances in which TIP liability is incurred appear, there would be appreciable revenue from TIP. This could exceed by many times the estimated cost figures cited here. The scrutiny of costs and operations involved in TIP might also produce a revenue payoff in terms of improved enforcement-compliance of the income tax as applied to the affected business sector.

9. View of TIP as being related to mandatory wage and price controls versus a social contract among government, labor, and business

TIP should be regarded as a preferred alternative to mandatory anti-inflation controls, in a situation in which we are fast running out of options. TIP does not attempt absolutely to prohibit inflationary conduct on the part of labor and employers. It merely imposes a tax penalty (or loss of reward) for economic decisions which impose widespread social and economic damage and costs on other groups and society in general.

TIP may also be regarded as a supplement to a social contract arrangement in which government, labor, and business come together in a broad agreement to decelerate and minimize inflation-laden settlements and related actions. Where the general terms of the social contract designed to slow or halt the inflation spiral are breached or threaten to be breached due to intransigence or disagreement on the facts in cases where hardship or special need may justify departure from the

general rule, the TIP penalty serves to deter still greater infringement and to symbolize in tangible fashion the general consensus that such actions are inimical to the general interest in high employment with stability.

To pursue the question of interrelationships among the basic options a little further, while TIP and social contract voluntarism may be conceived to operate side by side but mandatory controls are antithetical to voluntary arrangements of the social contract type, it is possible to conceive of some forms of compatibility between a mandatory system of anti-inflation controls and some elements of the TIP approach. Entertaining these "far-out" models has some heuristic value in a field that is in dire need of explorative thought and ideas. One combination approach which would rely upon both a "control" system and TIP would embody a wage guideline system that was operated by a stabilization authority outside the tax administrative structure. If the control standard was infringed, the penalty would be determined and collected under a TIP structure, which might well impose progressively greater penalties the greater the degree of infringement, ranging up to prohibitive levels for extreme infringement.

The combination system just described would transfer the specialities of inflationary wage definition and interpretation to a specialized stabilization group, keeping them out of the revenue structure. It would retain the advantage of flexibility and elasticity with respect to the enforcement of conformity by permitting infringement subject to specifically determined tax penalties.

TIP: The Wrong Way to Fight Inflation

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According to a recent survey, most Americans believe that inflation is our number one problem and President Carter "isn't doing enough" to combat it.^{1/} The only proven way to solve our inflation problem--fiscal and monetary restraint--takes time to work. But with inflation accelerating, pressure is mounting on the Administration to come up with a quick fix. And that likely means some form of incomes policy: a government policy which directly limits wage and price increases.

The government has moved in that direction this year. In his first State of the Union Address, President Carter proposed a system of "voluntary constraints" on wage and price hikes in 1978. As Herbert Stein, past chair of the President's Council of Economic Advisers, aptly noted, "voluntary constraints" is a contradiction in terms, since constraint implies compulsion or coercion.^{2/} Few people expected an appeal to patriotism to have much effect on inflation, so it seemed likely from the outset that emphasis would eventually switch from the "voluntary" to the "constraints" side of this program. That is how AFL-CIO President George Meany saw it when he termed President Carter's proposal "jawboning" and then voiced the concern held by many others that "it would be 'a step down the road' to outright wage and price controls."^{3/}

That concern was not unwarranted. President Carter recently appointed Robert Strauss as his special counselor on inflation and assigned him the task of jawboning down wage and price increases. He

will launch public attacks on companies or unions which violate the spirit of the government's "voluntary" anti-inflation program. He has stated, "We will certainly be speaking out where we think there has been poor citizenship." And Barry Bosworth, director of the Council on Wage and Price Stability, issued a public reminder that his agency has the power to subpoena cost information from business.^{4/} This is voluntary?

If the government takes the next step of actually implementing an explicit wage and price constraint policy, there is a strong chance it will be a Tax-based Incomes Policy (TIP). In its basic form, this policy levies a tax on wage increases and counts on lower wage increases turning into lower price increases. Arthur Okun of the Brookings Institution and Henry Wallich of the Board of Governors of the Federal Reserve System have urged adoption of their own versions of TIP in speeches and articles carried prominently in the media,^{5/} the Council of Economic Advisers discussed TIP plans in their 1978 Annual Report,^{6/} the Ford Foundation gave the Brookings Institution \$75,000 for a one-day seminar on TIP in April,^{7/} and the Senate's Banking, Housing, and Urban Affairs Committee held two days of hearings on TIP in May.^{8/}

In this article we examine the case for TIP and explain why this policy is the wrong way to fight inflation. Looking closely at how TIP would affect the economy, we find that it would be counterproductive.

A major flaw in TIP is its reliance on the stability of the relationship between wages and prices. TIP proponents argue that the relationship is so close that lower wage inflation turns directly into lower price inflation. Economic theory and empirical evidence show, however, that while wages and prices may be closely related in normal times, the relationship changes when government policies disrupt the

wage process. With TIP, the relationship would change enough to actually result in higher prices with lower wages.

Another big flaw in TIP is the side effects it would have. Contrary to what its proponents believe, TIP would cause all the distortionary and administrative problems of other incomes policies; the difference between TIP and explicit wage controls is just a matter of degree.

The Mechanics of TIP

Although TIP has many variants, they all reduce to being a tax on wage increases. They would work something like this: Each year the government would announce a wage increase guidepost for the next calendar year. It would also announce a TIP tax schedule. At the end of the year firms would pay a tax according to the schedule if the wage increases they granted exceeded the government's guidepost; they would receive a subsidy (a negative tax) according to the schedule if the wage increases were below the guidepost.

As an example, suppose the government announced a wage increase guidepost of 6 percent and a tax rate of 3 percent. That would mean that for each percentage point of wage increase a firm granted over (or under) 6 percent, 3 percentage points would be added to (or subtracted from) its corporate profits tax rate. If a firm granted a 10 percent wage increase--4 percentage points more than the guidepost--the firm would have 12 percentage points (the 4 excess points times the 3 percent tax rate) added to its profit tax rate (see illustration). If a firm actually granted a 6 percent wage increase, it would pay no tax and receive no subsidy. But if a firm granted a wage increase of, say, 4 percent, that would come under the 6 percent guidepost by 2 percentage

Illustration

Example of Effects of TIP on a Corporation's Profits

	<u>Initial Assumptions</u>	<u>10 Percent Wage Increase without TIP</u>	<u>10 Percent Wage Increase with TIP</u>
Profits before taxes and salary expenses	2,000,000	2,000,000	2,000,000
Less: Salary expense	<u>-1,000,000</u>	<u>-1,100,000</u>	<u>-1,100,000</u>
Equals: Profits before tax (π_{BT})	1,000,000	900,000	900,000
-----	-----	-----	-----
Profit tax rate	.50	.50	.50
Plus: TIP surcharge	+0	+0	+.12*
-----	-----	-----	-----
Equals: Effective profit tax rate (t)	.50	.50	.62
-----	-----	-----	-----
Profit tax ($T = \pi_{BT} t$)	<u>500,000</u>	<u>450,000</u>	<u>558,000</u>
Profits after tax ($\pi_{BT} - T$)	500,000	450,000	342,000
Employment costs: Salary expense and TIP Surcharge	1,000,000	1,100,000	1,208,000

*Calculation of TIP Surcharge:

Assumptions:

- . 6 percent guidepost
- . 3 percentage point surcharge for each percentage point of excess wage increases

Computation:

Excess wage increase = 10 percent - 6 percent = 4 percent.

TIP Surcharge = 3×4 percent = 12 percent or .12

points, so the firm would have 6 points (the 2 points short times the 3 percent tax rate) subtracted from its profit tax rate (a subsidy).

TIP, as presently described, could affect output and prices through two channels:

1. It would change firms' employment costs since each dollar of wage increase would cost firms more than a dollar when the tax was included.
2. It could change federal revenues and thus alter the federal deficit.

TIP proponents have proposed that the tax rate and guidepost be set so that the taxes and subsidies balance out.^{9/} TIP is intended, then, to have no direct effect on the federal deficit.^{10/}

The goal of TIP is to reduce inflation at given levels of employment. According to Wallich and Sidney Weintraub:

The twin goals of price level stability and full employment have so far eluded conventional monetary and fiscal techniques . . . [TIP] is conceived as a supplement to the familiar monetary-fiscal policies so that the economy might operate closer to full employment without the inflationary danger of excess demand and "overheating."^{11/}

Two features of TIP distinguish it from previously implemented incomes policies.

First, although the goal of TIP, like that of all incomes policies, is to slow the rate of price inflation, TIP would act directly only on wage inflation. Previous incomes policies have coupled wage constraints with price constraints. Thus, TIP's effectiveness relies on

the closeness and stability of the actual relationship between wage increases and price increases.

The other and perhaps most novel feature of TIP is that it would allow wage increases in excess of the government's guidepost; it would, however, penalize excessive wage settlements with a tax. Business and labor would still be free to reach their own bargains, though the costs of settling could be different for firms under TIP. Wage constraints applied in the past have treated guideposts as ceilings and prohibited wage settlements above them. In this respect TIP is intended to be less repressive and more reliant on market forces than previous wage constraint policies.

The Case for TIP

Arguments in favor of incomes policies generally reduce to the claim that they improve the Phillips curve relationship between inflation and unemployment--at least in the short run. That is, they allow at least temporarily a lower inflation rate at any given rate of unemployment. Indeed, Wallich and Weintraub state:

An incomes policy projects a direct attack
[on wage and price increases] and can thus improve
such a tradeoff between inflation and unemployment
as may exist in the short run.^{12/}

The claim that TIP will improve the tradeoff between unemployment and inflation is built on three arguments:

1. TIP will lower the rate of wage inflation.

According to its proponents, TIP will do this by stiffening employers' resistance to labor's wage demands. Since TIP makes larger

wage settlements even more expensive to employers, they will be more willing to hold out for smaller settlements.

2. Lower wage inflation resulting from TIP will be translated directly into lower price inflation.

This argument is based on one observation and one claim. The observation is that for the economy as a whole, prices tend to be a constant markup of unit labor costs (the total wage bill divided by total output). A constant markup implies that the rate of growth in prices is equal to the rate of growth in wages less the rate of growth in output per hours worked (productivity). The claim is that while productivity growth may vary due to cyclical factors such as employment and structural factors such as technological innovation, it will not be affected by the introduction of an incomes policy such as TIP. Since TIP will not affect productivity growth, it will, according to the growth rate relationship, lower the rate of price inflation by the same amount that it lowers the rate of wage inflation.

While TIP proponents' first two arguments build a case why TIP will reduce the rate of inflation, they do not imply by themselves that TIP will improve the existing tradeoff between unemployment and inflation. It is logically possible that TIP will lower inflation by creating more unemployment and so result in a different outcome along the Phillips curve rather than in shifting the curve. That is why TIP proponents must add a third argument to their case.

3. TIP will have only minor effects on output and employment.

Proponents include these points in their case: First, since wages and prices will be free to adjust to market forces under TIP, the program will introduce very few economic distortions and inefficiencies.

Second, most versions of TIP couple it to the corporate profits tax which is considered to be a nondistortionary tax. That is, the corporate profits tax is not supposed to alter the profit-maximizing level of a firm's output, and proponents argue TIP won't either. Finally, since TIP will be a surcharge on corporate profit taxes, it will be easy to enforce. The IRS can police TIP with little increase in staff, so unlike previously implemented incomes policies, a huge bureaucracy draining resources from the private economy need not arise.

Our Case Against TIP

We believe TIP proponents are right that TIP would slow wage inflation but wrong in their other contentions: lower wages under TIP would translate into higher, not lower prices, and TIP could have large effects on output and employment. To reach those conclusions, we first consider how TIP changes the employment, pricing, and output decisions of a typical firm. We find that TIP acts as a tax on labor. We then expand this analysis to the overall economy.

Our representative firm is assumed to have some power to determine wages and set prices; that seems consistent with what TIP proponents have in mind when they say firms are able to bargain for lower wages and mark up prices based on costs. The firm can produce one good with various combinations of capital and labor. It can employ all the capital it wants at a fixed per unit rental rate, but it can add more workers only by paying a higher wage rate.^{13/} It can sell more of its product only by lowering the price.

Without TIP the firm maximizes its profits by producing up to the point where the extra revenue from one more unit of output exactly equals the extra cost of producing that unit. Similarly, the firm

employs each input up to the point where the extra revenue from the resulting increased production exactly equals the cost of that additional input unit. The extra revenue generated by one more unit of either input is essentially the increase in revenue from selling more output at the original price less the decline in revenue from selling the original output at a lower price. The cost of an extra unit of capital is the per unit rental rate; the cost of an additional unit of labor is essentially the wage paid for the extra unit plus the increase in the wage bill resulting from the higher wage required to attract the extra labor. When the firm maximizes its profits, the change in revenue generated by a minute increase or decrease in labor or capital is exactly offset by a change in costs, leaving its profits unchanged.

Now let us suppose TIP is introduced as a surcharge on the corporate profits tax, as in the earlier illustration. Without loss in generality, we assume that the TIP guidepost is set equal to the wage increase the firm would have paid without TIP. The question is whether TIP changes any of the firm's hiring, pricing, or output decisions.

TIP doesn't change some things. It doesn't change the extra revenues generated by additional units of capital or labor. Those relationships depend on how much output is produced with an extra unit of either input, on how much revenue is increased by selling the extra output at the original price, and on how much revenue is reduced due to lowering the price to sell the extra output. And the cost of an extra unit of capital is still its per unit rental rate.

TIP does, however, change some things. The cost of adding one more unit of labor is now higher. Besides the original cost, the firm will have to pay the TIP tax, because to hire another worker the firm

will have to pay a wage above the guidepost. Thus, at the original profit-maximizing position adding another worker under TIP raises costs more than revenues and therefore decreases profits. But if at that same position the firm hires one less unit of labor instead, its costs decline more than before. That is because the firm can pay a lower wage to attract less labor, allowing its wage to come in under the guidepost and entitling it to a subsidy. Thus, at the original profit-maximizing position the decline in costs from hiring one less unit of labor is more than the decline in revenues and therefore increases profits.

So TIP will cause the firm to change its hiring, pricing, and output policies: The firm will hire less labor and offer a lower wage, and it will increase its ratio of capital to labor. It will offer fewer goods on the market due to the reduction in labor and thus will charge a higher price for its product. With the guidepost set at its original wage offer, the firm's profits will increase as a result of the TIP subsidy.

Not only will TIP change the firm's decisions in a given economic environment, it also will change the firm's responses to a changing environment. Normally, the firm will increase its labor force and its output when demand for its product increases or when its production process improves to make labor more productive. But with TIP the cost of adding labor rises more steeply than before, so that the firm will respond less to such changing conditions: it will hire fewer extra workers and increase production more modestly than without TIP.

So even though TIP is a tax on profits, it still affects a firm's employment, output, and pricing decisions. In fact, its effects are precisely those of an excise tax on labor. The economy-wide effects

of TIP, therefore, will be similar to those of any excise tax--and quite different from what TIP proponents claim.

1. TIP will lower wages, as proponents say.

An excise tax lowers the demand for the good being taxed--in this case, labor--and results in a lower price net of the tax--in this case, the wage.

2. But TIP will raise prices, not lower them, as intended.

The average price level in the economy is determined by aggregate demand and aggregate supply, the schedules of all goods demanded and offered at given prices. As a first approximation, an excise tax affects aggregate demand only to the extent that it changes government tax receipts. Since we are assuming, as TIP proponents have proposed, that the taxes and subsidies balance under TIP, we conclude that TIP will not change aggregate demand.

TIP will, however, reduce aggregate supply. Just as with other excise taxes, TIP will result in a lower demand for and a lower supply of the good being taxed. Here, the good is labor, and as we have seen, TIP raises the cost of hiring more workers and reduces firms' demand for them. Faced with lower wages, more workers will substitute leisure for labor, thus lowering the amount of labor supplied. With less total employment and a given stock of capital, then, firms altogether will produce less; that is, the aggregate supply of goods will fall.

Since TIP will not change aggregate demand but will reduce aggregate supply, it will increase the average price level. This means that TIP will change the normally stable relationship between average wages and average prices, the relationship TIP proponents count on to

make TIP an effective inflation fighter. Because of the TIP tax "wedge" between what employers have to pay for labor and what workers receive, prices will no longer be the same constant markup of wages.

Standard economic theory suggests that any government policy which alters the wage process will also affect the relationship of prices to wages for a price-setting firm. In his careful study of firm decision making, John Geweke found that:

. . . it cannot be inferred that since prices of manufactured goods are a markup on wage and raw materials prices, only the latter need be the target of any wage and price control program . . .

It is . . . likely that the form and very existence of the price equation are sensitive to any major change in policy.^{14/}

Historical evidence supports this contention--and not the case for TIP. Geweke's study sharply rejected the hypothesis that the relationship between wages and prices was the same during either of the last two price control regimes as in other times.^{15/} And our study of the early 1970s controls yields similar results: Before and after the last controls, prices were closely related to unit labor costs. However, this relationship does not imply a one-for-one pass-through from wages to prices. And more importantly, the relationship shifted significantly when wage and price controls were introduced.^{16/} Controls seem to have initially lowered inflation by lowering the price markup and, hence, profit margins. Both the markup and margins quickly recovered after the policies were removed.

3. TIP's effects on output and employment can be significant.

TIP proponents argue that wages can adjust better to market forces under TIP than under explicit wage controls, so TIP will produce relatively few market distortions and inefficiencies. But the easier it is for wages to adjust under TIP (the lower the TIP tax rate), the less effective TIP will be in controlling wage inflation. The more effective TIP is in controlling wage inflation, therefore, the less wages will be able to adjust to changing economic conditions, and the effects on output and employment can be very great.

Also contrary to what its proponents believe, TIP will divert resources from productive use to the maintenance of a costly bureaucracy. All the administrative problems normally attributed to controls also occur to some degree with excise taxes. That is because an excise tax and a control are not substantively different; they are different only in degree: the size of the tax rate. With a high enough TIP tax rate on wages, for instance, no firm can afford to pay a wage above the guidepost, so that the guidepost becomes a wage ceiling. And the higher the TIP tax rate, the more severe the administrative problems will be. As the tax rate climbs, people will have more incentive to evade TIP, so maintaining voluntary compliance will be harder. And as with all taxes, defining the tax base will not be easy.

Our last bout with wage controls required 82 pages of definitions, regulations, and rulings.^{17/} Just some of the questions likely to arise with TIP:

Definitions

1. Since TIP is attached to the corporate income tax, how will it be applied to unincorporated businesses and nonprofit institutions?

2. How will TIP be applied to new firms with no past records of salary expenses?
3. How will "the wage" be defined? Wallich and Weintraub suggest that a wage be computed for each firm by totaling wage and salary payments in each job classification and grade, dividing by the number of hours worked in the respective categories, and then combining into a weighted index.^{18/} This definition does not resolve many problems:
 - How will firms be kept from evading TIP by granting promotions? If firms promote people receiving above-guidepost wage increases, their wage indices could grow less than the guidepost although all individual increases are above it.
 - How will dollar values be attached to increased payments in kind, like more liberal use of company cars or longer work breaks and vacations?
 - How will TIP be applied to payments for work contracted out to self-employed people?

Special Cases

1. Will TIP be applied retroactively to previously negotiated wage increases?
2. Will TIP allow wage catchups to preserve wage structure? Coal miners, for instance, settled for ~~for~~ reported 37 percent wage and benefit increase over three years; should not other miners be allowed to receive similar increases?
3. Will TIP allow wage increases in excess of the guidepost if they are needed to satisfy government regulations? It is

conceivable that to comply with an OSHA regulation, for example, a firm will have to hire some high-priced labor which will cause the increase in its wage bill to exceed the guideline. Should the firm also have to pay the TIP tax as a penalty?

What if TIP taxed price increases too?

TIP is obviously the wrong way to fight inflation. While it could hold down wages, it would boost prices and cause a lot of economic distortions and administrative problems.

Possibly in response to criticisms like these, Wallich has suggested that TIP be expanded to also tax price increases.^{19/} But this would make TIP not essentially different from past wage and price control policies. The difference once again would be just a matter of degree, the size of the TIP tax rate. And many economists have pointed out that although wage and price control policies have been used against inflation in many countries at many times in history, they have never worked for long. Though they may temporarily hold down price increases, once they are removed the distortions they have caused push prices higher than they would have been otherwise.^{20/}

Why, then, do governments continue to resort to incomes policies?

The answers usually given to this question are either that governments do not learn from history or that people can be fooled into believing that their governments are attempting to do something about inflation. Maybe these answers are right, but they do not attribute much intelligence to governments or their citizens.

Our answer is that governments use incomes policies as a form of taxation. Just as income taxes and inflation transfer resources from

the private sector to the public sector, so too do wage and price controls. With controls, the government takes the resources it wants and then does not let people buy all the goods and services they want at market prices. By not allowing people to spend all they want at given prices, controls can be considered a kind of tax on money holdings.

Some form of taxation is necessary to pay for most government expenditures, of course, and governments use a variety of them--income taxes, sales and excise taxes, property taxes, inflation. This is because any single tax creates economic distortions which grow increasingly severe as the tax grows in size.

This is true for incomes policies, too. When government expenditures outstrip revenues which can be comfortably raised through existing taxes and inflation, wage and price controls may be no worse a way to transfer resources to the government than greater reliance on normal channels--but not for long. Experience has shown that very quickly controls disrupt our market economy so much that they have to be lifted.

Incomes policies, therefore, are very expensive as both a tax and an inflation fighter, and we should be wary of using them. Except in very unusual situations, the government should rely on normal ways to get resources. And it should use the only proven way to control inflation: sound monetary and fiscal policies.

¹Richard J. Levine, "Carter Inflation Battle Still Faces Problems Despite Tax-Cut Delay," Wall Street Journal, May 15, 1978, p. 1.

²Herbert Stein, "Is Government Our Partner?" Wall Street Journal, January 30, 1978, p. 12.

³Michael Ruby, Rich Thomas, and Pamela Ellis Simons, "Carter and Your Money," Newsweek, January 30, 1978, p. 23.

⁴Levine, p. 18.

⁵Henry C. Wallich, "Stabilization Goals: Balancing Inflation and Unemployment," American Economic Review, May 1978 (Papers and Proceedings of the Ninetieth Annual Meeting of the American Economic Association, New York, December 28-30, 1977), pp. 159-164; Arthur M. Okun, "The Great Stagflation Swamp," Challenge, November-December 1977, pp. 6-13; Lindley H. Clark, Jr., "The Outlook: Review of Current Trends in Business and Finance," Wall Street Journal, February 6, 1978, p. 1; Gardner Ackley, "Okun's New Tax-Based Incomes-Policy Proposal," Economic Outlook USA (Survey Research Center, Institute for Social Research, University of Michigan), Winter 1978, pp. 8-9; "Another Weapon Against Inflation: Tax Policy," Business Week, October 3, 1978, pp. 94, 96.

⁶U.S., President, Economic Report of the President together with The Annual Report of the Council of Economic Advisers (Washington, D.C.: Government Printing Office, 1978), pp. 151-2.

⁷Thomas E. Mullaney, "\$75,000, One-Day Seminar on Okun Plan for Inflation," New York Times, February 15, 1978, p. 53.

⁸David Pauly and Rich Thomas, "TIP: A New Approach," Newsweek, May 29, 1978, p. 76.

⁹Business Week, p. 94.

¹⁰One version of TIP would tax wage increases above the guidepost but would not subsidize increases below it (the "stick" approach), while another version would subsidize but would not tax (the "carrot" approach). Each version is a special case of the policy examined in the text. Each one would increase the cost of hiring an extra unit of labor--the stick version due to the increase in tax; the carrot version due to the decrease in subsidy. The actions needed to neutralize the effect of TIP on the federal budget, however, would be different for the two versions.

¹¹Henry C. Wallich and Sidney Weintraub, "A Tax-based Incomes Policy," Journal of Economic Issues, June 1971, p. 1.

¹²Wallich and Weintraub, p. 2.

¹³If we had assumed that the firm could hire all the workers it wanted at a given wage rate, TIP would be irrelevant. The extent to which the market wage rate exceeded or fell short of the guidepost would raise or lower the firm's corporate profit tax rate, but it would not affect the cost of hiring an additional worker.

¹⁴John Geweke, "Wage and Price Dynamics in U.S. Manufacturing," New Methods in Business Cycle Research: Proceedings from a Conference (Federal Reserve Bank of Minneapolis, Minnesota, 1977), p. 133.

¹⁵Geweke, pp. 128-9.

¹⁶We estimated a quarterly regression of consumer prices except food against ten past and four future lags of unit labor costs in the private nonfarm sector. In the period 1953:1 through 1971:2 the relationship appears close with an adjusted R^2 of .87. However, the coefficients on future lags are significant and indicate there is feedback running from prices to unit labor costs. Hence, ordinary least squares regressions of prices on current and past values of unit labor costs will have

biased coefficients and will not give reliable estimates of how prices change to a change in wages. Moreover, our study, like Geweke's, very strongly rejects the hypothesis that the relationship of prices to unit labor costs remained stable after the imposition of controls in 1971.

¹⁷U.S., General Services Administration, Office of the Federal Register,

Code of Federal Regulations: Economic Stabilization, revised as of October 1, 1972 (Washington, D.C.: Government Printing Office, 1972).

¹⁸Wallich and Weintraub, p. 14.

¹⁹Wallich, p. 164.

²⁰See the preceding article in this Quarterly Review.

by Walter S. McConnell and Stephen D. Leit

Inflation, Stock Prices and Job Creation

THE poor price performance of common stocks over the past decade and the resulting substantial loss of real wealth by stock investors is widely recognized. As measured by the Dow Jones industrials, the average level of stock prices in 1976 was up only 14 per cent from the average level 10 years earlier, in contrast to an increase in Gross National Product over the same period of 125 per cent. After adjustment for inflation, stock prices declined 36 per cent while GNP rose 29 per cent.

The principal cause of this poor performance has been the steep rise in the rate of inflation, which has led to higher interest rates and a fall in price/earnings ratios for common stocks. Although earnings for the Dow Jones companies increased approximately 70 per cent in the 10 years ended 1976, the positive effect on stock prices was largely offset by a reduction in price/earnings ratios from an average of 15 in 1966 to 10 last year.

Apart from the direct impact on the owners of these securities, the weak trend of stock prices has important implications for capital investment and job creation. Jobs depend on investment and investment depends on the availability of adequate supplies of capital. Outside financing has accounted for approximately 40

per cent of total fund requirements for non-financial corporations over the past 10 years, and the dependence on external sources of funds is likely to be at least as great in the 10 years ahead. Corporate financial positions have deteriorated, meanwhile, because of past emphasis on debt financing. As a consequence, a larger volume of equity financing seems necessary if overall capital needs are to be met. An adequate supply of equity capital would appear to require a stronger trend of stock prices, and this in turn will depend importantly on the pattern of inflation.

The interrelationship of these factors— inflation, interest rates, stock prices, capital investment and job creation— suggests that inflation and unemployment are not separate issues, but rather that inflation must be controlled if a large, permanent reduction in unemployment is to be achieved.

Poor Investor Performance

Stock prices have lagged well behind the growth of the economy during the last 10 years and have actually declined after adjustment for the effects of inflation. As shown in Table I, the average price of 982 for the Dow Jones industrials in 1976 was only 14 per cent greater than the average price in 1966. After allowance for the loss of purchasing power of the dollar, stock values declined by 36 per cent.¹ Over the same period, Gross National Product more than

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1. Footnotes appear at end of article.

TABLE I

	1976	1966	Change
Gross National Product (\$ bil.)			
As Reported	\$ 1,692	\$ 753	125%
Adjusted for Inflation*	1,265	981	29
Dow Jones Industrials			
As Reported	982	862	14
Adjusted for Inflation*	720	1,123	(36)
Earnings	\$ 98 (Est)	\$ 58	70
Price/Earnings Ratio	10x (Est)	15x	(5) pts.

*1972 dollars.

doubled in current dollars and increased 29 per cent on a constant dollar basis.

The immediate cause of the lag in market performance has been the lower valuation placed on earnings by investors. While earnings did not expand in line with the economy in this period, they did increase by an estimated 70 per cent. The average level of price/earnings multiples, on the other hand, declined from approximately 15 in 1966 to 10 in 1976.

Causal Role of Inflation

Although a wide range of factors influence the market's valuation of earnings, particularly on a short-term basis, both investment theory and an analysis of events in the 1966-76 period support the view that the major depressant on price/earnings ratios has been the sharp advance in interest rates. The classical approach to valuation of common stocks is to (1) project the probable flow of earnings and (2) apply a capitalization rate based on the return available from essentially risk-free investment (generally the interest rate on high-quality bonds), with an appropriate adjustment for risk. From the standpoint of investment theory, therefore, common stock prices can be expected to vary inversely with changes in interest rates as well as directly with changes in earnings and earnings prospects.²

The relationship between interest rates and inflation also is well established. Interest rates consist essentially of two components—a real rate of interest, which represents the return to investors for the use of funds, and an inflation premium to compensate for

the loss of purchasing power caused by a rise in the general price level. Because the inflation premium is based on expectations of inflation, rather than current experience, the indicated real rate of return can vary significantly from year to year.³ Over a period of time, however, changes in interest rates can be expected to conform closely to changes in the pattern of inflation.

In practice, the influence of inflation on interest rates and stock earnings yields (the reciprocal of price/earnings ratios) has been closely in line with theoretical expectations. As shown in Table II, the rate of inflation increased by 2.9 percentage points from 1966 to 1976 and this was translated into similar increases in interest rates and stock earnings yields. As a consequence, price/earnings ratios declined by one-third, substantially offsetting the favorable influence of larger earnings on market prices.

Increased Investment Requirements

A continuation of the sluggish pattern of stock prices that prevailed in the 1966-76 period could seriously restrict the economy's ability to function effectively in terms of growth of output and creation of new job opportunities. Both business investment and external financing needs are estimated to increase substantially over the next decade. Because of the weakening of corporate balance sheets, the need for new equity capital is expected to rise more than proportionately, and this capital may not be forthcoming unless the experience of equity investors improves.

TABLE II

	1976	1966	Change
Inflation*	5.8%	2.9%	2.9 pts.
Interest Rates**	8.4	5.1	3.3 pts.
Stock Earnings Yields***	10.0	6.7	3.3 pts.

*Consumer Price Index.

**Moody's AAA Bonds.

***Dow Jones Industrial Average.

For the 10 years ended 1975, total fund requirements of non-financial corporations (for plant and equipment expenditures, other physical investment and acquisition of financial assets) averaged \$108 billion a year. Capital generated internally provided 60 per cent of the total sources of funds, while outside financing provided 40 per cent. Owing to the predominance of debt financing, net additions to debt averaged \$41 billion a year, or more than twice the \$19 billion average increase in equity capital (derived from retained earnings of \$13 billion and new equity financing of six billion dollars).

A significantly higher level of investment is expected to be needed in the 10 years 1976-85 if economic and social goals are to be met. For purposes of this analysis, real growth in the economy is assumed to average four per cent a year and the inflation rate five per cent a year. Using these assumptions, Gross National Product in 1976-85 would average 135 per cent higher than in the previous 10 years.

Expenditures for plant and equipment are expected to increase faster than GNP, because of higher outlays associated with (1) the development of new energy sources, (2) a shift by industry to more energy-efficient technology and (3) the installation of facilities to meet mandated environmental and safety standards.⁴ With other physical investment and the acquisition of financial assets expected to increase in line with general economic growth, total investment in 1976-85 is projected to average \$274 billion a year, up 154 per cent from the average in the previous 10-year period.

The balance between internal and external sources of funds seems likely to be maintained at about the same level as in the past decade. The relationship of capital consumption allowances to GNP has been comparatively stable and no significant change is anticipated. The long slide in business profitability, meanwhile, appears to have ended. Pre-tax profits of non-financial corporations (after inventory adjustment) declined from 8.9 per cent of GNP in 1965 to 5.5 per cent in 1975, but recovered to 6.6 per cent in the 12 months ended September 30, 1976. The profit rate for the 1976-85 period is estimated at 6.1 per cent, in line with the average for the prior 10 years. After allowance for a moderate decline in the dividend payout ratio, retained earnings are expected to be three times the average in 1966-75.

Need for Equity Capital

Because of the big buildup in the debt burden over the past 10 years, the heavy reliance on debt financing to meet outside capital requirements is not expected to continue. Complete data on assets and

TABLE III

	Earnings Available for Interest*	Interest Charges	Interest Coverage
		(\$ bil.)	
1976*	\$148.3	\$34.4	4.3x
1975	118.6	30.8	3.8
1974	76.0	29.0	3.5
1973	101.6	24.5	4.1
1972	90.9	19.1	4.7
1971	78.0	17.9	4.3
1970	68.6	17.0	4.0
1969	77.7	13.1	5.9
1968	80.3	10.1	8.0
1967	73.9	8.7	8.5
1966	76.0	7.4	10.3
1965	70.3	6.1	11.5

*Pre-tax earnings (after inventory valuation adjustment plus foreign branch profits and interest charges).

**12 months ended September 30, 1976.

liabilities of non-financial corporations are not available, but for manufacturing companies alone liabilities rose from 64 per cent of net worth at the end of 1965 to 86 per cent at the end of 1975. (For manufacturing companies with assets of less than \$50 million, liabilities increased from 76 to 100 per cent of net worth over the same period.)

With interest rates also higher, the coverage of interest charges by earnings has worsened to an even greater extent, as Table III shows. Interest coverage for non-financial corporations narrowed from 11 times in 1965 to less than four times in 1974 and 1975. Although coverage increased to just over four times in the 12 months ended September 30, 1976, the ratio was below the minimum standard recommended by investment authorities.⁵ It should be noted, moreover, that the coverage figure relates to non-financial corporations as a whole, with the ratio considerably worse for many secondary companies.

The weakening of corporate balance sheets already appears to be having an adverse effect on debt financing. The sharp rise in the incidence of bankruptcies and near-bankruptcies in 1974 and 1975 frightened lenders and borrowers alike. Many weaker credits are still unable to find a market for new debt securities despite the recovery in corporate profits since the bottom of the recession. In other cases, managements are emphasizing debt reduction, and this may be a factor in the current slow recovery in business spending for plant and equipment.

A reduced emphasis on debt as a source of capital will require a corresponding increase in equity financing if overall investment needs are to be met. The calculations used in Table IV assume that the ratio of debt capital additions to equity capital additions will decline to 1.5:1 in the 1976-85 period (an average of \$99 billion a year for debt versus \$66 billion for equity) from 2.1:1 in the prior 10 years.

TABLE IV: Sources and Uses of Funds
 (Non-Financial Corporations)
 (\$ bil.)

	1976-85 Average	1966-75 Average*	Change
Uses of Funds			
Plant & Equipment	\$213	\$ 82	160%
Other Physical Investments	35	15	133
Net Acquisition of Financial Assets	26	11	136
Total Uses	\$274	\$108	154%
Sources of Funds			
Capital Consumption Allowance	\$137	\$ 59	132%
Retained Earnings**	43	13	231
Net Addition to Debt	99	41	141
Net New Stock Issues	23	6	283
Total Sources	\$302	\$119	154%
Discrepancy	-28	-11	154
	\$274	\$108	154%

*Source: Federal Reserve Board, Flow of Funds.

**Earnings, including foreign branch profits, less dividends and inventory valuation adjustment.

With this rate of debt additions, by 1985 total liabilities of non-financial corporations would be more than twice the 1975 base. After allowance for a moderate increase in the effective interest rate, as lower-coupon bonds mature and are refinanced at higher rates, interest charges would rise about in line with the increase in pre-tax corporate profits and earnings coverage would stabilize at around the current level of four times.

Of the indicated requirement for additional equity capital of \$66 billion a year, retained earnings are estimated to supply \$43 billion, with the remaining \$23 billion to be provided by new equity financing. This level of equity financing would be almost four times the average in 1966-75 and twice the postwar peak of \$11 billion in 1971.

Barriers to Equity Financing

There is a serious question, however, whether adequate supplies of equity capital will be made available in the absence of a sustained upward movement in stock prices. The willingness of individual investors to absorb substantial quantities of new stock issues appears particularly subject to doubt. The Value Line Composite Stock Average, consisting of 1,635 equally weighted stocks, probably comes closest to documenting the experience of individual investors, and this has been the worst performing of the general market indexes over the past 10 years.

The softness in underlying demand for stocks by individual investors is reflected in two separate measures. First, a census taken by the New York Stock Exchange showed that the number of individual shareowners fell from 31 million in 1970 to 25 mil-

lion in 1975. Second, redemptions of mutual fund shares have exceeded new sales in each of the past five years, as shown in Table V. The cumulative total of net redemptions in this five-year period has amounted to over six billion dollars.

The attractiveness of common stocks to pension fund investors also has diminished as a consequence of the low rate of return realized on stocks over the past decade and the extreme price fluctuations from year to year. In addition, the new pension reform legislation has focused attention on the personal responsibility of pension fund trustees and fiduciaries and made them less willing to assume the risks associated with stock investment. As shown in Table VI, the portion of new pension fund investment allocated to common stocks dropped steeply in 1973-74 as market prices declined. The percentage

TABLE V: Mutual Funds*
 (\$ bil.)

	Sales	Redemptions	Net Sales (Redemptions)
1976**	\$3.6	\$6.2	\$(2.6)
1975	3.3	3.7	(0.4)
1974	3.1	3.4	(0.3)
1973	4.4	5.7	(1.3)
1972	4.9	6.6	(1.7)
1971	5.1	4.7	0.4
1970	4.6	3.0	1.6
1969	6.7	3.6	3.1
1968	6.8	3.8	3.0
1967	4.6	2.7	1.9
1966	4.7	2.0	2.7

*Excludes money market funds.

**11 months.

Source: Investment Company Institute.

TABLE VI: Private Non-Insured Pension Funds (\$ bil.)

Year-to-Year Change in Book Value			
Common Stocks	Total Assets	Change in Stocks	as percentage of Change in Assets
1976*	\$ 4.1	\$ 6.3	65%
1975	4.3	11.4	38
1974	(1.3)	7.2	—
1973	6.0	9.0	67
1972	11.8	11.1	106
1971	11.0	9.4	117
1970	3.9	6.4	60
1969	6.1	7.5	82
1968	6.8	8.8	77
1967	5.9	8.1	73
1966	4.0	7.0	56

*Six months.

Source: SEC Statistical Bulletin.

of funds applied to stock investment has since increased with the recovery in the market, but has remained below the levels typical of earlier years.

Implications

These indications of reduced investor interest in common stocks suggest that the market will not accommodate the much larger volume of equity financing that appears to be needed in the 1976-85 period. To the extent that a shortfall of equity capital develops, the economy is likely to be faced with a persistent problem of underinvestment and a chronic tendency toward unacceptably high levels of unemployment.

With the surplus of labor at present apparently greater than the surplus of plant and equipment, the effect on unemployment of an inadequate level of investment may show up over the relatively near term. As indicated in Table VII, the 7.7 per cent average rate of unemployment during 1976 was significantly higher than in earlier periods when the utilization rate for manufacturing capacity also was on the order of 80 per cent. The current utilization rate, meanwhile, is less than 10 per cent below the 1973 figure of 88 per cent, when the economy was characterized by shortages of a variety of products. Accordingly, an accelerated pace of new investment ap-

pears necessary if a relatively full rate of employment is to be achieved during the current recovery cycle.

In addition to the direct impact on employment, a lag in common stock financing and in overall capital formation would have secondary effects that also would be contrary to public policy. In an environment of relative scarcity of capital, funds would be expected to flow to the largest and financially strongest companies, with an accompanying increase in concentration of economic power. Because of the greater incidence of risk, capital inadequacies would be reflected primarily in a reduced supply of funds for secondary companies, small businesses and venture capital projects.

Policy Alternatives

Either of two courses of action could eliminate or modify significantly the prospective shortfall in the supply of equity capital. The first would provide tax incentives to increase business earnings and cash flow. Tax incentives might consist of a reduction in the corporate tax rate, an increase in the investment credit, the elimination of double taxation on dividends and a faster write-off of business investment. An increase in earnings as a result of tax relief for business would enhance the supply of equity capital directly and also indirectly through a rise in stock prices and an accompanying increase in the ability of the market to absorb new equity issues.

A major change in the tax laws to aid business profits, however, would probably not be practical from a political standpoint. Moreover, the effect of higher earnings on market prices and access to equity financing would depend importantly on the trend of inflation.

Another, and more promising, approach would be to focus fiscal and monetary policy on lowering the rate of inflation. A reduction of two percentage points in the perceived rate of inflation, for example, with a corresponding decline in interest rates and stock earnings yields, would increase price/earnings multiples from 10.0 times to 12.5 times. After allowance for earnings growth over, say, a three-year period, the combination of larger earnings and higher multiples might raise the overall level of stock prices by 50 per cent. Such an increase would be expected to have a meaningful effect on the market's ability to absorb new equity financing. At the same time, a lower inflation rate would reduce the current dollar cost of new investment, while a decline in interest rates would improve earnings coverage of interest charges and permit business to carry a larger volume of debt.

A policy emphasizing control of inflation would conclude on page 62

TABLE VII: Unemployment and Manufacturing Capacity Utilization

	Unemployment	Capacity Utilization*
1976	7.7%	80%
1971	5.9	78
1970	4.9	79

*Source: Federal Reserve Board.

Inflation, Stock Prices and Job Creation

concluded from page 29

also face political obstacles, although increased recognition by the general public of the adverse effects of inflation on real incomes and purchasing power suggests that opposition would be less than in the past. In view of the positive impact of a lower inflation rate on economic growth and job creation (as well as the ancillary advantages of increased social and political stability), the cost-benefit relationship of a policy of inflation restraint would appear to be clearly favorable. ■

Footnotes

- Figures for other stock market averages are as follows:

	1966-1976 Change	
	As Reported	Adjusted for Inflation
S&P 500	23%	(32)%
S&P Industrials	28	(28)
Value Line Composite	(31)	(61)

- Arthur Stone Dewing, *Financial Policy of Corporations*: "Irrespective of the influences which play upon the relative security of a particular investment and irrespective of other economic forces, a rise in pure interest rates tends to depress all investment values, and conversely a fall in pure interest rates tends to enhance all investment values."
- In 1974 and 1975, real returns were negative, apparently because bond investors assumed that the high current rates of inflation would not continue, an assumption that so far has proved correct.
- Capital Formation: The Problem Remains* (General Electric Company, 1976). Barry Bosworth, James Duesenberry and Andrew Carron, *Capital Needs in the Seventies* (Brookings Institute, 1975). Benjamin Friedman, *Physical Capital Formation and Financial Capital Scarcity* (Harvard University, 1976). *The Annual Report of the Council of Economic Advisers*, 1976.
- Graham, Dodd and Cottle, in *Security Analysis*, recommend a minimum coverage of fixed charges of seven times for industrial companies and four times for utilities. The earnings figure recommended for use in calculating coverage is the average for the prior seven years, a more stringent standard than current-year earnings.

Remarks by

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at the
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WAGE AND PRICE CONTROLS ARE WORSE THAN WE THINK

Isaac Newton was once asked why he was able to make so many great scientific discoveries. He responded; "if I have seen further than other men, it is because I have stood on the shoulders of giants." Unfortunately, when we talk about economics, we mostly stand on each others feet. For example, according to a recent national opinion poll, inflation is now regarded as the number one economic problem in the United States. And according to the same poll, 50 percent of the people feel that because of our worsening inflation problem, wage and price controls should be imposed on American businessmen and workers. This faith in the ability of wage and price controls to improve the inflation outlook is unfortunate, because the available evidence suggests that controls are ineffective in solving the inflation problem.

In fact, if we get off each others feet and try to stand back where we can get a clear view of wage and price controls, we see that they merely attack the symptoms rather than the causes of inflation. The principal causes are excessive monetary growth, large deficits in the federal budget, and government policies that inhibit the workings of our market economy. Consequently, only by cutting the government deficit, reducing the rate of growth of money, and improving the structure of our economy can we expect to make lasting progress against inflation. Wage and price control programs (including so-called TIP programs) won't work. In fact, they tend to make our inflation problem worse.

I. Why Wage and Price Controls Cause Higher Inflation

It has always been recognized that price controls can cause disruptions in economic activity. Because an economy under price controls is constrained in its ability to adjust to changing tastes and

resource availability, lower production will generally accompany any controls program. If the underlying factors that cause inflation are unaffected by price controls, the economy will end up with higher, not lower, prices. That is, with the same amount of money and government debt outstanding and with a smaller volume of goods produced, the average price of those goods will be higher.

A brief look at what happened in our ill fated use of controls in 1971-74 will hopefully remind us that such wage and price policies have very unfortunate and undesired effects.

Rigid Prices Produce Bottlenecks and Shortages

In setting prices in a market economy, individual decision makers process a lot of information. Each day, some businessmen adjust the prices of their goods and services in response to new information--they increase some prices, decrease others, and leave the rest unchanged. These relative adjustments in prices ensure that markets "clear" and that resources are directed toward uses most highly valued by spenders. But the imposition of wage and price controls short-circuits this automatic adjustment process. Prices of goods are locked into fixed relationships to each other, with the result that changing market conditions produce shortages in some sectors of the economy.

For example, in the summer and fall of 1973--two years after comprehensive controls were first imposed--we had extensive shortages of a wide variety of goods. But at the same time we had substantial slack, or excess capacity, in many sectors of the economy.

Production cutbacks in the aluminum industry, for example, caused serious shortages in other key industries. In the fall of 1973,

a large aluminum company announced that it was cutting production of several major items due to "poor cost-price relationships present under price restrictions." Other companies also reportedly cut production of low-profit items. At the same time, shortages of critical aluminum inputs threatened a significant reduction in production for air conditioning and refrigeration manufacturers. And according to a major architectural trade association, operations of its members were cut back 30 percent in the fall of 1973 due to shortages of aluminum. In each of these cases, many jobs were lost as production was shut down.

Similar problems developed in the steel industry. Although faced with substantial excess capacity and strong market demand in many product lines, steel manufacturers nevertheless cut production because the controls had frozen prices too low for them to make a reasonable profit. Production in both the coal and the petroleum industries was hurt by cutbacks in steel products necessary for oil drilling and coal mining. These cutbacks came in the weeks just after the OPEC embargo when energy shortages were mounting in the U.S.

Increased Exports at the Expense of Local Needs

Producers faced with controlled domestic prices often sought relief by stepping up their exports--and by selling abroad at higher world prices, more shortages were created at home. Both the chemical and fertilizer industries responded to low domestic prices set by the controllers by increasing sales of products abroad. By late 1973 foreign prices of chemicals were two to four times higher than domestically controlled prices, and some firms doubled their exports. In fertilizer, where the difference between foreign and domestic prices was

also large, exports increased substantially in 1973 before controls were removed late in the year. Once controls were eliminated, planned exports of all goods dropped precipitously. (Shortages of fertilizer, I might add, had a significant impact on output per acre in agriculture and, consequently, on food prices.)

Bartering and Other Distortions

Controlling relative prices also increased the number of firms bartering to exchange one scarce good for another. In some cases a scarce good passed through half a dozen or more hands, each time being bartered for something equally scarce before reaching a final purchaser. In fact, the revenues of chemical trading specialists, who locate and acquire chemicals for their customers, doubled in 1973; they jumped from \$300 million to \$600 million. And I don't have to tell you how inefficient and costly bartering is compared to exchange in a monetary economy.

Illegal activities were also on the rise as the controls program unwound. There were frequent reports of tie-in sales, which forced a purchaser to buy an unneeded good in order to get a needed good in short supply. Also, suppliers of such scarce goods sometimes arranged to sell them for export at the high world price; but the "importer" turned out to be a domestic firm, and the goods never left the country.

Disincentives for Investment

These distortions could conceivably have been anticipated and eliminated by a much wiser control authority--one that possessed the collective knowledge of all market participants, an obviously impossible task. But one distortion even an all-knowing control authority could not have prevented was the stifling of business investment spending.

It is easy to see why businesses would be reluctant to expand capacity during a controls program.

In an uncontrolled economy, a producer's desired level of capacity is based on a comparison of the costs and expected benefits of holding excess capacity. When producers decide whether or not to build a new plant, they do not know for sure how profitable their investment will be. They are uncertain about raw material and labor costs and about product demand. In effect, most producers face a distribution of possible outcomes ranging from a small chance of large losses through much more likely probabilities of moderate profits to some small chance of large profits.

Price controls narrow this range of probable profits considerably, thus reducing the average or expected profits from excess capacity. That is, under price controls, even when demand is heavy firms know they can make only modest profits because prices will not be allowed to rise to reflect the increased demand. Since the expected benefits of holding excess capacity are therefore reduced, some facilities which otherwise would have been built are left unbuilt. And more generally, the economy loses its ability to respond to future surges in demand.

This is clearly what happened during the recent U.S. price controls program. In manufacturing, for example, the Federal Reserve Board's index of capacity grew at an average rate of 5 1/4 percent between 1962 and 1970. For the two years just before price controls, the growth rate averaged 4 percent; however, that fell to 3 1/4 percent in the first two years of controls. This drop occurred even though the controls period was one of strong economic growth, while the period just before it included a recession.

The experience of individual industries in the materials-producing sector illustrates even more dramatically the depressing effects of price controls on investment. In the major materials industries--including paper, steel, aluminum, chemicals, and many others--capacity grew more slowly during the first two years of the controls program than during the two years before it. And by 1973, after very rapid growth in the economy, most industries continued to expand capacity at a slower rate than before the controls period--in fact, at a rate well below the trend growth of the 1960s. This investment slowdown, I should note, came at a time when capacity utilization rates were at or near record highs in many industries. So the reluctance of firms to expand capacity had to be mostly due to the wage and price controls program.

Controls Encourage Overly Expansive Monetary and Fiscal Policies

Aside from lowering real output, controls produce another major problem for the economy. During the early stages of a controls program, measured price increases are lower than the actual rate of inflation. With the inflation problem thus temporarily swept under the rug, policy makers have a tendency to become less concerned about inflation in formulating monetary and fiscal policies. They are thus tempted to let the money supply grow too fast or the deficit become too large in an effort to provide a stronger "stimulus" to the economy.

This appears to have happened during the 1971-74 wage and price controls program. In 1972, the first full year of price controls in the U.S., the narrowly defined money supply--M1--grew at a 9 percent annual rate, the most rapid annual growth ever for M1. At the same

time, the federal budget deficit was almost \$25 billion. And this occurred, I might add, while the economy was operating at nearly full capacity.

This tendency of policy makers to seek short-term gains at the expense of longer-term goals provides still another reason why wage and price controls have a negative impact on the economy.

II. Will Tax-based Incomes Policies--"TIP"--Work?

Recently people have been talking about a form of incomes policies that hasn't been tried in the U.S.: for example, using the government's taxing power to slow the rate of inflation by penalizing "excessive" wage increases. Yet I doubt these policies work to reduce inflationary pressures, because all of the criticisms of wage and price control programs apply also to tax-based programs.

A common version of a "TIP"--or "Tax-based Incomes Policy"--plan would tax employers who increased wages more than some percentage set by the government. In effect, the "TIP" plan falls somewhere between full wage controls and no controls at all. Unlike a standard controls program, which effectively imposes an infinitely large tax on wage settlements larger than government guidelines (since such settlements are prohibited), the TIP plan would permit wage settlements that exceed guidelines and would tax these settlements at some finite rate.

Just as any other incomes policy, this one is not likely to reduce inflation. TIP could be evaded by "promoting" employees receiving above-guideline pay increases and by expanding fringe benefits. The only way to avoid this would be to have detailed rules and regulations which were "enforced" by a large bureaucracy--just like any other wage and price control program.

In sectors where demand grew rapidly, TIP could actually increase inflation. Firms in these industries would want to bid labor away from other industries so that production could be increased to meet demand. But this would require firms in growing industries to raise wages more than the government allowed and thereby pay higher taxes. The total wage cost--including both wages paid to employees and wage taxes paid to the government--could therefore be higher under TIP than without it. Thus, under TIP the very industries producing goods most highly valued by society would be placed at a disadvantage relative to industries facing weaker demands.

TIP could lead to higher unemployment. The tax penalty levied against "excessive" wage increases represents a tax against labor. And everybody knows that whenever the government puts a tax on a particular item, that item becomes less popular in the marketplace. Put another way, the TIP tax on labor would encourage businessmen, seeking to keep their costs down, to substitute other factors of production for labor.

TIP would be hard and costly to administer too (as is any controls program). For example:

- . Since TIP would be tied to the corporate income tax, how would unincorporated businesses and nonprofit institutions be treated?
- . How would the program be applied to new firms with no past records of salary expenses?
- . How would TIP be applied to salary increases based on previously negotiated contracts?
- . How would it handle costs associated with work contracted out?

. How would demands for "catch up" wage increases be handled? Might not aluminum workers, for example, argue that a large pay increase is required in their next contract to preserve comparability with steel workers who received a large settlement in 1977?

In short, TIP would require detailed and cumbersome regulations, enforced by a large, costly bureaucracy, and cause many of the same kinds of economic distortions that we had in the recent U.S. control program--without reducing inflation.

III. Conclusion: There is Still No Free Lunch

Those who currently propose incomes policies to reduce inflation appear to think that a modest control program will yield major benefits in terms of reduced inflation. But, as we've seen, things don't work that way. Controls produce shortages and other distortions, and they reduce the incentives of businessmen to invest in the plant and equipment necessary to sustain a growing, dynamic economy. The economy with its massive needs for continual adjustment to changing conditions stag-nates under controls as the natural adaptive mechanism of the market is destroyed. Prices themselves may be held down temporarily. But the inevitable lifting controls unleashes even more inflation.

The evidence suggests that we are worse off after any incomes policies than before. The lower supply of goods aggravates inflation, and inequities of all kinds are created. Bureaucratic waste and a growing stack of government regulations emerge as the controllers adjusted to endless unanticipated effects of shackling the economy. And if maintained long enough, controls erode some of our basic political and personal freedoms.

Inflation is a serious problem--our most serious economic problem--but we cannot solve it through programs that ignore its fundamental causes. The price level and its rate of growth are largely determined by government policies. Businessmen and consumers operate within this framework to determine the relative prices of goods and services. The solution to our inflation problem, therefore, cannot be wage and price controls; it can only be more responsible fiscal, monetary, and other governmental policies.

Attempts to try the "free lunch" of stable prices with the currency of incomes policies are doomed to failure. Whether we call it jaw boning, TIP, wage and price controls, or anything else, they are not going to provide easy answers to a most difficult problem. I hope we will have the courage to stop looking for the easy way out, and instead meet the inflation problem head on. For if we continue to try for a free lunch through incomes policies, we will all too soon again realize we can't really afford the price. Prudent monetary, fiscal, and other government policies are the only really cost-effective alternatives we have.

STATEMENT OF GARY HART, A U.S. SENATOR FROM THE STATE OF COLORADO

Mr. Chairman and members of the Committee, thank you for the opportunity to speak to you today on proposals to combat inflation. This testimony highlights the worsening inflationary spiral, and proposes legislation for a counter-inflationary incentives program.

Unarguably, inflation is getting worse. Last March, consumer prices increased at a 10 percent annual rate, compared to last year's average rate of 7 percent. The wholesale price index increased at a 16 percent rate, compared to last year's average of 6 percent. Employees, especially unions, are likely to bargain hard for wage increases which will help them keep ahead of advancing inflation. Similarly, fearing inflation of labor and raw materials costs, corporate managers are likely to try to increase prices even faster to avoid a profits squeeze.

Individual actions by people trying to keep ahead will be self-defeating. Everyone acting independently will result in acceleration of the inflation that nobody wants. Existing policies to curb inflation are not working. It's time to try new approaches.

Before discussing new anti-inflation measures, it is important to show how our economy is crippled by inflation. To do this, it is necessary to understand the relation between inflation, investment, and productivity. Wages are directly related to the value of the product that workers make. Under normal conditions, firms invest in capital equipment which increases the productivity or the output of each worker, whose wages can be increased a corresponding amount. While trying to catch up with inflation, if workers obtain larger wage increases than their productivity gains, firms must pass on most of the wage increases as price increases. The resulting inflation reduces the purchasing power of higher wages. In the end, the wage bargain results in no gain for the workers.

NO GAIN IN WORKER'S REAL INCOMES

Figures for the past eight years show dramatically how wage increases were eroded by inflation. While average hourly wages increased by 75 percent over the eight years, the actual purchasing power of the higher wages (which economists call real incomes) increased only 2.9 percent. Over this same period, worker's productivity increased also by exactly 2.9 percent. It is clear, then, that to increase "real incomes," there must be more investment to increase productivity. Any wage bargains exceeding productivity lead to higher prices which are counter-productive. While the average worker received a very slight gain in purchasing power over the past eight years, some people on fixed incomes (from retirement, child support payments, etc.) actually suffered a reduced standard of living.

Workers should not be singled out as the only inflation problem. Corporate management is equally responsible. Management tries to recoup profits lost when inflation of wages and raw materials raises costs of profit-squeezing levels. Or management may anticipate future cost increases, and thus raise prices to "protect" profits. Either way, price increases result in reduced profits again.

When one firm increases prices, this can increase the costs of materials purchased by other firms, and often results in price increases for the first firm. For example, increased steel prices result in higher truck prices, which increase the cost of trucking supplies to steel mills. Also, price increases result in higher wages (as workers demand higher salaries to keep up), which in turn increase costs for the first firm.

NO INCREASES IN PROFITS

Thus, if only one firm followed this course, it might actually achieve higher real profits. But many firms are raising prices, with the result that profits are not actually increased after adjustment for inflation. During the last eight years, total profits increased by 45 percent. However, when adjusted for inflation, these profits really showed no increase at all. The rate of return on capital

actually declined. Thus, firms can increase profits only by investing in more capital equipment to increase output. With more output, both owners of firms and workers can achieve higher "real income."

To make matters worse, the present resurging inflation threatens to frighten investors away. When inflation begins to increase, investors grow fearful that costs, including interest rates, will eliminate future profits. They postpone investment which prevents the purchase of new capital equipment to increase wages and profits.

To increase investment, we must reduce inflation now. This can only be done if workers refrain from trying to increase wages too fast, and if firms refrain from unjustified price increases. The current system encourages workers to try to increase wages sooner and faster than managers raise prices. The same system encourages managers to increase prices sooner and faster than wages increase. To get workers and managers to refrain, we must change the economic incentives.

Now, what are we doing about inflation? It is now generally agreed by economists that monetary and fiscal policy cannot further improve business conditions for economic growth. Faster growth of money supply and larger Federal deficits may promote more jobs in the short run, but will lead to inflation and then recession in a year or so. Similarly, even higher interest rates and smaller Federal deficits will slow the present economic expansion, and will cause more unemployment with no guarantee that inflation will be cured.

Acknowledging that monetary and fiscal policy is inadequate, President Carter is currently asking unions and large corporations to voluntarily exercise restraint. This "jawboning" by the President is not working. Unions are unwilling to sign long-term contracts with small wage increases, both because they want to make up for last year's inflation, and because they fear corporations will increase prices in the future. Similarly, corporations are unwilling to agree to limit price increases, because they fear future cost increases, either by supplier firms or by labor.

"Jawboning" is a weak form of wage and price controls. It asks the firms and the unions to act differently than their economic self-interest dictates. And it is not working.

Although "jawboning" doesn't work, this does not mean that the only alternative is to control wages and prices directly. Direct wage and price controls would cause the economy to stagnate. Firms would have no incentive to expand if they could not increase profits, and firms could not acquire additional skilled labor if they couldn't offer higher wages. Wage and price controls would eventually reduce income and employment and would create the economic hardship we are trying to avoid.

We need new ideas—ideas which will put more institutional pressure against inflation, so that our monetary and fiscal policies can stimulate the economy to full employment without inflation. I believe we should create new economic incentives to reduce inflation. Eminent economists from both ends of the political spectrum have recommended various economic incentives under the designation TIP (Tax-based Incomes Policy). I intend to offer legislation which combines and modifies several of the plans; which will be designated "Counter-Inflationary Incentives Program."

COUNTER-INFLATIONARY INCENTIVES PROGRAM

A Counter-Inflationary Incentives Program must encourage non-inflationary behavior in a way that contains the following principles:

1. It must be fair to workers and firms alike.
2. It must be simple to administer.
3. It must maintain a freely functioning economy so that investment and economic growth are encouraged.

It will not be easy to establish such a program. To be fair to everyone, it would be desirable to treat every employee and every firm as a special case, and to require that every firm and every worker participate in the program. However, it is simply not possible to administer a program differently for tens of millions of workers and millions of firms.

Instead, the program must set up simple guidelines which any firm and employee can understand and follow. Also, because we have many very large corporations, we can directly affect about one-half of all sales in the nation by

affecting wage and price decisions in only 2,000 firms. By establishing a decentralized program for the major firms in the United States, the smaller firms will necessarily moderate wages and prices to stay in competition.

The program must allow firms to increase wages as necessary to attract new employees when expanding, and must allow firms to expect higher profits as a result of more efficient or expanded production. These incentives are absolutely necessary in a healthy, growing economy. On the other hand, however, one economic sector, such as labor, must not fear that it might lower wage demands and later suffer from continued price increases. Thus, the program needs safeguards and freedoms at the same time.

The program I intend to recommend will largely pay for itself, be mostly self-policing, and will continue free-market decisionmaking by individual firms. The proposal will pay for itself because target wage levels will be set so that the penalties imposed to dissuade inflationary wage increases will roughly equal the rewards to firms and employees for wage changes below inflationary levels. In effect, the program will pay the rewards out of revenues collected by penalty taxes. The program will be administered by the U.S. Treasury Department using existing tax laws with only slight modifications. Hence, after the rules are promulgated, the only administrative costs will be those required to conduct slightly more lengthy tax audits.

Individual firms will remain free to set whatever wages and prices they wish to maximize profits. However, because of the proposed new economic incentives, more firms on the average will find it in their own interest to moderate wage increases. Because a firm's competitors will also experience cost reductions through lower wages, competition will moderate price increases so that employees will find their purchasing power maintained, or even increased, at lower wage levels.

This legislative proposal would achieve these goals by setting appropriate national targets for wage increases, and then providing both "carrots" and "sticks" to employees and employers to encourage them to meet those targets. It would use the tax system to hold down wage increases, and it would let economic competition restrain price increases.

(1) First, a national target for wage increases would be set by the Secretary of the Treasury. It would be based on an estimate of the likely average wage increase under the incentives program for the year. Since economists have no experience with the response to wage incentives, the wage target will have to be set at some reasonable level for the first year. (Economists have suggested a rate of about 5.5 percent.) After the experience of the first year, the rate can be set so there will be roughly the same number of employees receiving wage increases above the target, as those below the target. As wage and price increases moderate, the target can be reduced each year until wage increases are just equal to increases in worker productivity, which will not be inflationary.

(2) Next, the tax system would be used to provide both "carrots" and "sticks" for employees to hold down wage increases. Workers in firms having an average wage increase below the target will get a reward—a reduction in personal income taxes—and those having an increase above the target will receive a penalty—a personal income tax increase. This will give workers greater incentive to reduce wage increase demands.

Personal income taxes would be adjusted by a set proportion of the amount that wage increases are below or above the target. Before deciding on the specific proportion, however, further hearings need to be held, business and labor should be fully consulted, and technical analyses should be made. The proportion should be set high enough so that the economic incentive will be large enough to discourage most inflationary wage increases. On the other hand, the economic incentive should not be so high that the penalty, in effect, amounts to a prohibition. In special circumstances, it should be economically feasible for management and labor at a particular firm to decide to pay the penalty and exceed the wage target. For example, say last year's average wage at a firm was \$10,000, and with a target wage increase of 5 percent, this year's target wage is \$10,500. If the firm gives a 10 percent wage increase so that average wages increase to \$11,000, each worker receives a wage of \$500 above the target wage. If the pre-set proportion is 0.5, then each individual's income taxes would be increased by \$250.

(3) "Carrots" and "sticks" would also be provided to encourage firms to hold the line. Corporate profits taxes would be similarly restructured to reward firms for keeping wage increases below the target. When average wage increases for an individual firm are below the target, the corporate profits tax rate would

be reduced. Likewise, when average wage increases are above the target rate, the corporate tax rate would be increased.

Economists have suggested that the corporate tax rate be increased by a set multiple of the amount the wage increase exceeds the target. For example, if the wage increase (7 percent) is two percentage points more than the wage target (5 percent) and the pre-established multiple is 4, then the firm's corporate profits tax rate would be increased (by 8 percentage points) from, say, 48 percent to 56 percent.

The benefit of this approach is that firms can easily calculate the penalty or reward for wage changes, and the penalty is proportionate to the profit level of the firm. This way, a low profit firm will not be thrust into losses and bankruptcy by the plan, yet highly profitable firms will receive a large economic incentive to modify wage increases.

Again, the specific increase in corporate tax rates will be determined in consultation with business and labor. The rate will be high enough to change profits enough to discourage inflationary wage increases in most firms. However, management and labor at any particular firm may exceed the guidelines and stay in business if their particular circumstances warrant paying the penalty.

The benefits of this "carrot" and "stick" approach are that individual employees are free to demand higher wages based on their merit and productivity. Firms are similarly free to seek higher profits based on their efficiency. On the average, the wage and price increases will not be as high as they are now, because competitors with lower wage costs will be moderating price increases. However, because the cost of living will be moderated, a smaller wage or profit increase will be worth more.

(4) Although economic evidence indicates that this provision would not be necessary, we can ensure that firms do not use the reduction in personnel costs to reap profits at their workers' expense. If total corporate profits in the United States increase faster than total wages increase, the corporate tax rate would be increased. Tax revenues from this provision would be returned to workers through a reduction in their taxes.

Alternatively, in order to ensure employees that profits will not increase at the expense of wage moderation, it may be necessary to restrict the total growth of profits in each firm to the total growth in wage payments. Under this restriction the growth of prices, in effect, could not increase faster than the growth of wages.

This incentives proposal focuses only on wages and profits because they are relatively easy to measure. Prices are too difficult to measure accurately, since firms can change the quality of products in many ways. However, since wages comprise 75 percent of the costs of U.S. products, deceleration of wages will bring deceleration of prices. According to economic research referred to by the eminent economists testifying at this hearing today, the price change will follow the wage moderation without further governmental programs. However, to ensure absolutely that employees are protected, the fourth provision above will prevent total profits in the United States from increasing relative to total wage payments.

Mr. Chairman, the proposal I have outlined above is relatively simple to administer and is fair to all sides. Business and labor remain free to undertake any action they wish. However, these economic incentives will promote many more non-inflationary wage and price decisions.

The specifics of this program are being defined. In future hearings and discussions, these ideas will be refined and modified as needed to establish a workable "counter-inflationary incentives program."

Mr. Chairman, to speed the analysis and consideration of counter-inflationary incentives programs, I suggest a modification to the Humphrey-Hawkins bill. I suggest an amendment that would require the President to study the economic incentives programs to combat inflation, and that a report and recommendations be made to the Congress on January 1, 1979.

Mr. Chairman and members of the Committee, thank you for offering an opportunity to work with you to find ways to counter inflation in this country.

